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Forecast

on the 8 New Member States

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This report was prepared by:

András Bakács, Veronika Czakó, Pál Gáspár, András Oszlay,
Gábor Pellényi (editor), Magdolna Sass

Overview of the NMS-8

Growth

Economic growth has remained strong throughout the region. Growth is broad-based: domestic demand is an important factor of growth in most countries but due to favourable external conditions exports could also contribute. GDP growth of the region as a whole increases to 5.5 per cent in 2006.

The differences between the Baltic and Central European economies are clearly visible in their growth performance. In the Baltics growth rates will reach or exceed 8 per cent until 2007. Domestic demand – boosted by rapid real wage growth and a foreign-financed boom of bank lending – is the main factor as well as the greatest risk of growth. Signs of overheating are apparent in all three economies: inflation is high, labour shortages are appearing and the external balance is deteriorating. The greatest threat is a reversal of real estate prices and the dramatic deterioration of loan portfolios. In Central Europe growth remains between 4 and 6 per cent with the exception of Hungary, where fiscal stabilisation will suppress growth in 2007. This more moderate growth is also broader-based; although the political cycle has given a boost to consumption, they benefit more from the pick-up of growth in Western Europe.

In the future tighter fiscal policies are required in almost every country due either to high inflation or budgetary problems hampering the entry to the euro-zone.[1] This will have a negative short-term effect on growth. Due to the slowdown in the Baltics, a fiscal stabilisation in Hungary and a tighter grip on public spending generally, GDP growth rates will decline slightly in 2007 throughout the region to 4.9 per cent.

Monetary developments

Inflation is either high or is on the rise in almost every single country. CPI in the whole country group rises steadily to reach and then exceed 3 per cent during 2006-2007. These developments stem from both supply- and demand-side factors. On the supply side, labour shortages give rise to a wage-price spiral in overheating Baltic economies; indirect tax increases and administered price rises take place in a number of countries; finally high energy prices are still being felt everywhere. On the demand side, persistently high domestic demand pushes up prices in the Baltics; real estate prices are being watched by analysts and policy-makers with particular attention. Inflationary developments in Hungary will be exceptional in 2007; indirect tax increases and the adjustment of previously suppressed administered prices will be the main causes of high inflation.

Under given circumstances the fulfilment of the Maastricht inflation criterion is a significant challenge for most NMS-8 economies; it is the key factor behind the postponed euro entry of Baltic economies. The situation is not going to improve much for most countries in 2007.

Fiscal Policy

The overall budgetary position of the NMS-8 group deteriorates in 2006 to -3.7 per cent, although this is caused by only two countries, the Czech Republic and especially Hungary, where the deficit will exceed 10 per cent of GDP.

The Baltic countries keep running surpluses or moderate deficits to curb demand pressures. Persistent inflation and wide current account deficits warrant a tighter grip on public finances in these countries, therefore their budget balances might even improve further in 2007. In Central Europe the Maastricht deficit criterion is the effective constraint of the entry to the euro-area.

External Balance

Despite favourable external conditions the current account balance of the NMS-8 group is deteriorating gradually. Although export growth to the rest of the EU has been strong, domestic consumption and investments fuel imports.

In the Baltic countries, where the current account deficit has been especially wide, improvements to the external balance have reversed in 2006. Although 2007 should bring a moderate slowdown in growth, recent high real wage increases have undermined the competitiveness of these economies. The current account deficit is considerably narrower in Central

[1] See the last chapter for the underlying problems behind a belated euro entry and its consequences.

Europe, although it is increasing in most countries. The fiscal restriction in Hungary will cut the current account deficit by 1.5 percentage points.

Labour market

Unemployment is falling in most countries of the region, most notably in the Baltics due to exceptional economic growth and emigration of the labour force. The only exception to this trend is Hungary where fiscal stabilisation and the resulting slowdown will hurt jobs and raise unemployment. The weighted average of regional unemployment exceeds 10 per cent due to the large weight of Poland, but it is expected to fall below 11 per cent per cent. Still, high unemployment remains a primary concern especially for Poland and Slovakia, as well as handicapped regions in almost every country.

Real wages are rising rapidly on the back of productivity gains. However, labour cost increases can be considered excessive and potentially harmful to external competitiveness in the Baltics and in Hungary. This is partly the result of policy measures, also driven by the political cycle. Labour shortages and inflationary pressures both push up wage demands, which might give rise to wage-price spirals in some economies.

Table 1. Summary indicators of the 8 New Member States

	2005	2006	2007
GDP growth (%)	4.7	5.5	4.9
Inflation (annual average CPI, %)	2.6	2.9	3.1
General government balance /GDP (%)	-3.2	-3.7	-2.4
Current account /GDP (%)	-3.4	-3.6	-3.8
Unemployment (%)	12.6	11.3	10.8

Note: all items are weighted by GDP

Czech Republic

The rate of growth is decelerating somewhat and inflation is growing

Growth

Output growth in the Czech Republic decelerated somewhat from the record high 7.4 per cent in the first quarter of 2006, on a year-on-year basis to 6.2 per cent in the second quarter. The relatively lower growth rate can be explained by the slower export growth (10.2 per cent on a year-on-year basis). However, export of goods and services is still the main engine of growth. On the other hand, growing investment spending and private consumption also contributed to the high pace of growth. This indicates a change in the composition of the factors of growth from foreign demand towards domestic consumption and investments. The growth rate of industrial production reached an impressing 12.5 per cent in real terms on a year on year basis, however, in the second quarter there was a decrease in the rate of growth compared to the first one. This also points to a slight slowing down trend in economic growth.

Net exports remain the main contributor to growth; however, the growth rate of imports slightly exceeded that of exports in July for the first time this year. According to the data of the Statistical Office, the growth rate of exports in January-July 2006, on a year-on-year basis was 14.4 per cent, while that of import reached 14.8 per cent, which resulted in a slightly lower positive balance compared to the corresponding period of the previous year.

The growth rate of private consumption increased to 3.8 per cent in the second quarter. The main factor behind the growth in private consumption was the increase in real wages. Average nominal wages increased by 7 per cent in the first half of the year. Moreover, low interest rates on consumer loans induced households to borrow - and consume - extensively. (Loans to households grew by 32 per cent.) Private consumption is expected to grow at an even higher pace in 2007, due to the planned cuts in personal income taxes. GFCF in the first half of 2006 grew at an increasingly high pace, by 17.8 per cent on a year-on-year basis. Thus, investments became the main contributor to growth. While growth rates are astonishing up till now, 2006 and 2007 growth developments are still surrounded by political uncertainty. Moreover, the growth rate is expected to slow down somehow in the second half of 2006 and in 2007 due to lower export growth.

Monetary developments

Inflation (CPI) grew moderately to 3.1 per cent in the Czech Republic on a year-on-year basis, according to the August data. Increase in food, regulated and energy prices as well as services prices (especially advertising and telecom services) are the main reasons behind the acceleration in inflation. As far as the producer price index is concerned, higher indices characterise market services (4 per cent) and construction work (3.1 per cent), while industrial and agricultural producer prices grew moderately (2.7 and 2.4per cent, respectively). The CPI is slightly higher than the 3 per cent target of the Czech National Bank, and higher than the forecast of international organisations. However, for the year as a whole, and for 2007, forecasts expect a higher level of inflation, due mainly to the growth in consumption, regulated prices and indirect taxes.

At the end of September, the Czech National Bank increased the two-week repo rate to 2.5 per cent, which is the lowest in the European Union, and lower than that of the ECB by 75 basis points. According to the Bank Board, inflationary pressures were slightly higher than the forecast of the Bank, domestic consumption grew stronger, the koruna weakened and fiscal prospects are bleaker. It is unlikely that the Bank would touch the interest rate this year, however, in 2007, it may be increased again. The exchange rate of the Koruna appreciated in real terms in the period as a whole; however, there were periods of weakening, especially before the Bank decision in September. All in all, in the first half of 2006, the koruna appreciated by 3.7 per cent against the euro and by 1 per cent against the US dollar. Turbulences in the regional currency market affected the Koruna as well, however, to a much smaller extent than the currencies of other Visegrad countries.

Fiscal policy

The budget showed a surplus (0.5 per cent of GDP) at the end of the first half of 2006. Compared to last year, there was a change in the structure of revenues: consumption related taxes grew significantly (by more than 20 per cent), while income taxes decreased (by more than 6 per cent). Revenues grew slower, while outlays faster compared to the first half of the previous year. According to the National Bank, budget developments pose an upside risk to inflation.

