ICEG European Center

Quarterly

Forecast

on the 8 New Member States

Spring

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OVERVIEW OF THE NMS-8

Growth

The average growth of GDP in the eight New Member States slightly accelerated in 2005 compared to the previous year. While aggregate performance remained almost unchanged, growth remained especially vibrant in the Baltic States, accelerated considerably in the Czech Republic and Slovakia, while slightly decelerated in Poland and Slovenia.

The vibrant growth in the Baltic States was driven primarily by the fast rise in private consumption and gross fixed capital formation. The former was the result of the above-the-average increases in real wages and incomes, the positive effect of EU accession on private sector expectations, while the latter was linked to improved productivity, increasing FDI inflows in these countries. In Central Europe the contribution of net exports to growth was more positive than a year ago as exports grew faster everywhere than imports. This reflected both improving competitiveness of NMS and also somewhat relaxing demand conditions. At the same time there were significant differences among the countries in the contribution of domestic demand to growth. In the Czech Republic and especially Slovakia private consumption and gross fixed capital formation increased considerably, while in Poland and Slovenia they either declined or grew at the same rate as in 2004.

In 2006 some deceleration of growth is expected on average in the analysed countries as average GDP growth is likely to decline from 6.4 per cent in 2005 to 5.6 per cent in 2006. Besides that the differences between the countries will diminish as fast growing economies (Baltic States and Slovakia) will grow slower while GDP growth is expected to accelerate in Hungary, Poland and Slovenia compared with the previous year.

Looking at the composition of growth, the major reason behind the deceleration of GDP growth is the smaller contribution of net exports to GDP with the exception of Baltic States. This contribution declines partly because imports are expected to rise faster in most of the countries and some (Hungary, Latvia and Poland) may also experience a slowdown in their export growth rates.

Growth will be driven mainly by the increase in private consumption, which remains buoyant almost in all countries stimulated by the rise in real incomes and further increase in net borrowing and net debt of the household sector. Besides private consumption, gross fixed capital formation will also grow fast in the Baltic States, Poland and Slovakia adding to the growth momentum.

Output growth may be influenced in some countries by the evolution of fiscal policy. In Hungary fiscal adjustment is needed to reach sustainable fiscal balances, while in the Baltic States in general tight fiscal policy is needed to achieve the Maastricht inflation criterion. The impact of tighter fiscal policies on growth is uncertain depending on the composition, scale and timing of fiscal tightening.

Monetary conditions

In 2005 three major trends characterised inflation performance in the NMS-8. First, amidst declining average CPI for the NMS-8, one could observe a mixed inflation performance in the Baltic States and Central European countries. Contrary to previous years when inflation was low in the Baltic States and moderate in most of the Central European countries, in recent two years as inflation was rising in the former and declining in the latter country group.

The acceleration of price increase in the Baltic States was driven by fast credit expansion and related increase of domestic demand, rise in non-tradable prices, above-the-average increase in producer prices and also increases in wage pressures. The Baltic States (especially Latvia) were less able to mitigate the inflationary consequences of EU accession and the second round effects of price increases are still felt. At the same time price increases moderated in the Central European countries due to the slower wage increases, the relative stability of their currencies against the Euro, firm stance of their monetary authorities and slower real wage increase due to high competition on the local markets following the entry to the Single Market.

The second marked feature of price developments in 2005 was the widening gap in the rise of consumer and producer prices. The acceleration of producer prices is related to the increase in import prices, in several countries to fast increases in wage levels and rise in inflation expectations. Finally, the NMS-8 proved to be so far resistant to increasing oil prices, rise in import prices as other factors counterbalanced the inflationary consequences of these exogenous developments.

Inflation is expected to decline further in 2006, though countries may be divided into two groups. The Baltic States may experience decline in consumer price increases due to the gradual evaporation of the one-off price increases, reduction in indirect taxes and the expected positive effect of fiscal tightening on the growth of domestic demand. In Hungary, Poland and Slovenia inflation may decelerate further notwithstanding the fast rise in domestic demand. In the Czech Republic and Slovakia inflation may accelerate due to the inflationary effect of rising import prices, fast increase in domestic demand and reversal of fast disinflation seen in 2005. Notwithstanding this acceleration all NMS-8 may be within the Maastricht limits with average consumer price increase varying between 2-3.5 per cent with the exception of Latvia.

Fiscal developments

The last year was remarkable from the point of fiscal performance as with the exception of Hungary all countries improved their fiscal balances, some quite unexpectedly and with significant pace. There were two major factors explaining the decline of average general government deficit from 2.5 per cent in 2004 to 1.9 per cent in 2005. The fast rise of output resulted in a favourable cyclical impact both in the Baltic States and in the Czech Republic and Slovakia. The faster than expected increase in output broadened the tax base, improved the primary balance and led, especially in the Czech Republic and Slovakia to unexpected decline in fiscal deficit.

The second factor explaining improving fiscal performance is related to tighter fiscal policies, which were observed in the Baltic States that tried to reduce the negative effect of increase in domestic demand on their inflation rates.

Concerning the forecast for 2006, fiscal deficits are likely to increase in most of the countries (with the exception of Slovenia and Slovakia and Estonia, which has a fiscal surplus expected to decline somewhat compared to 2005) but the rise will remain moderate. The worsening is explained by various factors: adjustments in the tax revenues, slower output growth leading to less favourable cyclical effects and also the increasing spending related to co-financing the growing inflow of EU Structural Funds. One crucial question for 2006 will be whether Hungary will reverse its fiscal policy resulting in a significant fiscal adjustment and launch of structural reforms in the public sector.

Balance of payments

In 2005 all countries in the region with the exception of Slovenia and Slovakia improved their current account balances. This was basically caused by fast rise in exports outpacing import increase, leading to marked improvements in the trade balance. In case of Slovakia the worsening current account is due to two factors: both the trade and current account balances worsen due to the temporary positive impact of FDI on import demand and there has been a slight increase in the deficit of incomes balance due to the higher profit repatriation after the increased FDI stock. In Slovenia the slight worsening of the current account is mainly due to the smaller revenues from services. In the Baltic States current account deficits remain around 10 per cent of GDP but they do not pose problems for the economies due to the size of capital inflows and monetary stability.

In most countries FDI grew in 2005 driven partly by new investments on the Single Market, expectations of continued fast economic and productivity growth. Therefore most NMS-8 doesn't experience a rise in their net foreign debts as current account deficits are covered by non debt creating inflows.

In 2006 the average of the current account deficit will decline further compared to 2005. The decline will be the biggest in the Baltic States where the slowdown of domestic demand will result in smaller increase in imports (while at the same time exports are also expected to decelerate). Both Estonia and Lithuania will improve their trade balances, while Latvia will experience somewhat worse trade balance. Among the eight countries Czech Republic and Hungary are expected to increase their current account deficits but other countries will see either unchanged (Poland) or improving current account positions (Slovakia and Slovenia).

Labour markets

The gaps among the NMS-8 countries in unemployment rates have remained significant. Unemployment levels are low and mainly unchanged in Hungary, the Czech Republic and Slovenia, while they have remained in the double digit range in the other NMS-8 countries.

A positive development in 2005 was the fast decline of unemployment rates in the Baltic States which had before double digit rates. Declining unemployment in the Baltic States are explained by various factors: fast increase of GDP and rise in labour demand, increased labour outflow to Scandinavian countries following the entry to the European Union, increased flexibility of labour market regulations. As a result of that average unemployment in the three countries declined from 10.5 per cent in 2004 to 8.6 per cent in 2005 a remarkable change considering the experience of the previous decade.

There are still two countries (Poland and Slovakia), which have double digit unemployment rates but they seem to be able to reduce their rates fast in 2005. The decline of unemployment has been driven by two factors: fast output growth resulted in increasing labour demand and led simultaneously to declining unemployment and slightly increasing employment rates. The other factor driving the decline of unemployment rates is the impact of labour market and other structural reforms, which is the most visible in Slovakia and Poland, where the unemployment rate which had been persistently high and close to 20 per cent started to decline to 16.5 and 17.5 per cent respectively.

Besides the impact of fast GDP growth this decline in the two countries is linked to the ongoing structural and labour market reforms, increasing flexibility of labour markets. In 2006 further decline of unemployment is expected in all countries and the average unemployment rate of the NMS-8 may decline for the first time below 10 per cent.

Real wages accelerated in 2005 except for Slovenia: in some countries (Estonia, Hungary and Latvia) the acceleration was especially sizeable. This rise in real wages was linked to fast increases in nominal wages (due to slightly relaxed incomes policies, temporary or permanent labour supply shortages in some countries) and to the fast decline of inflation in most countries, which was not followed by and reflected in changing inflation expectations of the private sector. In some cases the rise in public sector wages was another factor that kept real wages on fast increase.

In 2006 we expect a significant moderation of real wage growth. First inflation expectations adjust downward and private sector wage increases will moderate accordingly, while inflation as reported may slightly accelerate after its very low level in 2005. Second, fiscal and incomes policies will generally be tighter in 2006 moderating the rise in nominal and real wages.

Table 1. Summary indicators of NMS-8

	2003	2004	2005	2006*
GDP growth (%)	5,08	5,61	6,36	5,61
Inflation (%)	3,11	4,31	3,35	2,81
General government balance/GDP (%)	-3,55	-2,49	-1,99	-2,68
Current account balance/GDP (%)	-5,81	-6,74	-6,11	-5,39
Unemployment (%)	11,31	11,13	10,10	9,51

CZECH REPUBLIC

In 2005, the Czech Republic was characterised by high GDP growth, fuelled mainly by net exports and private consumption

Growth

Output growth accelerated to 5.8 and 6.9 per cent in the last two quarters of 2005, resulting in a 6 per cent growth rate for the year as a whole, according to the data of the Statistical Office. This is a high pace for the Czech economy even in historical comparison and compared to other EU economies. Export of goods and services remains the main engine of growth. Net exports are still positive – though imports may be significantly underestimated. Exports grew by more than 10 per cent in the majority of quarters, while the growth of imports decelerated significantly over the course of the year, to 4.4 per cent in the last quarter of 2005. GFCF played a much smaller than expected role in growth, with a decelerating and unexpectedly low (in some quarters even negative) rate in 2005. GFCF growth last year, according to preliminary data, was negative and thus the lowest in the Czech Republic among NMS.

Private consumption grew moderately, by 2.6 per cent in the year as a whole, but its growth slowed down during the course of the year. The main factor behind the growth in private consumption was the increase in real wages, which rose by 4.4 per cent. On the other hand, there was an increase in household savings, which curtailed the need for external borrowing, and contributed to the lessening of imbalances. Public consumption remained moderate in the first three quarters, while in the fourth quarter the seasonal deficit reached 11 per cent of GDP. Similar tendencies are expected for this year, with lower growth of net exports and sustained higher public spending due to the general elections, which is expected to result in an above 4 per cent growth for 2006.

Monetary indicators

Inflation is still at a low level, comfortably below the Maastricht criterion and it is the lowest among the NMS. CPI was 1.9 per cent in 2005. However, an increase in certain regulated prices (energy, gas, steam and water and postal services, which grew by 5.8 per cent on a year-on-year basis) and the relatively high growth in fuel prices (an increase of 6.8 per cent) slightly accelerated CPI towards the end of 2005, reaching 2.4 per cent in the fourth quarter. In 2006, this trend is likely to continue, with a slightly higher inflation rate of between 2.5 and 2.9 per cent, according to the forecasts of international organisations. January inflation data (2.9 per cent) supports the prognosis.

At the beginning of April, the two-week repo rate stood at 2 %per cent. According to the Bank Board, inflationary developments were in line with its forecasts, while the exchange rate of the Koruna appreciated and remained stronger than forecasted, posing a risk to monetary developments. Appreciation can be attributed to the high FDI inflow, the high growth rate of GDP and exports. The Czech Koruna appreciated against the Euro and the USD by 7.1 per cent and 7.3 per cent, respectively, during the course of 2005 on a year-on-year basis.

Fiscal policy

Due to higher than expected tax revenues and social security contributions and lower than planned expenditures, partly due to the low interest rates, which reduce the interest burden on government debts, a lower than expected budget deficit was attained at the end of last year. All in all, revenues were 5.1 per cent higher than planned, while expenditures exceeded the planned level only by 1.6 per cent. The budget deficit reached 1.9 per cent of GDP at the end of 2005, instead of the planned 4.7 per cent. However, government consumption is predicted to grow significantly before general elections take place in 2006, and signs of this could already be traced in the last quarter of 2005, with acceleration in the growth of the deficit compared to the previous quarters. For 2006, a 3.8 per cent of deficit is planned (ESA), though planned increases on the expenditure side (increase in public sector wages, pensions and R&D spending) and the uncertainty surrounding the July elections make the target somewhat unrealistic, while the 2005 budget outcome may make politicians and economists optimistic in that respect. General government debt compared to GDP decreased slightly in 2005 to 30.5 per cent.

The Czech Republic's external debt increased slightly in the fourth quarter, and it represented 38.4 per cent of GDP. The growth was concentrated on short-term maturity liabilities, which represented 31 per cent of total debt. The external liabilities of the government accounted for 24 per cent of total debt, while the corporate sector was responsible for 56 per cent.

Balance of payments

Compared to 2004, the two main developments in the balance of payments were the higher surplus of the financial account and the lower deficit (2.1 per cent of GDP) of the current account. Export growth is still the main engine of the increase in output in the Czech Republic. On an annual basis, exports of goods and services grew by more than 8.7 per cent, while imports by 6 per cent, according to the data of the Statistical Office – however, according to some experts, import data may be underestimated and underreported. However, net exports showed a decelerating tendency, in terms of GDP, during the course of the year. In terms of product composition, it was mainly the foreign trade of goods, and within that, the turnover in machinery and transport equipment, which represented the bulk of the turnover and resulted in a significant surplus. The balance of trade in services showed a slight surplus, especially because of a lower trade deficit in other services. Behind the favourable trade developments, high inflow of (export-oriented) FDI is one of the decisive factors. Companies with foreign participation are especially responsible for the good export performance of the machinery and transport equipment sector. On the other hand, trade developments were negatively influenced by worsening terms of trade, the one-off imports of Gripen fighters and the strengthening of the Koruna. In 2006, decelerating net exports may increase the trade deficit, as it is already shown in end-February data.

On the financial account, inflow of foreign direct investments was responsible for the surplus in 2005, which, according to the estimates of the Czech National bank, constituted 4.7 per cent of GDP. In foreign direct investments, two big privatisation deals represented the bulk of the inflow. Cesky Telecom was sold to Telefonica, Spain, while Unipetrol was acquired by the Polish PKN Orlen. This is reflected also in the fact, that the most important investors in 2005 were Spain and Poland. These are very big deals, Cesky Telecom was sold for 2.9 billion Euros, and a 63 per cent stake in Unipetrol was sold for around 440 million Euros. These two deals are estimated to be responsible for more than one third of the 2005 inflow.

Another important source of FDI was reinvested earnings of companies with foreign participation already present in the Czech Republic, which, according to the data of the National Bank, may represent close to half of the overall inflow. Outflow of FDI was much less important, though the Czech electricity company participated in the privatisation in Romania. Further privatisation in 2006 may affect FDI inflows and the balance of payments positively, even though a deceleration in the growth of exports, and thus much lower trade balance surplus (or even deficit) is expected for this year.

The balance of portfolio investments was negative in 2005, and the outflow can be explained by the negative interest rate differential and thus relatively low interest rates offered on Czech bonds compared to other countries (Hungary or Poland) in the region.