The budget deficit is expected to reach 3.7 per cent of GDP for the year as a whole. For 2007, similar tendencies are expected with the level of the budget deficit reaching 4 per cent, and thus in both years surpassing the Maastricht criterium. The main reason is that 2005 revenue surprises were used as a basis for forecasting 2006 revenues and thus planning higher social spending and a decrease in certain taxes, the effect of which will be felt in the 2007 budget as well. Moreover, political uncertainties surround the budget, due to the outcome of the June elections and a possibility of the approach to the badly needed pension and health care reform is still also uncertain.

The higher than expected fiscal deficit made the prospects for co-financing EU-projects bleak, this year because this sum is missing from the budgets of the ministries, according to the finance minister. Moreover, fiscal problems induced the declaration of two new privatisation projects: the Prague airport and the CEZ are announced to be privatised in order to provide additional financing for the budget.

External balance

External imbalances remain low in the Czech Republic, though from a surplus in the corresponding period of last year it turned to a debt in the first half of 2006, according to the data of the Statistical Office. The two main changes between the two period were the following: a significant decrease in the surplus of the financial account and an increase in the deficit of the current account. In the current account, decrease characterised the most current transfers (of EU funds). On the other hand, on the capital and financial account, there was a decrease in foreign direct investments as well as in portfolio investments.

According to the estimation of the National Bank, the current account deficit widened to 3.2 per cent of GDP on an annual basis. Due to higher growth of import, goods trade showed a lower surplus than in the corresponding period of 2005. At current prices, exports grew by 10.2 per cent, while imports by 11.3 per cent. In terms of the product composition of foreign trade, it is still the machinery and transport equipment group, which shows a considerable surplus. In terms of geographical breakdown, trade surplus towards EU member countries grew, while deficit with other countries rose, mainly due to higher energy prices in imports from Russia and higher imports from China. The terms of trade deteriorated, mainly due to the higher growth of import prices, which is confined mainly to the increase in oil and gas prices.

On the capital and financial account, the decrease in FDI is mainly due to the high base of last year because of the high inflow of privatisation related FDI. The main part of FDI this year is came in the form of reinvested earnings. Portfolio investments showed a relatively high deficit, due to strong demand for foreign securities.

Labour market

There was an increase in the participation rate in the first half of 2006, induced mainly by the high growth rate of the economy. The rate of employment for people aged 15-64 went up to 65.1 per cent and participation rate for the same age group increased to 70.4 per cent. New workplaces can be found mainly in industry, as it can be expected on the basis of the high FDI inflow and high growth rate of GFCF. In some parts of the economy, the number of vacancies grew sharply, which highlights structural problems. For example, workers with secondary education are in shortage, according to the Statistical Office. Accordingly, unemployment decreased to 7.6 per cent. While still relatively high compared to EU-25, long-term unemployment decreased in the first half of 2006.

Nominal wages grew by 7 per cent, and its growth rate accelerated compared to the corresponding period of the previous year. Wage growth was the highest in the business sector. Sectoral wage differences continued to increase, because high-wage activities (financial services, energy) experienced higher wage growth than those with lower wages (manufacturing, construction).

Table 2: Main macroeconomic indicators for the Czech Republic, 2005-2007

	2005	2006*	2007*
GDP growth (%)	6.0	6.3	**5.5**
-Private consumption (%)	2.6	3.8	**2.9**
-Public consumption (%)	-0.5	1.0	**0.2**
-Investments (GFCF, %)	3.7	5.0	**3.9**
-Export (%)	8.7	9.0	**8.7**
-Import (%)	6.0	9.2	**8.9**
Consumer price index (average,%)	2.4	3.0	**2.8**
Unemployment ratio (%)	7.9	7.5	**7.2**
Real wages	4.4	5.0	**0.8**
Real ULC	-0.7	1.0	**0.5**
General government balance (%)	-2.6	-3.7	**-4.0**
Public debt/GDP (%)	30.4	30.8	**30.9**
Current account /GDP (%)	-2.1	-2.8	**-2.9**
Trade balance /GDP (%)	0.1	-0.5	**-0.5**
Gross foreign debt /GDP (%)	38.4	38.5	**38.5**
2-week repo rate (%)	2.0 (December)	2.5 (September)	**2.5**

** Forecasts by ICEG staff*

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

Estonia

Strong growth with risks of a hard landing

Growth

Economic growth continues exceptionally: the 12 per cent growth rate in the second quarter exceeds potential output growth by 4 to 5 percentage points. Growth is driven primarily by domestic demand: this is reflected in exceptional growth of retail sales (turnover rose by 25 per cent in the second quarter), construction and an increasing trade deficit. Capital formation accounts for 32 per cent of GDP with real estate investments playing a major role.

Domestic demand is still fuelled by rapid income growth and a credit boom financed from abroad. The 15 per cent year-on-year wage growth in the second quarter is out of line with productivity developments, therefore the external competitiveness is declining. Meanwhile, rapid credit growth creates additional vulnerability to global financial markets.

According to the Bank of Estonia there is risk of a sharp slowdown in the future. Since the cooling of the economy is slower than expected, a growth rate of around 9 per cent is expected for 2006, while 2007 might finally bring a gradual deceleration to about 8 per cent.

Monetary developments

The overheating of the economy results in higher than expected inflation in the first half of the year both in terms of consumer prices and core inflation. Rapidly rising housing costs and food prices were the key factors behind these developments. By September, 12-month CPI decreased to 3.8 per cent.

The annual average inflation for 2006 is expected at 3.6 per cent. Assuming the postponement of raising excise duties' CPI will come down to 3 per cent in 2007, but will bounce back to 3.7 per cent in 2008. Thus the 2008 euro adoption looks unlikely due to persistently high inflation.

The stock of outstanding bank loans increased by an annualised rate of 35 per cent by the end of August; loans to the private sector soared at 65.6 per cent. Interbank interest rates are slowly picking up, following developments in the euro area; the 1 month TALIBOR rate stood at 3.33 per cent at the end of September. At the end of August the average interest rates for kroon and euro loans stood at 6.85 per cent and 4.6 per cent respectively. The quality of the loan portfolio is good thanks to the rapid growth in new loans.

Fiscal policy

During the first eight months of the year 69.6 per cent of budget revenues were collected, compared with a 68.3 per cent collection rate 12 months before. Revenues increased by 17.6 per cent year-on-year while expenditures rose by 19.6 per cent by the end of August. Although supplementary budget will be adopted for 2006 due to higher than expected revenues, the consolidated budget surplus will still exceed 2 per cent of GDP (instead of 3.4 per cent) despite additional expenditures.

Under current demand pressures, external imbalances and in lack of a monetary policy toolkit, fiscal policy is the only effective instrument in controlling both the overheating of the economy and the current account deficit. Therefore a budget surplus is the key objective of fiscal policy. This still creates some demand stimulus; the Eesti Pank recommends surpluses of at least 2 per cent of GDP in the coming years as well. Given the good record of Estonian fiscal policy and strong revenue collection due to fast economic growth, this target is achievable in 2007.

External balance

The value of exports increased by 29.4 per cent in the second quarter. Remarkably, without oil products exports decelerated by 13 per cent, possibly indicating the declining cost competitiveness of the economy. Meanwhile domestic demand boosted import growth by 30.7 per cent. As a result the improvement of the external balance has reverted, the four-quarter moving average of the current account deficit increased by 0.4 to 0.5 percentage points of GDP. Net FDI inflows covered 42 per cent of the current account deficit in the first half of the year.

The current account is expected to improve slowly. In 2006 it is unlikely to turn below 10 per cent of GDP; conditional on cooling domestic demand it can reach 9.5 per cent in 2007.

External debt remains large, gross and net external debt increased by 31 per cent and 51 per cent respectively between the second quarters of 2005 and 2006. As a consequence, gross external debt will exceed 100 per cent of GDP in 2006.

Labour market

Economic growth contributed to rapid job creation. Employment rose by 6.7 per cent in the second quarter, reaching its highest level in 12 years. Labour shortages are already appearing, exerting upward pressures on wages. Regional disparities persist, the lowest unemployment rate is 2.4 per cent in Western Estonia while a 14 per cent rate was registered in Northeast Estonia.

Unemployment forecast will decrease to 7 per cent in 2006 and 6.4 per cent 2007. Wage growth will exceed 10 per cent in 2006-2008, although real wage growth is expected to peak this year.