Labour markets

In 2005 as a whole, labour productivity and the number of employees grew, and unit labour costs decreased by 0.7 per cent. The average number of employees grew by 1.8 per cent on a year-on-year basis, resulting in an increased activity rate. The decline of unemployment continued as well, due to the high increase in economic activity: the average number of unemployed was by 3.7 per cent lower in 2005 than in 2004, and the average unemployment rate declined to 7.9 per cent. While the share of women among unemployed remains high, there was even a slight decrease in the stubbornly high long-term unemployment. Thus, structural imbalances of the labour market seemed to ease somehow last year. Real wages increased by 4.4 per cent, however, their impact on inflation and monetary development was moderate, because it was not translated into consumption directly, while household savings increased. However, differences between sectoral wages became more pronounced in 2005, according to the data of the Statistical Office.

Table 2. Major macroeconomic indicators for the Czech Republic 2004-2006

	2004	2005*	2006**
GDP growth (%) (constant prices)	4.0	6.0	5.0
Private consumption (%)	2.5	2.6	3.5
Public consumption (%)	-3.2	-0.5	0.8
Investments (GFCF, %)	9.1	3.7	3.4
Export (%)	20.9	8.7	9.0
Import (%)	18.5	6.0	9.2
Consumer price index (average,%)	2.8	2.4	2.9
Consumer price index (dec/dec, %)	2.6	1.9	2.6
Unemployment ratio (%)	8.3	7.9	7.6
Real wages , (%), growth	2.7	4.4	5.0
Real ULC (%), growth	-2.7	-0.7	-0.5
General government balance (% in GDP)	-3.0	-1.9	-3.5
Public debt/GDP (%)	36.8	30.5	30.8
Current account /GDP (%)	-5.2	-2.1	-2.8
Trade balance /GDP (%)	-0.8	0.1	-0.5
FDI (billion USD)	4.5	11.0	8.0
Gross foreign debt /GDP (%)	34.2	38.4	38.5
Exchange rate (Koruna/EUR)	31.9	29.8	28.5
2 week repo rate (%)	2.5	2.0	2.0

**2005: projection, preliminary or actual*

*** 2006: preliminary prognosis*

Sources: EU, IMF, Czech National Bank, Czech Statistical Office

ESTONIA

Another year of strong economic growth is expected; fulfilment of the Maastricht inflation criterion is the key policy challenge in 2006

Growth

Estonian GDP growth reached a staggering 9.5 per cent in 2005. Final consumption, fixed capital formation and exports contributed significantly on the back of large (9.4 per cent) real wage increases, a continuing lending and housing boom and favourable external conditions. In 2005 the sales of enterprises increased by 20 per cent, led by the extraordinary performance of the construction sector and by booming energy prices. Corporate investments increased by 21 per cent; half of these was made in real estate.

Strong growth in industrial output and retail trade as well as favourable business confidence forecasts suggest that buoyant economic growth will persist in 2006 as well. Forecasts of various institutions range from 6 to 8.2 per cent for 2006. Taking into consideration that the country exceeded its growth forecast for 2005 by far, we believe that a growth rate of 8 per cent is achievable for 2006. Continuous real wage growth and FDI inflows should fuel consumption and investments respectively although rising interest rates and tightening lending conditions are expected to cool down the housing boom.

Monetary indicators

12-month consumer price inflation stood at 4.6 per cent in February 2006; housing and transportation costs exhibited the largest increases during this period. This was the consequence of a mixture of rising energy prices, an 8.9 per cent increase of administered utility prices and demand-side pressures. The producer price index changed by 3.1 per cent during the same period. Estonia currently does not comply with the Maastricht inflation criterion although it passes all other criteria with flying colours. The target date of Euro adoption, January 2007 might be viable nevertheless as the government can resort to the postponing of excise tax increases originally planned for 2006-2007.

Housing loans grew by 57 per cent year-on-year in the second half of 2005; by the fourth quarter of last year, annual growth of housing prices reached 45 per cent. Meanwhile, banks turned their attention to the value of the collateral instead of the debtor’s ability to pay, thereby increasing the risk of a looming housing bubble affecting financial stability. The Estonian national bank responded by tightening conditions for housing loans as of 1 March 2006: their risk weighing (when calculating the capital adequacy ratio) was raised from 50 per cent to 100 per cent, while 50 per cent of the housing loans portfolio was added to the reserve requirement calculation base of commercial banks. The national bank also proposed to the government that the deductibility of housing loan instalments from income tax base should be abolished as it misleads borrowers over the actual risks of their loans.

Interest rates started to increase in the second half, the TALIBOR interbank rate rose to 2.9 per cent by February 2006. As U.S. and European rates are expected to increase in 2006, further rises are expected in Estonia as well.

Fiscal policy

Rapid economic growth and rising inflation lead to windfall gains in government revenues, therefore the fiscal target of 1.8 per cent for 2006 can be met without much effort. This fiscal surplus is expedient since the main economic policy of 2006 is the fulfilment of the Maastricht inflation criterion; given the strong domestic demand, a tight fiscal stance is necessary to contain demand-side inflationary pressures. General government debt will decrease to 4 per cent by the end of 2006 and gradually decline to 2.3 per cent of GDP by 2010.

External balance

The current account deficit in 2005 reached 10.5 per cent of GDP; its absolute value decreased from 2004 by 4 per cent. The deficit of goods trade decreased by 7 per cent year-on-year thanks to a 32 per cent rise of goods exports; on the other hand, the surplus of the services balance declined by 8.6 per cent year-on-year as the import growth of transport services outpaced their export growth.

Foreign direct investments strengthened to 10 per cent of GDP. The takeover of Hansapank was a single outstanding FDI transaction, offset in the financial balance by the decrease of portfolio investments. The rest of FDI consisted largely of reinvested earnings; net FDI is expected to cover 60 per cent of the current account deficit in the coming years. A growing share of the external deficit is financed through credit: foreign-owned banks take loans from their parent companies, which can also be considered a stable form of external financing.

Labour markets

Thanks to the rapid economic growth job creation was vigorous throughout 2005 forcing unemployment to its lowest rate in a decade, under 8 per cent (according to the labour force survey). The trading and real estate sectors were responsible for most new jobs. Economic growth and bottlenecks on the labour market contributed to exceptionally high wage growth. Average monthly gross wages and salaries rose by 12.8 per cent in 2005, while net wages increased by an estimated 14 per cent. Continuing economic growth will dictate similar tendencies – decreasing unemployment, rising real wages – in the coming years as well.

Table 3. Major macroeconomic indicators for Estonia, 2004-2006

	2004	2005	2006*
GDP growth (%)	7.8	9.5	8.0
Private consumption (%)	4.4	6.5	6.5
Public consumption (%)	6.9	5.7	5.9
Investments (GFCF, %)	6.0	8.3	6.5
Export (%)	16.0	18.5	16.0
Import (%)	14.6	13.7	11.6
Consumer price index (average,%)	3.0	4.1	3.4
Consumer price index (dec/dec, %)	5.0	3.6	3.0
Unemployment rate (LFS, %)	9.7	7.8	7.5
Real wages (%), growth	5.1	9.4	6.8
General government balance/GDP (%)	1.7	1.8	0.6
Public debt /GDP (%)	5.5	5.1	4.0
Current account balance /GDP (%)	-12.5	-10.5	-8.5
Trade balance /GDP (%)	-7.8	-6.4	-4.0
Gross foreign debt /GDP (%)	81.2	90.3	97.0
Exchange rate (EEK/EUR)	15.646	15.646	15.646
TALIBOR rate (12 months, %)	2.67	2.86	3.2

Sources: European Commission, Eesti Pank, Statistical Office of Estonia

** Projections, expectations*

HUNGARY

Rapidly worsening fiscal position: stabilisation after the elections?

Economic Growth

After the significant slowdown in the first quarter (real GDP increased only by 2.9 per cent) economic growth accelerated in the remaining part of the year reaching 4.5 per cent in the third and 4.1 per cent in the last quarter. Preliminary figures show that altogether GDP rise was 4.1 per cent, below both the GDP growth of 2004 (4.6 per cent) and the average of NMS.

The main reason behind the slowdown compared to 2004 was the more modest increase in net foreign demand due to the slowdown of import demand from the major trading partners. At the same time the growth of private consumption decelerated compared with 2004 though it started to grow faster from the second quarter. Public consumption and capital formation were vigorous, the latter reflecting the increase of public investments.