Table 3: Main macroeconomic indicators for Estonia, 2005-2007

	2005	2006*	2007*
GDP growth (%)	9.5	8.9	**7.9**
-Private consumption (%)	8.1	7.7	**7.2**
-Public consumption (%)	7.5	9.4	**7.0**
-Investments (GFCF, %)	13.9	11.9	**8.6**
-Export (%)	21.3	15.0	**14.1**
-Import (%)	17.4	15.1	**13.7**
Consumer price index (average,%)	4.1	3.6	**3.0**
Unemployment ratio (%)	7.9	7.0	**6.4**
Real wages (%)	7.7	8.3	**7.1**
Real ULC (%)	-2.2	1.0	**-1.3**
General government balance (%)	1.8	2.0	**2.0**
Public debt/GDP (%)	5.1	4.0	**2.0**
Current account /GDP (%)	-11.0	-10.0	**-9.5**
Trade balance /GDP (%)	-6.4	-6.6	**-6.5**
Gross foreign debt /GDP (%)	90.3	96.2	**102.6**
1 month TALIBOR (%, annual average)	2.33	3.00	**3.00**

** Forecasts by ICEG EC staff*
Sources: EU, IMF, Bank of Estonia, Statistical Office of Estonia

Hungary

In spite of favourable external conditions the signs of deceleration are already unfolding

Growth

The year-on-year growth rate of real GDP fell to below 4 per cent in the second quarter of 2006, despite stronger than expected external demand. A surprise element in this slowdown was the sharp deceleration of investments. Behind this lies a marked reduction in private investments, while public investments also lost momentum as is usual after parliamentary elections. Private consumption growth is also on a downward path, since weaker income expectations and fear of massive lay-offs led to a marginal increase in the savings ratio as well as a deceleration in consumption credit growth. However, backed by favourable external developments (significantly lower oil prices, better than expected growth performance in the euro-zone), exports continued expanding vigorously, which, together with surprisingly slow import growth resulted in considerable improvement in net exports.

The rest of 2006 will see private consumption slowing even further. Investments will also follow a downward trend, but a slight upward correction after the unexpectedly low Q2 data can not be excluded. Nevertheless, in 2007 the effect of fiscal stabilisation will be fully felt in domestic demand, leading to an explicit fall (the first after 1996) in private consumption and one of the lowest growth in investments for a decade. However, contrary to what we expected three months ago, net trade will have a significant positive contribution to economic growth both in the rest of 2006 and even in 2007, through dynamic export growth. Consequently, we expect that real GDP will expand at a rate of 3.9 per cent in 2006, and a further 2.2 per cent growth is projected for 2007. These forecasts are almost unchanged from the one we presented three months ago, but behind the figures there is considerable difference: the main contribution to growth will come from net exports, while the contribution from domestic demand will be significantly smaller.

Monetary developments

12-month CPI-inflation hit 5.9 per cent in September. The recent increase of consumer prices began around April, mostly reflecting fuel price developments, increases in import prices, food prices and also special effects. Of these, fuel prices have considerably decreased since then, but a rise in the VAT rate and also in administered prices – as part of the fiscal stabilisation package – began to exercise an upward pressure on consumer prices. We assess, that the fiscal stabilisation package in itself will generate an additional inflation of close to 2 per cent in 2006, resulting in a nearly 6 per cent 12-month CPI-inflation rate by the end of the year (3.7 per cent average annual rate).

2007 will see further increasing consumer price indices due primarily to developments in energy prices, the reduction of subsidies on medicines and public transport and also the secondary effects of the 2006 tax changes. Import prices will also push consumer prices upwards, while the offsetting effect of moderating wage growth and decreasing public consumption will be weak. Inflation will culminate at around July or August next year at a 12-month rate close to 8 per cent, but will gradually decrease afterwards. In all, average annual inflation can be as high as 7.2 per cent in 2007.

During the third quarter of the year the Magyar Nemzeti Bank (the central bank) increased its base rate in three steps. It now stands at 7.75 per cent compared to its end-June value of 6.25 per cent. Considering that the fiscal stabilisation package might induce secondary effects through influencing inflation expectations, and the fact, that foreign money and capital markets became tighter due to interest rate rises in both the euro-zone and the USA, we think that the Nemzeti Bank will further increase its base rate in one or two steps, which will thus stand at 8.25 per cent at the end of 2006. With the easing of pressures at the end of 2007, the base rate could fall back to 7 per cent by the end of next year.

The exchange rate of the forint has become rather volatile recently, mostly reflecting the increased risks originating from the unsustainable fiscal deficit. Despite increased volatility we expect, that the forint's flotation centre will be at around the 270-275 band vis-à-vis the euro, which is probably consistent with the present fundamentals.

Fiscal policy

The budget deficit (excluding local governments) reached 6.3 per cent of GDP by the end of September on cash basis. This is 2 percentage points higher than in the same period last year, and by the end of the year it could rise to 8.2 per cent. The more relevant accrual based ESA-95 figure will be even higher at 10.3 per cent of GDP (without adjustment for the pension reform).

It should be stressed, that without the fiscal stabilisation measures announced in June, the deficit could even reach 11.7 per cent this year, due to markedly higher expenditures. Part of these originate from well above planned outflows on some budget items (e.g. pension, subsidies on medicines), another part comes from the higher price of imported gas and increased interest payments on outstanding government debt. Thus, the fiscal stabilisation measures per se lead to a 1.4 percentage point (relative to the GDP) reduction of the budget deficit in 2006 mostly reflecting increased revenues through tax rises, to a lesser extent also a cut in expenditures through freezing outflows on some items.

As the stabilisation measures exert their full effect in 2007, we expect a further improvement in the budget balance next year. The ESA-95 budget deficit figure could fall to 7 per cent of GDP (based on already announced measures), and the bulk of improvement will be the result of reduced expenditures rather than increased revenues. The improvement in the primary balance can be even larger, since payments on outstanding government debt will still increase in 2007.

Public debt will stand at 69 per cent of GDP by the end of 2006, which is almost 7 percentage point higher than at the end of 2005. The bigger part of this increase is to be attributed to the high deficit, but the revaluation of the foreign currency denominated stock of debt through the depreciation of the forint also plays a role. Although the budget deficit will moderate somewhat in 2007, interest payments will still be high, thereby further increasing the government debt to approximately 71 per cent of GDP by the end of next year.

External balance

The current account exhibited a deficit of EUR 1.5 billion in the second quarter of the year, raising the cumulated deficit to slightly over EUR 3 billion in the first six months. Goods export and import both increased considerably between April and June, with a marked improvement in the trade balance (less than EUR 70 million). There is still an ill feeling about the import figures, because of the high errors and omissions balance, which may be the consequence of underreported imports.

The services balance did not change significantly compared to the last year, but there was continued worsening in the income balance. Especially net income payments after non-debt generating investments exhibited higher deficit than in last year. Unrequited transfers showed slightly negative balance in the second quarter, though, because of the recording method of payments both to and from the EU, this figure in itself is not indicative about current trends.

Continued improvement in the trade balance (a large part of which can be attributed to decelerating domestic demand in the wake of fiscal stabilisation measures) will lead to a minor improvement in the current account relative to the GDP in 2006, and a further, larger improvement in it in 2007. This might result in a current account deficit of 6.6 per cent of GDP in 2006, and 5 per cent of GDP in 2007.

The stock of gross foreign external debt at the end of June stood at 87.3 per cent of GDP, more than 10 percentage points higher, than at the end of 2005. Besides the current account deficit, this is also attributed to the depreciation of the forint. We expect no further depreciation of the domestic currency (only higher volatility) until the end of next year, since, however, the current account deficit will be financed primarily by debt-generating inflows in the forecast horizon, gross foreign debt could increase to over 90 per cent of GDP later in 2007.

Labour market

The relatively good growth performance this year led to considerable job creation, but mostly in construction and services, while employment in manufacturing decreased again. At the end of the year the first stage of a massive lay-off in public employment – as a consequence of fiscal stabilisation measures – will be started.

The full effect of the fiscal measures will, however, be felt rather in 2007, when the decelerating economy will be unable to create as many jobs as will be destroyed in public administration and construction. From its end-2006 value of 7.4 per cent, unemployment ratio will rise to close to 8 per cent by the end of 2007.

Despite the acceleration of inflation at the end of 2006, real wage growth could be as high as 3.4 per cent in 2006, mostly because of wage increases in the private sector. The next year, however, will see decreasing real wages due to high inflation, weak demand for labour, the freezing of nominal wages in public administration as well as rises in taxes and social contributions.

Table 4: Main macroeconomic indicators for Hungary, 2005-2007

	2005	2006*	2007*
GDP growth (%)	4.1	3.9	**2.2**
-Private consumption (%)	1.4	2.4	**-0.4**
-Public consumption (%)	-0.9	1.4	**-0.9**
-Investments (GFCF, %)	6.6	3.9	**3.1**
-Export (%)	10.8	13.9	**9.8**
-Import (%)	6.5	11.4	**8.3**
Consumer price index (average,%)	3.6	3.7	**7.2**
Unemployment ratio (%)	7.3	7.4	**7.9**
Real wages	6.0	3.4	**-2.6**
Real ULC	2.4	-0.6	**-0.5**
General government balance (%)	-7.5	-10.3	**-7.0**
Public debt/GDP (%)	62.3	69.0	**71.0**
Current account /GDP (%)	-6.8	-6.6	**-5.0**
Trade balance /GDP (%)	-1.6	-2.0	**-1.8**
Gross foreign debt /GDP (%)	77.0	89.0	**90.8**
Basic interest rate (%)	6.00	8.25	**7.00**

Forecasts by ICEG EC staff.
Sources: EU, Central Statistical Office, Ministry of Finance, Magyar Nemzeti Bank, IMF

Latvia

Looming credit and housing bubble poses risks to growth

Growth

Buoyant economic growth continues; GDP growth reached 11.1 per cent in the second quarter of 2006. Domestic demand remains the major driving force; this is reflected in growth rates of wholesale and retail trade (18.7 per cent), real estate, lending and business activities (16.5 per cent), as well as construction (16.1 per cent). Domestic demand is fuelled by fast income and credit growth. Real wages rose by 14.5 per cent in the second quarter, accelerating markedly from 9.1 per cent one year before. The growth of labour costs undermines external competitiveness while imports are growing rapidly, leading to a decline in the trade balance.

Economic growth is expected to reach 8.8 per cent in 2006. A gradual slowdown would bring GDP growth down to 8.1 per cent in 2007. The key risk to economic development is a credit and housing bubble, which is now seen a real possibility.

Monetary developments

Inflation is decreasing, the 12-month consumer price index in September was 5.9 per cent, while core inflation declined to 4.8 per cent by August. The effect of past energy price increases fades away but rising housing and public utility costs as well as food prices keep inflation high. Annual average inflation for 2006 is expected to be 6.5 per cent. In 2007 inflation will moderate to around 6 per cent. The main risk to inflation developments is a potential wage-price spiral.

Rapid credit growth continues: banking sector assets rose by 43.2 per cent year-on-year by July. 82 per cent of new credit in the last 12 months was denominated in foreign currencies; 73 per cent of outstanding loans is now denominated in foreign currencies. The share of non-performing loans decreased slightly, from 1 per cent to 0.5 per cent; this is not surprising, due to the fast growth of new loans. Interest rates are rising, following EU trends. Rate increases amounted to 0.5 percentage points in the 12 months preceding July 2006, except for loans to households in lats, where rates increased. However, due to high inflation real interest rates are still negative and will remain so in the foreseeable future.

Fiscal policy

The budget surplus has increased since last year: in the second quarter it amounted to LVL 228.6 million compared with the LVL 128.5 million one year ago. Revenues increased by 24.5 per cent while expenditures rose by 20.8 per cent in the first eight months. Despite upcoming elections the government refrained from a supplementary budget, thereby helping to tackle the overheating of the economy. This will result in a positive budget balance in 2006, reaching 0.5 per cent of GDP. Fiscal policy is expected to remain cautious in 2007, aiming for a similar budgetary position as in 2006.

On August 17, Fitch improved the country ceiling for Latvia from A+ to AA-. This can reduce the risk premium on loans to Latvia, thereby moderating interest rates, and giving a further boost to credit growth.

Public debt is relatively small and decreasing; its ratio to GDP is expected to decrease further, below 11 per cent.

External balance

Goods and services exports rose by 13.6 per cent, while imports increased by 28.3 per cent in the first half of 2006; the value of goods trade deficit increased by 58 per cent compared to the first six months of 2005; an improving balance of services could not offset this change. As a consequence, the current account is also deteriorating: its deficit in the first half of 2006 increased by 87 per cent in value since last year. Net FDI inflows covered 54 per cent of the H1 current account deficit.

Rising labour costs may harm external competitiveness, while strong domestic demand continues to boost imports. Therefore recent trends are expected to continue, resulting in current account deficits of 13.1 and 13.0 per cent for 2006 and 2007 respectively.

Labour market

The rate of unemployment decreased to 7.2 per cent in the second quarter, full 2 percentage points lower than a year before. Year-on-year gross wage growth was 21.8 per cent in the second quarter while real wage growth reached 14.5 per cent.

Unemployment is decreasing due to economic growth and large-scale emigration of the labour force. Wage pressures are present due to labour shortages, sectoral wage bargaining and implicit or explicit wage indexation. These developments signal the risk of entrenched high real wage growth and a possible wage-price spiral.

Unemployment is expected to decline further in 2006 and 2007, reaching 7.8 and 7.5 per cents respectively. Wage growth will remain high, real wages are expected to increase by approximately 10 per cent in 2006.

Table 5: Main macroeconomic indicators for Latvia, 2005-2007

	2005	2006*	2007*
GDP growth (%)	10.2	8.8	**8.1**
- Private consumption (%)	11.4	7.8	**8.0**
- Public consumption (%)	2.7	2.8	**3.0**
- Investments (GFCF, %)	18.6	15.0	**12.0**
- Export (%)	20.7	12.8	**11.7**
- Import (%)	13.5	13.0	**12.0**
Consumer price index (average, %)	6.7	6.5	**6.0**
Unemployment rate (%)	9.7	7.8	**7.5**
Real wages	10.1	10.0	**8.0**
Real ULC	-3.4	0.0	**0.0**
General government balance/GDP (%)	0.2	0.5	**0.5**
Public debt/GDP (%)	11.9	11.3	**10.8**
Current account /GDP (%)	-12.5	-13.1	**-13.0**
Trade balance /GDP (goods and services, %)	-14.2	-14.7	**-15.3**
Gross foreign debt /GDP (%)	98.4	100.1	**104.0**
RIGIBOR rate (1 month, end of period, %)	4.37	4.5	**4.6**

** Forecasts by ICEG staff*
Sources: EU, Latvian Statistical Office, Bank of Latvia, IMF

Lithuania

Pressures are mounting in a possibly overheating economy

Growth

Real GDP expanded at an 8.4 per cent rate in the second quarter of 2006 compared to the same quarter of 2005 (revised up from 7.7 per cent announced first at the end of July). Continuing high economic growth driven primarily by strong domestic demand led to questions whether the Lithuanian economy is overheating. Indeed, analysts have expected some deceleration for the second quarter, but there was renewed surge both in private consumption and gross fixed capital formation. Furthermore, although the volume of imports is still significantly higher than that of exports, the latter has expanded at somewhat faster rates recently, leading to less severe drag on growth by foreign trade. On the production side construction and manufacturing output were again the main drivers of growth, while financial intermediation and real estates-related services also expanded at double-digit rates.

Though our latest expectations of a deceleration in private consumption did not materialise in the second quarter, we still think, that private consumption should lose some pace despite growing wages and lower personal income tax. This is because they tend to become more and more heavily indebted, therefore will soon face the need for saving more. Gross capital formation will remain buoyant backed by favourable financing conditions and the wider availability of EU funds. Exports will also continue to be strong (reflecting the investment boom of the past years), but imports will not be lagging (due to the still steady domestic demand component). We thus expect somewhat higher real GDP growth both in 2006 and 2007 than a quarter ago. The figure could be 7.5 per cent this year, and 6.5 per cent in the next one.

Monetary developments

12-month CPI-inflation stood at 3.2 per cent in September 2006. Although, this is a drop in consumer prices compared to August, this will probably prove to be temporary. In the coming months the price of natural gas and food are all expected to increase steadily. Besides these, excise duties are planned to be raised in 2007, while expected wage increases will also exert an upward push on consumer prices. Based on these we significantly modify our earlier projections on the development of the Lithuanian CPI. Average annual inflation can reach 3.8 per cent in 2006, and will rise further to 4.2 per cent in 2007.

By running a currency board regime, developments in the central bank's (Lietuvos Bankas) policy rate merely reflect changes in the relevant foreign interest rate. Lietuvos Bankas establishes its overnight repo rate to be equal to the ECB's marginal lending facility rate, thus this was raised by 25 basis points from 3.75 to 4 per cent on the 9th of August, than by an additional 25 basis points again on the 11th of October. Overnight VILIBOR (the Vilnius Interbank Offered Rate) also exhibited a rise of about 50 basis points during this period, while longer-term interest rates increased more moderately by 25 to 30 basis points. Because real interest rates in the euro-zone are still quite low despite the two recent interest rate hikes, we expect a further interest rate increase of 25 basis points by the ECB yet in 2006, and one more of similar magnitude in the first quarter of 2007. This will, of course, be automatically applied by Lietuvos Bankas.