In 2006 faster GDP growth is expected due to the rapid increase of domestic consumption and improving external conditions. The growth of private consumption will accelerate driven by the rise in incomes of the household sector and also by the further increase of its net debt. The growth of private consumption was around 2,5 per cent in 2005 and this accelerates to 3.7 per cent in 2006.

At the same time public sector consumption will accelerate especially after its rise in the first quarter., stimulated by the elections (Parliamentary elections in April 200 and local government in Autumn 2006). While exports are expected to grow by around 10 per cent, their increase will be outperformed by the growth of imports leading to somewhat smaller contribution of net foreign demand to GDP growth.

Monetary indicators

Consumer prices declined remarkably in 2005 resulting in 3.3 per cent average annual CPI and disinflation is expected to continue further in 2006. The disinflation in 2005 was mainly driven by the slowdown of core inflation, reflecting slower rise in industrial prices, decline in wage inflation, downward adjustment of private sectors' inflationary expectations. The decline of core inflation drove CPI down notwithstanding the fast increase in oil prices, increase in domestic demand.

In 2006 further disinflation is likely mainly due to spill over effect of the reduction in VAT rates, low industrial and declining service price increases. Average CPI will be in 2006 1.5 per cent but the December/December index may increase again reaching 2 per cent. The upward risk on inflation forecast is due to the inflationary consequences of faster GDP increase, weaker Hungarian currency and high oil prices. Additional uncertainty is related to the inflationary consequences of fiscal correction expected for the second half of the year.

Contrary to the regional developments and the domestic trends in 2005, the Hungarian Forint weakened considerably in the first quarter of 2006. The almost 6 per cent depreciation was due to increased risk awareness of foreign investors, downgrading of Hungarian sovereign debt amidst worsening fiscal and current account expectations and increase in Euro and dollar interest rates. The currency stabilised in the 263-268HUF band against the Euro, but its further evolution is very uncertain and depends on domestic macroeconomic imbalances, timing and scale of necessary fiscal correction. In case of a positive scenario the currency may remain around the stronger edge of this band, but if macroeconomic imbalances worsen, then it may weaken considerably.

Interest rate trends are influenced by two contrasting developments. On the one hand low and declining inflation would require the central bank to lower its prime rate, but increasing risk premia, more difficult public sector financing conditions and exchange rate pressures may require temporary rise in rates. The expectations is that even with the necessary fiscal adjustment the central bank will not be able to reduce in 2006 its prime rate; moreover it will first rise and then stabilise at 6.5 per cent by the end of the year.

Fiscal Developments

The ESA'95 deficit of the general government in 2005 was 6,3 per cent with the adjustment to the effects of pension reform and 7,5 per cent without this correction. The weak fiscal performance continued further in 2006 as by the end of the first quarter the deficit target was overshot by 10 per cent (reaching 789 billion HUF instead of the forecasted 698 billion HUF) and the cumulated deficit by the end of the first quarter reached more than 50 per cent of the planned annual level.

The likely increase in the deficit of the general government was driven mainly by the worsening primary balance, which is partly due to the decline of tax revenues influenced by the reduction of the standard VAT rate from 25 per cent to 20 per cent effective of 1 January. Besides declining revenues, the deficit is also due to higher spending by the central government and the social security funds. While the level of quarterly deficit of the central government is close to the projected one, social security funds accumulated in the first quarter deficit equalling four times the planned total annual deficit. The significant overshooting of the target was due to rising pensions, wage expenditures in the health care sector and increase of medicine expenditures.

Based on the expectations formulated in the previous report, on the outcome of the first quarter and assuming no change in the fiscal position, the ESA'95 deficit of the general government with the adjustment of the pension reform will be 7.8 per cent of GDP, without it 9 per cent of GDP.

Both the fast rise in deficit and also the twin deficit require sizeable stabilisation measures in the second half of the year. However even with the planned adjustment, public debt is likely to increase further due to high public deficit and slightly increasing interest rates. As a result public debt to GDP may increase from 60 per cent in 2005 to 63,5 per cent by the end of 2006.

The share of Forint denominated debt will increase in 2006 in the financing of the public sector borrowing requirement.

Balance of payments

The current account deficit is still sizeable, exceeding 8 per cent of GDP in 2005. The deficit reflects the varying financing and saving capacity of different sectors of the economy: net financing capacity of the private sector improved in 2005 following the rise of gross private savings, which was however more than balanced by increased public sector borrowing requirements. On the other hand the unchanged current account deficit has been accompanied by slightly improving trade and services balances, mainly due to the fast increase of exports. At the same time the income balance worsened both due to increasing debt service expenditures on the increasing net foreign debt and growing profit repatriation of foreign investors.

In 2006 the current account deficit of 8,6 per cent of GDP will be determined by slightly improving net financing capacity of the private sector and growing borrowing requirements of the public sector. At the same time unchanged goods and services balance will be accompanied by increasing incomes balance deficit.

Net foreign financing requirement reflected in the current account deficit was financed in 2005 to smaller extent by non debt generating capital flows.

In 2005 the volume and share of debt generating capital inflows increased simultaneously with the improvement of the net FDI balance due to the increasing gross foreign direct investment inflows. The process is expected to continue in 2006 as increasing gross FDI inflows will be accompanied by rising debt creating capital inflows due to the increase of gross and net debt to GDP ratio.

Labour markets

The relatively fast economic growth has been associated with almost unchanged demand for labour, which resulted in increasing unemployment due to the rise in labour supply. The number of unemployed has been growing slowly but continuously and unemployment rate may reach 7.2 per cent of the labour force by the end of 2006. At the same time employment creation remains weak and the employment rate stabilised around 54 per cent, a relatively low figure in European comparison. In 2006 no significant increase in public sector employment is expected, while at the same time employment may slightly accelerate in the private sector. If stabilisation measures will be credible and sizeable, one may expect further dismissal from the public sector and growth of structural frictions in the labour market.

While employment creation remains limited, real wage growth may slightly moderate in 2006 as the corporate sector reduces its inflation expectations and the growth of nominal wages also moderates. In 2006 real wages may increase by around 4.5 per cent which is close to productivity increases and as mentioned should not pose any serious threats for inflation.

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Table 4. Major macroeconomic indicators for Hungary 2004-2006

	2004	2005	2006*
GDP (%)	4.6	4.3	4.5
Private consumption (%)	3.5	3.5	3.7
Public consumption (%)	-1.5	-1.5	3
Gross fixed capital formation (%)	8.2	8	6
Export (%)	15.5	11	10.5
Import (%)	14	8	11.0
Consumer price index (average, %)	6.8	3.6	1.5
Consumer price index (dec/dec, %))	5.5	3.6	2.1
Unemployment ratio (%, ILO definition)	6.1	7.3	7.2
Real Wages (%)	2.6	6.0	4.5
General government balance/GDP (%)	-5.5	-6.3	-7.8
Public debt/GDP (%)	58	61.0	63.5
Current account/GDP (%)	-8.9	-8.3	-8.7
Trade balance/GDP (%)	-3.1	-2.9	-3.1
Exchange rate (HUF/EUR)	245	255	265
Base rate (%)	9.5	6	6.5

*Source: Eurostat, National Bank of Hungary, *Forecast*

LATVIA

Fast economic growth is accompanied by high inflation and wide current account deficit: fulfilling the Maastricht inflation criterion and safeguarding the external balance are the most important tasks ahead

Economic growth

Buoyant economic growth persisted throughout 2005 in Latvia; annual GDP growth is expected to reach an all-time high 10.4 per cent. Retail turnover rose by 18.6 per cent while industrial production in manufacturing increased by 5.8 per cent. Domestic consumption and investments remain the main driving forces of economic growth in 2006, which is expected to reach a rate of 8 per cent.