Fast growth of domestic credit continued further, with the outstanding amount of credit to households increasing by almost 80 per cent in August compared to the figure 12 months before. Credit to non-financial corporations increased by some 47 per cent only. Credit growth will moderate in the forecast horizon, but will still remain high.

Fiscal policy

Due to remarkable revenues in the second quarter the general government budget look very sound. Indeed, while revenues increased by almost 15 per cent in the first six months of the current year compared to the first half of 2005, expenditures are only 7 per cent higher, resulting in a sizeable net operating surplus.

Good growth prospects will further improve the revenue side in the remaining part of 2006. On the expenditure side it is only social benefits that increase at a relatively high rate, government consumption and investment expand at a moderate pace. Some deceleration in revenue growth and a pick-up in expenditures is expected by 2007, but the budget balance will still remain very attractive. Taken together, the budget balance can even be in a small surplus in 2006 (0.1 per cent of GDP), but a minor deterioration in 2007 will follow (-0.6 per cent of GDP).

Public debt stood at well below the Maastricht criteria at 18.7 per cent of GDP at the end of 2005 and is surely to remain below 20 per cent in both 2006 and 2007.

External balance

The current account deficit amounted to EUR 1.1 billion in the first half of the year, almost double to that of the first six months of 2005 (EUR 615 million). Goods exports and imports all increased very dynamically, but the latter from a much higher base, thereby widening the trade deficit by close to EUR 330 million compared to last year's. Another factor of higher current account deficit is the development in income on direct investment, which exhibits a close to EUR 130 million worse balance in the first to quarters of 2006 than it did in the same period last year.

This, however, partly reflects much higher reinvested earnings, as is clearly shown in the financial account. Nevertheless, net foreign direct investment was almost only half of that in the same period of last year, as there also were considerable outflows (Lithuanian mother companies increased their claims on their foreign affiliates). Since net portfolio investment flows exhibited a balance close to zero in the first half of 2006, the main element of current account financing was the accumulation of long-term liabilities by the banking sector (in itself close to EUR 900 million).

With GDP expanding faster than we anticipated a quarter before, there will be further room for imports to increase (due to even more dynamic consumption and investment growth). Exports also perform better than we expected, this, however can not totally offset import growth, and thus the trade balance will worsen. Some deterioration in the income balance will also continue both in the remaining part of 2006 and in 2007. Under these circumstances for 2006 we expect a current account deficit around 8.4 per cent of GDP, this will further rise to around 8.6 per cent of GDP in 2007.

The stock of gross foreign external debt was 51.4 per cent of GDP at the end of 2005, and it further increased to close to 54.3 per cent of GDP (EUR 12.1 billion) by the end of June. Since both in 2006 and in 2007 more than half of the current account deficit will be financed by debt-generating inflows, the stock of gross external debt will continue to grow and by the end of 2007 it will approximate 60 per cent of GDP.

Labour market

Labour supply still remains a challenge in Lithuania, as the labour force is shrinking mostly due to emigration. As the economy continues growing above the potential rate, growing labour demand will lead to upward pressures on wages, and falling unemployment. Indeed, the official unemployment figure could be as low as 5.5 per cent by the end of 2007.

Wage increases will be partly offset by marked productivity growth, thus unit labour costs will only marginally increase in 2006 and 2007. Sectoral mismatches between labour supply and demand will contribute to sustain the tightness of the Lithuanian labour market. Part of the inflationary pressure will thus originate from this segment of the economy.

Table 6: Main macroeconomic indicators for Lithuania, 2005-2007

	2005	2006*	2007*
GDP growth (%)	7.6	7.5	**6.5**
-Private consumption (%)	9.9	10.9	**8.2**

-Public consumption (%)	4.9	4.1	**3.8**
-Investments (GFCF, %)	9.2	8.8	**7.9**
-Export (%)	14.5	15.2	**11.7**
-Import (%)	16.0	15.9	**12.0**
Consumer price index (average,%)	2.7	3.8	**4.2**
Unemployment ratio (%)	8.3	6.8	**5.5**
Real ULC	0.3	0.1	**0.4**
General government balance (%)	-0.5	0.1	**-0.6**
Public debt/GDP (%)	18.7	18.5	**19.0**
Current account /GDP (%)	-7.2	-8.4	**-8.6**
Trade balance /GDP (%)	-11.5	-12.2	**-12.0**
Gross foreign debt /GDP (%)	51.4	56.5	**59.7**
1-year VILIBOR (%)	2.82	4.1	**4.3**

** Forecasts by ICEG staff*
Sources: EU, Bank of Latvia, Central Statistical Bureau of Latvia, IMF

Poland

Economic performance remains strong, along increasing fixed investments in Poland

Growth

Growth continued to be strong in the second quarter of 2006 in Poland, with the GDP growth rate reaching 5.5 per cent year-on-year (in the first quarter it was 5.2 per cent year-on-year). Domestic demand was the main driving force, reaching a 5.1 per cent growth rate year-on-year, while net exports grew only by 0.4 per cent year-on-year. Private consumption rose by 4.9 per cent year-on-year. The growth rate of fixed investments reached 14.4 per cent year-on-year in the second quarter of 2006 (in the first quarter it was lower, reaching 7.4 per cent year-on-year). Industrial production increased by 12.1 per cent and retail sales by 11.8 year-on-year in the period.

In July and August economic performance continued to be strong: the main driving forces behind favourable economic performance were industrial output, construction and assembly production and retail sales. Rise in industrial output reached 12.5 per cent year-on-year in August, growth in construction and assembly production amounted to 15.3 per cent year-on-year (after only 4.8 per cent year-on-year in July), and retail sales remained high at 11.5 per cent year-on-year (in nominal terms). The rise in consumer loans and hosing loans was rapid (in August reaching 19.6 per cent and 51.2 per cent year-on-year respectively).

Overall in 2006 a 5.2 per cent year on year real GDP growth rate is expected. That is higher than our earlier forecast, due to the better than expected growth performance in the beginning of the second half. Growth is expected to remain strong in 2007, but will be slightly lower than in 2006, with the GDP growth rate reaching 5 per cent year-on-year. The main driving forces will be industrial production, retail sales, improvement in the labour market, and high investment growth.

Monetary developments

The rise of consumer prices was slightly higher in the second quarter than in the first, with the CPI reaching 0.8 per cent and 0.6 per cent year-on-year (respectively). CPI has been showing a slight rising trend since April 2006. In July year-on-year CPI reached 1.1 per cent, which was higher than expected. A further increase occurred in August, when the annual growth rate of consumer prices rose to 1.6 per cent. This means that the inflation was slightly above the lower limit for deviations from the inflation target. The rise in consumer prices in August was a result of the higher than expected acceleration in the annual growth of prices of food and non-alcoholic beverages, which were affected by the unfavourable weather conditions in July. An increase was also observable in core inflation indicators. Producer prices increased by 3.5 per cent year-on-year in July 2006. Inflation expectations of households also increased at the end of the summer.

Despite the higher than expected consumer price increase in July and August, the Monetary Policy Council of the National Bank of Poland left interest rates unchanged at its September meeting. The higher rise in consumer prices in July and August was the result of one off factors. Therefore the reference rate remained at the (record low) level of 4 per cent. The growth of wages is still below the rise of labour productivity, therefore the labour market is still not a source of inflationary pressure. Interest rates are expected to remain unchanged until at least next spring (according to the forecast of Polish commercial banks). CPI at the end of the year is expected to reach 2 per cent year on year in 2006 and 2.4 per cent in 2007.

Fiscal policy

Not long after the departure of Prime Minister Marcinkiewicz (who was replaced by the President Lech Kaczynski's twin brother, Jaroslaw Kaczynski) Finance Minister Zita Gilowska also left the government and was replaced by Stanislaw Gluza. Prime Minister Jaroslaw Kaczynski has made it clear, that the budget anchor (which amounts to 30 bln PLN) will not be abandoned, even though the demands of the more radical coalition partners (help for farmers, increased spending on social goals) would put increased pressure on the budget.

In July 2006 state budget expenditure amounted to PLN 125.5 bln, which is 55.6 per cent of the total budget expenditure planned in the 2006 Budget Act. State budget deficit in July amounted to PLN 15.6 bln, which is 51.1 per cent of the planned amount for 2006. As revenues are expected to be strong in 2006, as a result of planned increase of excise tax of tobacco and beer (13 and 10 per cent respectively), as well as for fuel, it is expected that the state budget deficit in 2006 will not be overshot. Budget deficit as a percentage of GDP is expected to reach 2.8 per cent in 2006, and 2.7 per cent in 2007.

External balance

The current account deficit was 1.4 per cent of GDP in the second quarter. Imports growth was driven by buoyant domestic demand (the growth rate reaching 17.6 per cent in the second quarter), while export growth also remained strong (reaching 19.5 per cent in the same quarter). Incoming FDI reached EUR 4.7 billion in the first half year (it was EUR 3.5 billion in the corresponding period of the previous year).

In 2007 Poland's trade and services balance is likely to deteriorate compared to 2006. According to the National Bank of Poland the current and capital account deficit will remain at a safe level and will be largely financed by the inflow of foreign capital from direct investment.

Labour market

In the second quarter of 2006 favourable tendencies continued in the labour market. A further reduction was experienced in the unemployment rate, which was 16 per cent. Strong economic growth was thus increasing labour demand. In August 2006 employment growth in enterprises reached 3.5 per cent year-on-year. According to the Labour Force Survey the number of people working outside private farming grew by 5.3 per cent in the second quarter. At the same time a drop was experienced in the economically active population (1.1 per cent compared to the corresponding quarter in the previous year).

The improvement in the labour market is expected to continue in the rest of the year 2006, and in 2007. By December 2006 unemployment rate is expected to go down to 15.4 per cent. The reduction is expected to continue in 2007, with unemployment rate reaching 14.2 per cent at the end of 2007.

Table 7: Major macroeconomic indicators for Poland, 2005-2007

	2005	2006*	2007*
GDP growth (%)	3.3	5.2	**5.0**
-Private consumption (%)	2.0	4.9	**4.2**
-Public consumption (%)	2.2	2.0	**2.0**
-Investments (%)	6.6	10.5	**10.0**
-Export (%)	17.1	19.5	**15.0**
-Import (%)	12.6	19.4	**17.0**
Consumer price index (average, %)	2.1	1.0	**2.4**
Consumer price index (dec/dec, %))	0.7	2.0	**2.4**
Unemployment ratio (%)	17.6	15.4	**14.2**
Real wages (%)	1.2	4.0	**2.5**
General government balance (% in GDP)	-2.9	-2.8	**-2.7**
Public debt/GDP (%) ESA 95	46.3	47.0	**46.0**
Current account/GDP (%)	-1.4	-1.4	**-2.4**
Trade balance/GDP (%)	-0.9	-1.5	**-2.2**
Gross foreign debt/GDP (%)	43.5	40.6	**41.7**
Base rate	4.5	4.00	**4.00**

** Forecasts by ICEG staff*
Sources: National Bank of Poland, World Bank, Bank Zachodni WBK, Bank Austria Creditanstalt, OECD, Deutsche Bank Research, EU

Slovakia

High economic growth takes a healthier path with net exports and investments gaining momentum

Growth

The rate of economic growth in the second quarter of 2006 reached 6.7 per cent in Slovakia, which indicates an acceleration of economic activity in the country given that the first quarter showed a year-on-year change of 6.3 per cent. This rate of growth is the highest among the Visegrad countries. It is forecasted to remain so in 2007 as well, with an even stronger growth performance of around 7 per cent.

As it was already indicated in our last report, in 2006, there is a shift between the contribution of foreign and domestic demand to growth, the former becoming more pronounced than in previous years. The contribution of investment (GFCF) to growth is also more significant than in previous years. High investment rate can be partly attributed to FDI, which is still more moderate compared to the GDP, than in the Czech Republic or Hungary, but the annual inflow is estimated to be higher this year than in the three years after 2002. Government and household consumptions' growth contribution was lower compared to previous periods, however, their rate of increase is still significant (above 6 per cent).

The change in the contribution of growth factors, indicated already in our last report, seems to be more pronounced in the second quarter. Government and especially household consumption had a slower (below 6 per cent) growth rate, while exports accelerated again by more than 18 per cent in a year-on-year comparison, according to the data of the Statistical Office. GFCF went up by close to 7 per cent, according to the same source.

Monetary developments

The level of consumer prices (CPI) increased by 5.1 per cent on a year-on-year basis in August 2006, according to the data of the Statistical Office, which indicates an acceleration in the monthly rates of inflation in 2006. (The January rate was only 4.1 per cent, which gradually increased to above 5 per cent by August.) It is mainly the prices of public services (health, energy and education), which increased the most on a year-on-year basis, mainly due to a change in regulated prices at the beginning of the year. Inflation (CPI) is expected to increase to above 5 per cent in 2006 as a whole. This trend is backed by the fact, that PPI is running ahead of CPI, according to the World Bank. Both cost-push and demand-pulled elements of inflation are present, together with one-off impacts. However, predictions by international organisations assume a weaker inflationary pressure for 2007, resulting in a below 3 per cent rate of inflation for that year, not endangering the fulfilment of the relevant Maastricht criterion and thus not delaying the adoption of the euro.

The Bank Board decided to increase the two-week repo rate by 0.25 percentage points at the end of September. The main reason behind the decision is the increase in the rate of growth of GDP, and connected increase in employment and wages. This latter also indicates that inflationary pressures are present in the economy. Moreover, the monetary policy will be under further pressure this year because of strong output growth, 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. It is also a problem, despite of the entering of the koruna in the ERM-II, that investors do not differentiate between Slovakia and other Visegrad countries, which is indicated by the turbulences in May-June-August. Frictions by the difference between ECB and NBS rates may cause problems for the monetary policy.

Given the uncertainty surrounding the results of the elections and then the economic policy stance of the new SMER-SNS-HZDS coalition government, the emerging market sell-off affected Slovakia negatively in May-June 2006. The fall of the exchange rates induced the NBS to intervene on the market – it spent a part of its reserves (an estimated

USD 4 billion) to keep the exchange rate of the koruna at the desired level.

Fiscal policy

The budget deficit will be kept below the level of the Maastricht criterion of 3 per cent of GDP in 2006 and 2007 as well (without the cost of pension reform). In spite of being an election year, in 2006, a lower than 2005 budget deficit is expected, due to the strong growth record and large tax revenue growth. According to the plans of the government, the budget deficit will be further reduced in 2007. Uncertainty surrounds the spending plans of the new government, however, it declared to stick to the original timetable of the introduction of the euro, which does not allow great changes in fiscal plans. The draft budget for 2007-2009 points in the direction of keeping the deficit below the 3 per cent level. Positive impacts of the fiscal reform are appearing in the budget data of the Slovak Republic as well as in better records of the country in international comparisons (e.g. Doing Business by the World Bank). 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 is also a sign 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. According to the plans, the budget deficit will reach 2.2 per cent this year and 1.9 per cent in 2007 (without the cost of pension reform).

External balance

The rate of growth in export and import increased further in the second quarter, to 22.4 per cent and by 24.1 per cent on a year-on-year basis, respectively. This resulted in a 30 per cent higher trade deficit compared to the corresponding period in 2005. However, the current account deficit is expected to be slightly lower in 2006 than in 2005, backed by the more favourable developments in net exports forecasted for the year as a whole. Signs of this latter are still awaited. Exporting of large greenfield FDI projects in the car industry may contribute to high growth of exports, the realisation of which is indicated by the high growth rate of industrial production in the manufacture of transport equipment (27.6 per cent in July) and the related metal industry (24.8 per cent). Partly fuelled by this latter factor, net exports are expected to turn positive later in the year and the current account deficit is forecasted to narrow further in 2007.

Balance of payments data of the January-May period show a significant trade deficit and a slight surplus of the services trade. However, the capital account shows a negligible deficit, which is more than counterbalanced by the surplus of the financial account, resulting in a positive overall balance. Foreign direct investments show a much better picture than in 2005: in the first five months of 2006 it already surpassed USD 1.7 billion, mainly coming from new investments, and to a lesser extent from reinvested earnings. The balance of portfolio investments showed a surplus of USD 712 million, while other investments turned into a deficit of more than USD 800 million. Further improvement of the current account is expected to keep the balance of payments data in a better position than in 2005, which trend is expected to continue in 2007.

Labour market

In the second quarter of 2006, total employment increased further by 4.6 per cent on a year-on-year basis, which may be attributed to the favourable growth record. Thus, decreasing unemployment is largely of cyclical nature. There is an increase in the number of vacancies, which contributed to a further reduction in the number of unemployed to its lowest value in the last seven years. However, the unemployment rate is still among the highest among the NMS countries (together with Poland). According to the data of the Statistical Office, the unemployment rate went down to 14.2 per cent and registered unemployment stood at 10.2 per cent at the end of July. As far as the branches of the economy are concerned, unemployment went down to the greatest extent in industry and in social services. In terms of the length of unemployment, decrease was detected in all categories. The only problematic field is that of first time employed people, for which category there was an increase in the number of unemployed. On the other hand, while declining, long-term unemployment is still among the highest in Visegrad countries. For 2006 as a whole and 2007, a further decrease in unemployment is expected due to strong economic growth.