Monetary indicators

In February 2006 12-month CPI stood at 6.9 per cent while core inflation dropped to 5.4 per cent. As excise taxes increased in January 2006 and administered prices are also expected to rise, there is little chance for further disinflation in the coming months. Latvia currently does not comply with the Maastricht inflation criterion; the introduction of the Euro is projected to take place in January 2008 at the earliest.

Supply-side shocks (fuel prices and tax increases) are a potential explanation to the high Latvian inflation rate but it does not offer a complete answer as the fuel price shock was common to all EU members, still the inflation rate did not increase much in other countries. The Latvian national bank offers a variety of other factors such as demand pressures, price-making strategies of companies, and self-fulfilling expectations of price convergence to the EU levels.

Loans to residents grew by 62.1 per cent in 2005; 82 per cent of new loans were denominated in foreign currencies. Less then one-third of all loans are denominated in lats currently. This is due to the 2.5 per cent interest rate differential between foreign and domestic denominated loans, and the stability of the currency board system implying a large degree of substitutability between assets in Euros and lats. The low share of domestic loans also means that monetary policy loses effectiveness as domestic interest rates do not directly influence lending in foreign currencies: on the other hand, should the central bank raise rates to contain inflation, the increasing interest rate differential will only encourage further lending in foreign currencies.

The RIGIBOR money market rate has started increasing, reaching 4.14 per cent in April 2006. Further increases in the interest rate are expected as the European Central Bank raises its rate during the year. This will have a cooling effect on credit growth and aggregate demand.

Fiscal policy

Vigorous economic activity ensured that fiscal targets were easily met in 2005; this will be the case for 2006 as well. Last year a supplementary budget was passed to spend windfall tax revenues, but the government should restrain its spending to curb aggregate demand growth in 2006. This is critical for two purposes: fighting inflation and keeping the high current account deficit under control. A budget deficit of around 1.5 per cent is expected for 2006.

In March 2006 Moody's improved the credit rating outlook of Latvia from stable to positive, leaving its rating unchanged at A2. This was a consequence of a favourable international environment, prudent fiscal policy and the stability of the ERM-II exchange rate regime.

External balance

In 2005 the current account deficit was broadly unchanged at 12.5 per cent of GDP. The trade deficit increased by 14 per cent in nominal terms but improved by 0.8 percentage points relative to GDP. Strong domestic demand and rising fuel and materials prices boosted import growth (27.3 per cent in nominal terms) but favourable external conditions permitted an even faster growth of exports (33.8 per cent nominal growth), especially towards EU-25 countries. Net FDI inflows amassed to 1.8 per cent of GDP and covered 12 per cent of the current account deficit. The rest of the deficit was almost entirely funded by other investments, primarily in the form of loans from foreign parent banks to Latvian affiliates.

2006 will not bring major improvement in the external balance as high domestic demand will persist especially with ongoing reconstruction work in the energy sector and the fleet rebuilding of the shipping company Latvijas Kugnieciba.

Labour markets

Unemployment fell to 7.8 per cent during the last quarter of 2005 thanks to strong economic growth. Some shortages and bottlenecks are appearing on the labour market, supporting high real wage growth, which exceeded 10 per cent in 2005. Gross earnings increased by 16.5 per cent while regular wages rose by 15.4 per cent. Strong economic growth should maintain these tendencies in 2006 as well: high real wage growth but continuing job creation is expected in the foreseeable future.

Table 5. Major macroeconomic indicators for Latvia 2004-2006

	2004	2005	2006*
GDP growth (%)	9.8	9.1	7.7
Private consumption (%)	9.3	8.4	7.8
Public consumption (%)	2.1	2.4	2.6
Investments (GFCF, %)	23.8	16.5	10.0
Export (%)	9.4	13.6	12.3
Import (%)	16.6	9.5	10.5
Consumer price index (average, %)	6.2	6.7	5.1
Unemployment rate (%)	9.8	9.7	7.8
Real wages	3.1	10.1	7.0
General government balance/GDP (%)	-0.9	-1.2	-1.5
Public debt/GDP (%)	14.7	12.8	13.0
Current account /GDP (%)	-12.9	-12.5	-10.5
Trade balance /GDP (%)	-15.9	-15.1	-16.3
Gross foreign debt /GDP (%)	93.2	98.4	100.1
Exchange rate (lats/EUR, annual average)	0.66	0.70	0.70
RIGIBOR rate (12 months, end of year, %)	4.26	3.33	4.5

Sources: European Commission, Latvian Statistical Office, Bank of Latvia, IMF

** Projections, expectations*

LITHUANIA

Overall economic conditions are favourable; inflation and the stability of the financial system are the key issues of the macroeconomic agenda

Growth

Economic growth reached an exceptional 7.5 per cent in 2005, well above the 5.75 per cent potential growth rate calculated by the IMF. Private consumption, public transport infrastructure projects and property development, supported by cheap and easy credit, were key driving factors on the demand side. EU membership helped food exports, reducing the negative contribution of net exports to growth.

Strong business and consumer confidence suggest expectations of a favourable economic environment in 2006 as well. Domestic demand will remain the main source of growth; fiscal impetus created by EU structural funds and tax cuts is expected to help, although GDP growth should remain more moderate, between 6-6.5 per cent. Exports will face the challenge of squeezing profit rates in certain industries (e.g. fertilizers) due to high oil and gas prices.

Monetary indicators

12-month inflation stood at 3.3 per cent in February 2006; increases in food, transport and public utility prices were the main factors behind price increases. Core inflation picked up slightly in 2005 reflecting demand pressures. Lithuania currently does not comply with the Maastricht inflation criterion although it is the closest to the reference level of the three Baltic states. It is yet uncertain whether projected adoption of the Euro on the 1 January 2007 is sustainable. However, even a delay in the introduction of the Euro should not affect the economy adversely.

Bank credit grew by around 50 per cent in 2005 and mortgages almost doubled. The share of non-performing loans is still low but had increased in 2005 to 2.5 per cent; meanwhile, the capital adequacy ratio of banks declined to 10 per cent. The main risk to the stability of the financial system is a potential real estate bubble; policy measures are already under consideration to cool down the housing market, especially the reduction of tax exemptions from mortgage payments and the introduction of a broad-based property tax.

Fiscal policy

The general government deficit was better than the anticipated 1.5 per cent. This was a result of exceptionally strong economic growth and an overall good budgetary performance. The most recent version of the Lithuanian Convergence Program plans a 1.5 per cent deficit for 2006 which should gradually decrease to 1 per cent by 2008. On one hand, a record of cautious revenue planning suggest the over-performance of targets while uncertainties arise over public sector wage moderation and the impacts of pension reform and tax cuts.

The European Commission suggested a more ambitious deficit target for 2006 to take advantage of the current growth cycle and accelerate structural adjustment towards the medium-term deficit objective. Such fiscal restraint would also be beneficial for inflation as monetary instruments are limited under a currency board regime.

The public sector debt is expected to remain stable at 19-20 per cent of GDP in the coming years. In December 2005 Standard & Poor's improved Lithuania's sovereign debt rating from A- to A (leaving its positive outlook unchanged).

External balance

The 2005 current account deficit amounted to 7 per cent of GDP, 0.7 percentage points down from 2004. The trade balance of goods and services remained stable relative to GDP but rose by 14.6 per cent in nominal value, driven by strong import demand. The rise of fuel prices contributed significantly to the nominal growth of both goods exports and imports: trade of mineral products accounted for 36 per cent of export growth and 48.8 per cent of import growth in 2005.

Net FDI amounted to 2.6 per cent of GDP; direct investments and other capital inflow (mainly through EU structural funds) covered almost 60 per cent of the current account deficit. The rest has increasingly been financed by short-term lending from reputable foreign banks to their Lithuanian subsidiaries; the stability of these short-term capital flows and the proven resilience of the currency board system suggest that the current account deficit continues to be sustainable.

A more moderate economic growth in 2006 will mean more contained import growth of consumption and investment goods; although the share of oil products in Lithuania's foreign trade is large, the trade deficit is barely affected by fuel prices since the country is an importer of crude oil and a net exporter of refinery products.