Real wages increased further in the second quarter, by 4 per cent, according to the data provided by the Statistical Office. While this indicates an acceleration compared to the previous quarter, the rate of growth is lower than in the corresponding period of 2005. Real wages grew in all branches of the economy and the fastest growth characterised public administration, education and trade. Altogether, real wages grew more on a year-on-year basis in the private sector than in the public one.

Table 8: Main macroeconomic indicators for Slovakia, 2005-2007

	2005	2006*	2007*
GDP growth (%)	7.5	6.7	**7.0**
-Private consumption (%)	5.8	4.9	**4.5**
-Public consumption (%)	1.6	3.3	**3.5**
-Investments (GFCF, %)	11.5	9.5	**8.5**
-Export (%)	10.2	11.7	**12.6**
-Import (%)	9.3	10.7	**12.2**
Consumer price index (average,%)	2.7	4.6	**3.6**
Unemployment ratio (%)	16.2	14.4	**14.3**
Real wages	6.3	4.2	**4.0**
Real ULC	n.d.	1.0	**1.5**
General government balance (%)	-2.9	-2.2	**-1.9**
Public debt/GDP (%)	44.2	44.0	**44.0**
Current account /GDP (%)	-6.1	-6.5	**-6.4**
Trade balance /GDP (%)	-4.8	-4.6	**-4.4**
Gross foreign debt /GDP (%)	49.8	48.0	**47.5**
Basic interest rate (%)	3 (November)	4.75 (September)	**3**

** Forecasts by ICEG staff*
Sources: EU, IMF, OECD, Slovak National Bank, Slovak Ministry of Finance

Slovenia

Final months in a smooth run-up to the euro; structural reforms remain a medium-term challenge

Growth

Impressive economic growth continued in the first half of this year. Real GDP grew by 4.9 per cent year-on-year in the second quarter of 2006. This marks a substantial increase compared to the figure of 2005, when Slovenian economy grew at 4 per cent. The favourable growth trend of this year was caused mainly by strong investment spending. As the euro introduction draws nearer household consumption is expected to strengthen. This will be due to favourable credit opportunities and increasing employment. Accelerated construction of motorways and surging housing construction will continue to boost investment spending this year. In the light of the strong economic growth in the first half of 2006 we expect that the annual real GDP growth will be 4.5 per cent this year and 4.1 per cent in 2007. The real GDP growth rate forecasted for next year reflects the expected slowdown in the international economic activity.

Monetary developments

The Bank of Slovenia raised its main refinancing rate by 25 basis points to 3.75 per cent at the beginning of August 2006. However the rate hike did not lost long as it was lowered to 3.5 per cent on 6 October 2006. Meanwhile ECB raised its key policy rates twice in the last two months to 3.25 per cent (minimum bid rate on the main refinancing operations). Thus the gap between the Bank of Slovenia and ECB rates was reduced to 25 basis points. We expect that this gap will disappear by the end of 2006 as part of the process of nominal convergence with euro-zone interest rates.

The euro will become legal tender in Slovenia on 1 January 2007 and will replace the Slovenian tolar at the irrevocably set conversion rate of 239.640. This exchange rate is the same as the central parity of the ERM2 which Slovenia joined in June 2004.

Year-on-year inflation decreased to 2.5 per cent in September 2006 after a sharp rise in August 2006 - reaching 3.2 per cent - mainly fuelled by high oil prices. Average annual inflation remained unchanged in September compared to the previous month and stood at 2.5 per cent. The largest risk concerning price developments remains the possibility of an oil price hike caused by production cut of OPEC countries.

We are expecting average annual inflation rates of 2.5 per cent in 2006. Average annual inflation will not decrease next year due to the announced hikes in excise duties.

Fiscal policy

General government finances had almost no deficit in the first half 2006 due fast revenues growth which outstripped expenditure growth.

The Slovenian government led by Janez Janša planned to introduce a flat tax system with a rate of 20 per cent from the beginning of 2007. However trade unions strongly opposed the idea of a flat tax system. The government latest tax reform proposal was unveiled in September 2006. If the Slovenian Parliament passes the law in November the new tax legislation will enter into force as of 1 January 2007. The number of tax brackets will be reduced from five to three. The highest personal income tax rate will be 41 per cent, the middle rate 27 per cent while to lowest income tax rate will remain at 16 per cent. Corporate income tax rate will be reduced by two percentage points to 23 per cent from the beginning of next year.

Tax reform will have a negative affect on the central government revenues, which will not be fully compensated by stronger economic growth and planned expenditure cuts. We expect the general government deficit will reach 1.4 per cent of GDP in 2006 and 1.6 per cent in 2007.

Financing pension is the major medium and long term challenge for Slovenian public finances. The European Commission has recently called on Slovenia to enact changes in the pension system. According to the Commission's report the projected expenditure related to population ageing is expected to increase by 9.7 per cent of GDP between 2004 and 2050.

External balance

Due to methodological changes in the balance of payments statistics the Bank of Slovenia reviewed the balance of payments figures for the 2000 to 2005 period. Thus our current forecast includes the revised data for the year 2004 and 2005. According to the latest data of the Bank of Slovenia the current account deficit amounted to EUR 79 million (0.6 per cent of GDP) in the first half of 2006. This shows a slight improvement compared to the same period of 2005. We expect that the current account deficit will reach 2.3 per cent of the GDP this year while it will amount to 1.5 per cent of GDP in 2007. Current transfers from the EU budget will improve the balance of the current account next year.

According to recent UNCTAD World Investment Report FDI inflows to Slovenia amounted to USD 496 million while outward FDI flows amounted to USD 568 million in 2005. The share of foreign direct investments in gross fixed capital formation was 5.9 per cent, much lower than in other NMS countries.

Labour market

The number of people in employment in the first half of 2006 increased on average by 1.8 per cent compared to the same period of last year. The unemployment rate was 5.9 per cent in the second quarter of 2006. Favourable economic conditions and the phasing out of the payroll tax will positively contribute to employment growth in 2006. Owing to the high activity rate and the increasing population the unemployment rate will stay around 6.3 cent in 2006 and 2007.

Table 9: Major macroeconomic indicators for Slovenia, 2005-2007

	2005	2006*	2007*
GDP (%)	4.0	4.5	**4.1**
-Private consumption (%)	3.4	3.3	**3.2**
-Public consumption (%)	2.5	2.5	**2.6**
-Export (%)	10.3	10.0	**8.4**
-Import (%)	6.8	9.0	**7.4**
Consumer price index (average, %)	2.5	2.5	**2.5**
Consumer price index (Dec/Dec, %)	2.3	2.4	**2.2**
Unemployment ratio (%, ILO)	6.5	6.3	**6.3**
Real wages (%)	2.1	2.3	**2.6**
General government balance (% in GDP)	-1.4	-1.4	**-1.6**
General government debt /GDP (%)	29.3	29.5	**29.8**
Current account /GDP (%)	-2.0	-2.3	**-1.5**
Trade balance /GDP (%)	-0.5	-0.7	**0.1**
Gross foreign debt /GDP (%)	71.4	76.8	**82.5**
Main refinancing rate (end of period)	3.75	3.0	**3.0**

** Forecasts by ICEG staff*

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

EMU entry: Growing Delays in Central Europe and the Baltic States

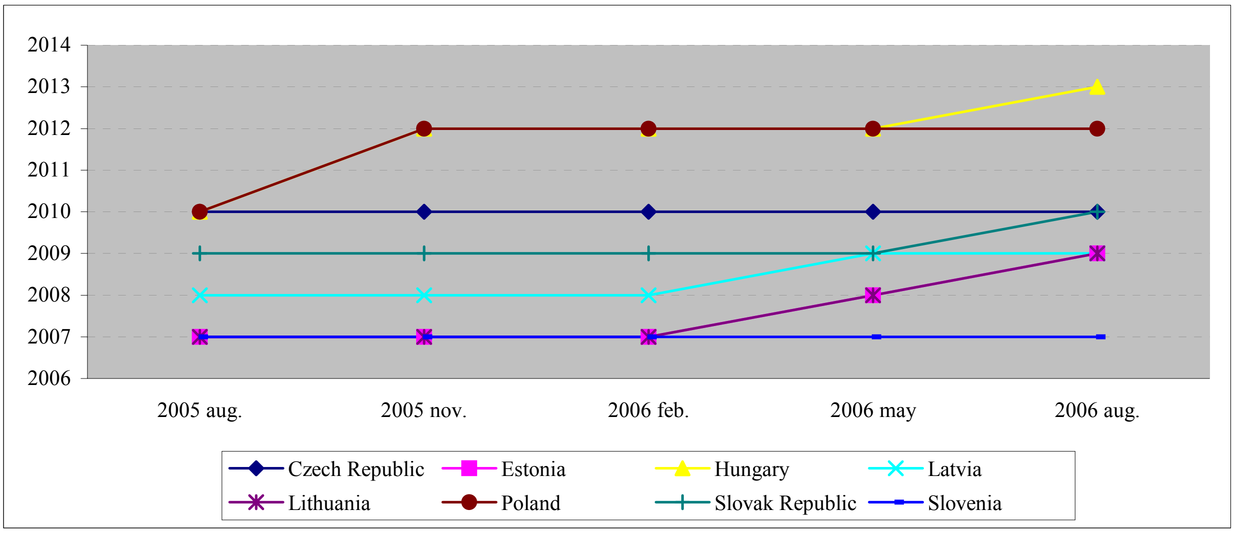
Pál Gáspár

Introduction

Notwithstanding the benefits of joining the euro-zone and the earlier strong commitments of the new member states to become its member, the prospects of the fast entry seem to fade away in Central Europe and the Baltics. While economic growth remains robust and in most cases sustainable and broad-based, macroeconomic imbalances have started to build up in the areas most relevant for the qualification to EMU entry (inflation and fiscal imbalances). As described later these imbalances don't seem to be only of cyclical nature but reflect structural weaknesses, which make their management more time consuming and costly.

The stance of policy makers also reflects delays in the timing of entry. In several cases (Hungary, Lithuania, Estonia) the official entry target dates have been postponed, in others (Poland) the policy makers expressed open concerns related to fast entry, while in others (Czech Republic) the official entry date have not been announced so far.

Chart 1: The gradual shift of entry date expectations by the markets



Increasing macroeconomic imbalances and the changing attitude of policy makers have also affected the perceptions of the markets as they have also become more sceptical about the likely entry dates. As the chart above shows markets have shifted forwards their expectations in recent months: in the last 12 months the average of the expected entry date moved forward by almost two years, which reflects a significant increase in the pessimism of markets concerning the timing of EMU membership.

Inflation and fiscal performance behind delays

The reasons behind the likely later entry are linked to macroeconomic imbalances in the new member states. The major problems are related to growing inflationary pressures and worsening fiscal imbalances across almost all countries. However, there is a clear distinction between the Baltic States and Central European countries: while in the former group the main cause of the delay is related to inflation performance, the delay in Central European countries is linked to fiscal imbalances.

Consumer price inflation has been rising in almost all Baltic and Central European countries, though from different level and with varying speed. There are several, mainly supply side factors, which account for the acceleration of inflation. On the one hand there has been a fast increase in food and energy prices, driven by the changes in internal terms of trade and global market conditions (mainly oil prices). This has been associated with a marked rise in producer prices, which may feed back to consumer price increases, especially as inflation expectations are also on rise in most of the countries.

Another supply-side source of inflation in the Baltic States has been the fast increase of nominal wages leading to real wage increase far exceeding labour productivity growth. The decline of labour supply and tightening of labour markets have been behind the fast increase of real wages, which in most of the Baltic States has been around 10 percent.

As these supply side factors of inflation are either exogenous or structural, it will be difficult to reverse them. Moreover, core inflation has also been in rise in recent months especially in Hungary, Poland and in the Baltic States with the exception of Latvia. The rise in core inflation may also reflect the effect of fiscal imbalances, and fast nominal and real growth in loans to both corporate and mainly households sectors, which leads to declining liquidity constraint and growing spending propensity of the private sector.

Inflationary pressures have already delayed the adoption of euro in the Baltic countries and will cause problems for Slovakia and especially Hungary, where it might be difficult to reduce the temporary inflation surplus stemming from the inflationary effects of the announced fiscal austerity program. In the Baltic States official entry dates have been delayed and there are additional factors (including increases in excise taxes) that may create further delays in meeting the Maastricht inflation criterion.

While there are differences in the inflation record of individual countries, it may prove costly and time consuming to reduce inflation. First, some of the symptoms of fast real convergence (increases in real wages, fast rise in labour productivity leading to the well-known Balassa-Samuelson effect, credit growth to the household sector, etc.) will prevail for long time and will add to inflation. Second, several factors of inflation are of structural nature (labour shortages, food prices, etc.), which will require prolonged adjustment and commitment from policies. Finally, market sentiment seems to be changing in several countries leading to a renewed rise in inflation expectations.

While inflation performance is worrying mainly for the Baltic States, fiscal imbalances are a problem in the Central European countries. According to our estimates no Central European country will be able to meet the deficit criteria either in 2006 or in 2007 with Hungary surpassing quite significantly the debt criterion as well.

There are several factors that deepen the recent fiscal problems and complicate the undergoing fiscal corrections. First, the renewed increase in fiscal deficits partly reflects the lack of fiscal adjustment during the recent years of good cyclical position and beneficial external financial conditions. None of the Central European countries was able to utilise the positive effects of fast real GDP growth on the primary balance, or the savings derived from benign international financial conditions.

Instead of tightening, Central European countries (with the exception of Slovakia) relaxed their fiscal policies reflected in worsening primary balances. This relaxed fiscal stance has also reflected the rises of social expenditures driven by the political cycle, increases in public sector investments and rises in wage outlays.

Second, the countries were so far unable to adjust fully to the fiscal consequences of EU entry. Several earlier studies estimated that the entry will lead to the decline of primary balances by 2-4 percentage point of GDP due to the decline of revenues and increase of co-financing expenditures related to the receipt of the EU Structural Funds. While the decline of revenues materialised immediately, the rise in co-financing expenditures will become full scale during the next financial perspective, when the level of Structural Funds received by these countries will exceed significantly its level during 2004-2006. The entry to the EU has worsened by 1-1.5 percentage points the fiscal balances in the Central European member states.

Another reason behind worsening fiscal stance is the absence of consensus on major structural reforms. With the exception of Slovakia (where the new government seems to be inclined to reverse partly these fiscal reforms) Central European countries refrained themselves from introducing institutional and structural changes in general governments.

The maintenance of existing expenditure regimes has proven increasingly costly and has been one of the main driving factors behind the rise of primary expenditures. With the exception of Slovakia, no country embarked on ambitious structural reforms, reflecting also the lack of political consensus on the main areas and instruments of these reforms.

Hungary is in the most difficult fiscal position due both to the size of the fiscal adjustment needed to reduce the deficit to the threshold level and to reverse the fast accumulation of public debt, and to the depths of structural problems inside the general government.

Poland and the Czech Republic have seen in recent years the decline of fiscal deficits driven mainly by the positive cyclical effects of fast real growth. However the absence of structural reforms and the rise in fiscal expenditures may lead to higher deficits as reflected among others in forecasts for 2006 and 2007.

While Slovakia is the only country which embarked on significant reforms affecting both the revenue and expenditure sides, the future of these reforms is uncertain considering the political changes. The new government sent unclear signal concerning its intention to keep the major reforms unchanged, some of the recent measures create uncertainty and increase the likelihood of worsening fiscal performance.

In the Baltic States, the fiscal criteria do not seem to be an effective constraint as both fiscal deficits and public debt levels are low. At the same time, Latvia and Lithuania may move from fiscal surplus to deficit or to increase their fiscal deficits driven mainly by the rise in social outlays of the central governments.

Consequences of the later entry dates

The delays of the entry to the euro-zone will affect the macroeconomic performance of the seven countries as they will start enjoying the benefits of the euro-zone membership later. This is especially related to the positive growth effects of the EMU membership stemming from its trade creating effect, absence of exchange rate volatility and increased correlation of business cycles among the EMU members.

Another macroeconomic effect of later entry to the euro-zone will be exchange rate vulnerability and higher interest rate levels in the Central European countries. These small open economies are heavily exposed to the sentiment of international capital markets, while their monetary and fiscal policies frequently create additional market turbulence. The delay of the entry will keep exchange and interest rate volatility high with its negative effect on both economic growth and macroeconomic imbalances.

A third consequence of the later EMU entry will be the increase of financial vulnerability in the new member states, which stems from the exchange rate volatility. There has been in recent years a fast growth of total and especially foreign currency denominated credit to the private sector. While on the one hand this has been a sign of financial deepening and real convergence, on the other hand the speed of increase raised concerns regarding its risks and sustainability. The later entry to the euro zone will increase debt service expenditures, the larger the exposure to exogenous shocks and vulnerability due to remaining exchange rate volatility and higher interest rates.