Labour markets

Unemployment reached its lowest rate in five years (8.2 per cent according to the labour force survey) thanks to robust economic growth and job creation; in particular, the number of long-term unemployed fell by one quarter. The outflow of blue collar workers caused shortages in the booming construction sector while the migration of health care workers is also significant.

Monthly gross earnings increased by 12.1 per cent in 2005; real earning rose by 7.8 per cent. Unemployment is expected to ease further in 2005; on the other hand, improving productivity and looming bottlenecks in certain professions should keep wage growth at a high level, boosting domestic demand, economic growth and job creation in return.

Table 6. Major macroeconomic indicators for Lithuania 2004-2006

	2004	2005	2006*
GDP growth (%)	7.0	7.5	6.2
Private consumption (%)	9.7	9.5	8.0
Public consumption (%)	7.5	5.2	4.9
Investments (GFCF, %)	12.3	7.1	8.2
Export (%)	4.2	10.7	10.9
Import (%)	14.8	11.5	11.4
Consumer price index (average,%)	1.1	2.7	2.6
Consumer price index (dec/dec, %)	2.8	3.0	2.8
Unemployment rate (LFS, %)	11.4	8.2	8.1
Real wages	4.9	7.8	7.0
General government balance/GDP (%)	-1.4	-1.0	-1.5
Public debt/GDP (%)	19.6	20.7	20.2
Current account /GDP (%)	-7.7	-7.0	-7.1
Trade balance /GDP (%)	-7.0	-7.1	-7.0
Gross foreign debt /GDP (%)	42.8	49.0	52.0
Exchange rate (LTL /EUR, annual average)	3.45	3.45	3.45
VILIBOR rate (end of year, %)	2.88	2.82	3.2

Sources: European Commission, Bank of Lithuania, Statistics Lithuania, Ministry of Finance, IMF

** Projections, expectations*

POLAND

Strengthening domestic demand, and low inflation

Growth

GDP growth in Poland reached 3.3 per cent in 2005, which is lower than we earlier expected. This occurred despite strong growth performance experienced in the second half year. Industrial production and retail sales remained strong in the beginning of 2006, reaching a growth rate of 9.5 per cent and 8.5 per cent year-on-year respectively in January. Industrial output is expected to remain on an upward trend, mainly due to good results in manufacturing. At the same time a drop was experienced in construction output, but as it was mainly a result of unfavourable weather conditions, this development is likely to be of a temporary nature.

Therefore we expect to see an improvement in construction, especially in the medium term, as road constructions will gain momentum in the beginning of 2007, mostly financed by EU funds. The upward trend in retail sales seems to be of a strong nature, even despite the difficulties experienced in the new-car market.

In 2006 year on year GDP growth is expected to be stronger than in 2005, reaching 4.3 per cent. The main drivers behind growth will be private consumption and investment. The year-on-year growth rate of fixed investments has been following an upward trend in the past year, and it is expected to remain on the current 8 per cent level during 2006.

Monetary indicators

Annual consumer prices growth in January stayed at the same level as in December 2005 (0.7 per cent year-on-year). The lower than expected inflation was the result of higher than-expected-drop in growth of fuel prices (which, along with the strong zloty led to the fall in transport prices), and the drop in the prices of newspapers, magazines and electronic equipment. Low inflation occurred despite an increase in the annual growth rate of food, housing and energy prices. Growth of producer prices also remained low, reaching 0.5 per cent year-on-year in January 2006, which is a slight increase compared to its December 2005 level (0.2 per cent year-on-year).

Inflation is currently well below the 2.5 per cent inflation target of the National Bank of Poland. Even if economic expansion continues and results in some pressure on prices, its extent will not be substantial. The growth in domestic demand and slowly rising unit labour costs will put a gradual upward pressure on inflation in the medium term. At the same time growing imports from low cost countries and increasing flexibility in the labour market will be factors that may decrease inflation. The Monetary Policy Council of the National Bank of Poland lowered interest rates by 0.25 percentage points at its February meeting, which put the reference rate at the record low 4 per cent. The MPC left interest rates unchanged at its March meeting.

Tension is increasing between the new government and the National Bank of Poland, as the government forming PiS party aims to curb the statutory independence of the NBP. It proposed to broaden the inflation fighting responsibilities of the NBP to include fighting unemployment and promoting economic growth.

Inflation is expected to remain low in 2006, under the inflation target, with annual consumer prices growth reaching 1.7 per cent year-on-year.

Fiscal policy

The PiS government presented a draft budget for 2006 in December 2005, which was slightly modified compared to the draft budget of the preceding government, which was made prior to the election, in September 2005. As part of the amendment planned revenues were increased, and some areas of spending were reduced. Therefore the level of budget deficit was reduced to PLN30.6 billion from its original level of PLN32.6 billion.

Certain expenditures were increased: spending on the baby bonus (a two-week extension to the maternity leave, introduction of a childbirth allowance) and social subsidies for farmers will be higher. Access to scholarships was improved as well. At the same time reductions occurred in some areas. Contributions to the European Union were lowered, spending on guarantees for the Agricultural Market Agency and shipyards were reduced, and spending on public administration will be lower as well. The increase in revenues is expected to be a result of higher revenues from indirect taxes and income tax, and higher receipts from dividend payments. The generally good economic situation is expected to support budget revenues.

The original assumptions of 4.3 per cent GDP growth rate and 1.5 per cent average yearly inflation for 2006 were kept by the new government. The expected GDP growth rate is realistic according to our estimations, however the inflation forecast on which the budget is based is likely to prove too low. According to European Commission (2.3 per cent), IMF (2.5 per cent), and OECD (1.9 per cent) forecasts, annual average inflation will probably be higher than that.

The original finance minister of the PiS government, Ms. Tereza Lubinska was dismissed from office in January. This was probably the result of her calls for higher fuel taxes and higher budget deficit. Her successor as minister of finance is the liberal Ms. Zyta Gilowska a former member of the centre-right opposition (PO). In her first statements she expressed firm determination to establish order in public finances.

Balance of payments

In 2005 the current account improved significantly. The improvement was more pronounced in the first half year, when the current account deficit fell by EUR 3.7 billion. The narrowing of the deficit (to 1.6 per cent of GDP year-on-year in 2005) was due to favourable changes in all components of the balance of payments (apart from the balance of transfers, which had an opposite effect). The greatest improvement was a result of the favourable developments in the trade balance of goods. December 2005 data show that growth rates of exports and imports remained high, 17.8 per cent and 14.8 per cent year-on-year, respectively. High growth rates of exports and imports were also contributing to the improvement in economic growth. As for the geographical structure of exports, sales to Euro area countries and other New Member States increased, while the growth rate of sales to non-EU countries decreased.

In December 2005 acceleration was observable in FDI inflow. Overall in 2005 net FDI inflow reached 6,780 million Euros, which is a decrease compared to the previous year (the net FDI inflow was 10,070 million Euros in 2004).

Growth rate of exports is expected to decrease as the year advances, while the growth rate of imports is expected to remain higher, although also following a decreasing trend. The current account deficit is expected to widen to a little extent compared to 2005, reaching 1.9 per cent of GDP.

Labour markets

A slight rise due to seasonal factors was experienced in the unemployment rate in January 2006, when it reached 18 per cent. At the same time the improvement in labour market conditions that started in 2002 is still continuing. In December 2005 the unemployment rate was 17.6 per cent in Poland, 1.4 percentage points lower than a year earlier. The trend of employment growth in the enterprise sector is still maintained. An average employment increase of 2.6 per cent year-on-year was experienced in January, like in the previous month.

As for wage pressure on inflation, a marked acceleration in the growth of wages in the economy was experienced in Q4 2005, amounting to 5.1 per cent year-on-year, while it was only 3.4 per cent year-on-year on the previous quarter. The growth of unit labour costs in the economy as a whole, most likely increased in Q4 2005. At the same time in manufacturing a relatively low growth rate of unit labour costs was experienced.

After Poland's accession to the EU in May 2004 high number of people left a country to search for work in the Old Member States. This development has a considerable impact on the labour market trends, however it is difficult to assess its extent.

The unemployment rate is expected to decrease to 16.6 per cent by December 2006, while employment in the corporate sector is expected to grow by 2.5 per cent year-on-year in 2006.

Table 7. Major macroeconomic indicators for Poland 2004-2006*

	2004	2005	2006*
GDP (%)	5.4	3.3	4.3
Private consumption (%)	3.4	2.0	3.2
Public consumption (%)	3.5	2.2	2.0
Investments (%)	5.3	3.5	6.9
Export (%)	22.3	16.5	8.4
Import (%)	19.5	12.2	9.1
Consumer price index (average, %)	3.5	2.1	1.0
Consumer price index (dec/dec, %))	4.4	0.7	1.7
Unemployment ratio (%)	19.1	17.6	16.6
Real Wages (%)	0.8	1.2	3.1
General government balance (% in GDP)	-4.5	-3.0	-3.4
Public debt/GDP (%) ESA 95	43.6	46.3	47.0
Current account/GDP (%)	-4.1	-1.6	-1.9
Trade balance/GDP (%)	-2.3	-1.3	na
Gross foreign debt/GDP (%)	46.0	43.3	42.0
Exchange rate (PLN/EUR)	4.53	4.02	3.6
Base rate	6.5	4.5	4.00

Sources: National Bank of Poland, World Bank, Bank Zachodni WBK, Bank Austria Creditanstalt, OECD, Deutsche Bank Research, EU

**Predictions, expectations*

SLOVAKIA

Exceptionally high growth in 2005: highest in Slovak history and among the Visegrad countries

Growth

According to the estimates of the Statistical Office of the Slovak Republic, GDP growth in Slovakia reached 7.6 per cent in real terms. Thus, projections of international organisations were surpassed to a great extent. Besides domestic demand, foreign demand also played an important part in raising the rate of growth. Investment also contributed significantly to economic growth.

However, according to the analysis of a Slovakian financial institution (Slovenska Sporitelna), other, speculative reasons may also be responsible for the exceedingly high growth rate: because of the planned increase in excise taxes in 2006, retailers accumulated stocks in tobacco products and beverages, which contributed by 1.5 percentage point to the growth rate in the last quarter of 2005. This assumption is supported by the fact, that positive change in inventories was the biggest contributor to growth in the last quarter of 2005. Because of this factor, prognosis of GDP growth for this year must be revised downwards by 0.8 percentage points, according to the analysis of the bank.

International institutions expect GDP growth this year to be in the range of 5.4-5.6 per cent. On production side, it is especially construction, industry and trade, which had the highest (close to or more than 10 per cent) growth last year, according to the data of the Statistical Office. However, growth in industrial production is still the lowest compared to other Visegrad countries.

Private consumption remained vigorous in the fourth quarter, fuelled by the relatively high growth in real wages and reflected in the highest among Visegrad countries growth in retail sales in 2005. This latter rose by 4.7 per cent, according to the data of the Statistical Office. In the year 2005 as a whole, real wages rose by 6.3 per cent. Sustained high level of private spending is expected in 2006, because of an expected increase in real wages of 3.6 per cent and an improving indicator of consumer's confidence (published by the Statistical Office).

Public consumption grew moderately in 2005, and it is to increase this year because of elections-related expansion in government consumption. In 2006, the Ministry of Finance forecasts a 3.3 per cent growth compared to a 1.6 per cent increase of last year. International organisations expect public consumption to augment in the range of 3-4.2 per cent, due to differing assumptions on the extent of pre-election spending.

Investments grew quickly in 2005, and contributed to the eminently high growth rate, with acceleration in the GFCF growth rate from quarter to quarter last year. One reason can be the realisation of large, FDI-related greenfield projects and partly the decision of the government to finance highway construction and FDI incentives from excess tax revenues. At the same time, domestic entrepreneurs also contributed to the high investment demand. The rate of growth of GFCF stood at 11.5 per cent in 2005, and it is expected to be much lower, around 6.5 per cent this year, which may be partly responsible for the lower GDP growth in 2006.

Monetary indicators

The level of consumer prices increased by 2.7 per cent on a year-on-year basis in 2005, and producer prices by 4.8 per cent. Inflation is expected to accelerate to around 4 per cent in the first half of 2006, and for the year as a whole, prognosis of international organisations is spread in the range of 2.7-4.3 per cent, while the Statistical Office forecasts a 3.5 per cent increase – together with a 4.9 per cent increase in producer prices. January and February data (a HICP of 4.1 per cent and 4.3 per cent, respectively, on a year-on-year basis) indicate an increase in inflationary pressures in the Slovakian economy. Prices of energy and certain services were first of all responsible for the price increases – regulated prices increased the most in the Slovak Republic last year compared to other Visegrad countries, according to the estimations of the World Bank. Producer prices were also higher: in February, by 7.4 per cent on a year-on-year basis, supporting the presumption on growing inflationary pressures. Both cost-push and demand-pulled elements of inflation are present, together with one-off impacts (such as the effect in the increase of excise taxes on tobacco products and beverages).

At the end of February, the two-week repo rate stayed at 3.5 per cent, when the Monetary Council decided for a half percentage point increase. The main reason behind the decision is the increase in inflationary tendencies. The monetary policy will be under further pressure this year because of large capital inflows connected to privatisation, FDI, portfolio and other (mainly short-term) investments, which all seem to be insensitive to the strong koruna and the relatively low interest rate. Frictions by the difference between ECB and SNB rates may cause problems for the monetary policy.

Fiscal policy

Slovakia fulfilled the Maastricht criterion of a budget deficit of below 3 per cent of GDP already in 2005, one year earlier than expected. According to the original plan, a budget deficit of 3.4 per cent was expected, but due to the robust growth of the economy, tax revenues exceeded the planned level – by 41.5 per cent, according to the data of the Statistical Office, thus the actual outcome was a 2.9 per cent budget deficit compared to the GDP. This year a similar level of budget deficit is planned by the government, which prognosis is supported by the expected high rate of growth. However, if the assumption about purchases brought forward because of the increase in excise taxes proves to be true, the budget deficit may exceed 3 per cent at the end of this year.

Other positive impacts of the fiscal reform are appearing in the budget data of the Slovak Republic. By 2006, among Visegrad countries, Slovakia has the lowest level of budget revenues and expenditures compared to GDP. The significant decrease of the budget deficit from the 7.8 per cent of GDP in 2002 to 2.9 per cent in 2005 are also signs of the improvement, connected to the reform. However, the reform did not aim directly at reducing the deficit by decreasing expenditures and increasing revenues, but more at structurally “redefining” the fiscal system. That is why its impact can be traced only on a longer run.

Balance of payments

The current account deficit widened rapidly in 2005, however, after the summer, developments were more favourable. For the year as a whole, the current account showed a deficit of 6.1 per cent compared to GDP, which is lower than in Hungary, but higher than in other Visegrad countries. In 2006, an improvement to 4.2 per cent is expected. Exports grew by 10.2 per cent, and imports by 9.3 per cent in 2005, according to the data of the Ministry of Finance. The main reason behind the trade deficit is the strong growth in domestic demand. Data for the fourth quarter indicate an increase in the trade deficit, because of higher imports of goods for final consumption and of machinery and raw materials, which reflects the (possibly one-off) impact of FDI inflow in Slovakia.

The current account deficit is expected to be lower this year, backed by the more favourable developments in net exports. This year, exports is forecast to grow quicker, than last year, by 11.7 per cent; while import growth is put to 10.7 per cent; resulting in a slightly lower trade deficit. The composition of trade partners have changed significantly after EU-accession, it is especially striking, how turnover grew with other Visegrad countries, and imports increased from China and South-Korea.

In 2005, the balance of payments showed a close to 2.5 billion USD goods trade deficit, while services trade resulted in a surplus of more than 300 million USD. However, the capital and financial accounts more than counterbalanced the deficit of the current account. Foreign direct investment reached in Slovakia almost 2 billion USD, more than half of which came from reinvested earnings, while Slovakian FDI abroad was negligible. The balance of portfolio investments stood at a deficit of 1 billion USD, while other, especially short-term investments were close to 5 billion USD.

Labour markets

During 2005, total employment went up by 1.4 per cent compared to 2004, which may be attributed to the favourable growth record. The growth in employment was especially strong in the fourth quarter, according to the data of the Statistical Office.

Unemployment is still among the highest among the NMS, though it continued to fall in the fourth quarter and dropped to 16.2 per cent. However, this rate is still the second highest among the NMS and must be evaluated against the low activity rate characterising the country. In terms of the length of unemployment, the number of long-term unemployed increased, and it represented at least 70 per cent of total jobless. For 2006, a further decrease in unemployment is expected due to strong economic growth.

Table 8. Major macroeconomic indicators for Slovakia 2004-2006*

	2004	2005*	2006**
GDP growth (%)	5.5	7.5	5.2
Private consumption (%)	3.5	5.8	3.8
Public consumption (%)	1.2	1.6	3.3
Investments (GFCF, %)	2.5	11.5	6.5
Export (%)	11.4	10.2	11.7
Import (%)	12.7	9.3	10.7
Consumer price index (average,%)	7.5	2.7	3.5
Consumer price index (dec/dec, %)	6.9	*2.7*	*3.5*
Unemployment ratio (%)	18.0	16.2	15.5
Real wages	3.4	6.3	3.6
Real ULC	-2.0	n.a.	1.0
General government balance (%)	-3.3	-2.9	-3.0
Public debt/GDP (%)	43.6	44.2	44.0
Current account /GDP (%)	-3.4	*-6.1*	*-4.2*
Trade balance /GDP (%)	-3.5	-4.8	-4.6
FDI (billion USD)	1.0	2.0	2.0
Gross foreign debt /GDP (%)	53.9	49.8	48.0
Exchange rate (Koruna/EUR)	40.0	37.8	37.5
Basic interest rate (%)	5	3	3.5

**2005: projection or final data*

***projection*

Sources: EU, IMF, Slovak National Bank, Slovak Ministry of Finance

SLOVENIA

Unchanged stability of growth and macroeconomic conditions

Growth

Real GDP grew by 3.9 percent in 2005 and by 3.7 percent in the fourth quarter of 2005. Last year's growth was mainly based on strong export performance and a slower growth of imports. Foreign trade contributed around 2.3 percentage points to the 3.9 percent GDP growth.

Domestic demand is expected to be the driving force of growth in 2006. We expect that real GDP will grow by 4 per cent this year. Growing real wages, converging interest rates will increase private consumption. However public consumption is not expected to increase substantially in spite of the local elections in 2006. Due to the expected stronger growth on Slovenia's major export markets, net exports will continue to positively contribute to real GDP growth this year.

Monetary indicators

Tolar remains stable against the Euro (at a level 0.04 per cent below the central rate). Exchange rate deviations from the central parity have been negligible since the entering of ERM2 in June 2004. The main risk, which could have jeopardized Slovenia's Euro zone entry in 2007 is inflation.

Consumer prices increased 2.4 per cent in January 2006 compared to the same period of last year. HICP was at 2.5 per cent at the end of last year and remained unchanged in January 2006. The Maastricht inflation criterion (the average inflation rate in the three member states with the lowest inflation plus 1.5 percentage points) stood at 2.6 per cent in January 2006. While Slovenia's average inflation was just on the threshold in November and December 2005, the inflation went below the Maastricht reference value for the first time in January 2006.

The administered prices adjustment plan of the government will play a key role to preserve price stability in the medium term. According to the plan Slovenian government will try to ensure that the rise of administered prices does not exceed the rise in market-determined prices. However a slightly expansionary fiscal stance due to the local elections could increase inflationary pressure. While excise duties on fuels cannot be reduced further an increase in oil prices could pose an additional inflationary risk. We expect that the inflation will around 2.5 per cent this year and drop to 2.4 per cent on average in 2007.

On 3rd March 2006 the Bank of Slovenia cut its main refinancing rate by 25 basis points, which now stands at 3.25 per cent. This was already the second cut in her key rate in 2006. The interest rate decisions of the Bank of Slovenia reflect her strive to continue the gradual process of closing the interest rate differential between Slovenia and the Euro zone.

Following the reduction in base rates by the Bank of Slovenia and the increase in main refinancing rates by the ECB there is now a 0.75 percentage point differential between the Bank of Slovenia and the ECB interest rates. Market forces will not permit to maintain these interest rate differential throughout 2006.

As Slovenia requested, the European Commission will publish the Euro convergence report for Slovenia on 16 May 2006. While the joint convergence report for all other Euro candidates is to be drafted in October 2006. We expect that the EU summit in June will give a positive assessment stating that the country is meeting all Maastricht criteria.

Fiscal policy

According to the preliminary data of the Ministry of Finance the budget deficit reached 1.4 per cent of GDP in 2005. The deficit totalled SIT 90.931 billion. Slovenia as a net recipient of EU fund received SIT 72.5 billion for the EU budget. The total receipts from the EU budget fell short of the forecasts. Other items of the revenue side were in line with the Ministry of Finance's forecasts.

According to the available data general government expenditure grew by 4.8 per cent year-on-year in the first eleven months of 2005.

If Slovenia joins the Euro zone “on schedule” on 1st January 2007, from that date on interest rates will be set by the ECB in Frankfurt and the country will loose its exchange rate instrument. Hence conducting prudent fiscal policy, keeping wages and prices flexible will be even more important in order to avoid asymmetric shocks.

The Slovenian government's convergence programme which was submitted to the European Commission envisages a slight fiscal expansion in 2006 and a gradual deficit reduction over 2007-08.

Balance of payments

Slovenia’s current account deficit was 45 per cent lower in 2005 than in the previous year. The shrinking current account deficit was mainly due to favourable developments in trade in services. Export of goods rose by 12.2 percent while import of goods increased by 11.5 per cent in 2005 over 2004. The trade balance of services improved by 31 per cent in 2005. Slovenia’s current account deficit was slightly below 1 per cent of the GDP last year.

We expect that Slovenia’s external position will be balanced this year. Increase in the export of goods will surpass the growth of merchandise imports, while favourable trends will continue in services trade thus the overall trade balance will be positive in 2006 and 2007.

Labour markets

The registered unemployment rate stood at 10.5 per cent in January 2006. The number of registered unemployed persons rose by 2 per cent compared to January 2005. On average formal employment rose by 0.7 per cent in 2005 over 2004. According to the Slovenian Statistical Office average monthly net earnings amounted to SIT 180,193 in January 2006. Average costs of labour in the final quarter of 2005 were 46.8 per cent above their 2000 levels.

Due to continued growth of real GDP in the medium term, the number of persons in employment is expected to rise. The government’s planned tax reform measures will have a positive effect on employment. We expect that the rate of unemployment will reach 5.8 per cent in 2006 and 5.6 per cent in 2007.

Table 9. Major macroeconomic indicators for Slovenia 2004-2006

	2004	2005	2006*
GDP (%)	4.6	3.9	4.0
Private consumption (%)	3.5	3.4	3.2
Public consumption (%)	1.7	2.5	2.5
Export (%)	12.6	8.6	7.8
Import (%)	12.4	6.0	6.5
Consumer price index (average,%)	3.6	2.5	2.5
Consumer price index (Dec/Dec, %)	3.2	2.3	2.6
Unemployment ratio (%)	6.0	6.1	5.8
Real wages (%)	2.0	2.1	2.3
General government balance (% in GDP)	-1.9	-1.4	-1.3
General government debt /GDP (%)	29.5	29.3	29.5
Current account /GDP (%)	-0.7	-0.9	0.0
Trade balance /GDP (%)	-0.6	-0.4	0.4
Gross foreign debt /GDP (%)	59.3	69.0	72.0
Exchange rate (SIT/EUR)	238.9	239.6	239.6
Base rate (end of period)	3.25	3.75	3.0

Source: Bank of Slovenia, IMF, European Commission, IMAD, Statistical Office of RS

**Forecast*