ICEG EUROPEAN CENTER

Quarterly Forecast

on the 8 New Member States

Winter

TABLE OF CONTENTS:

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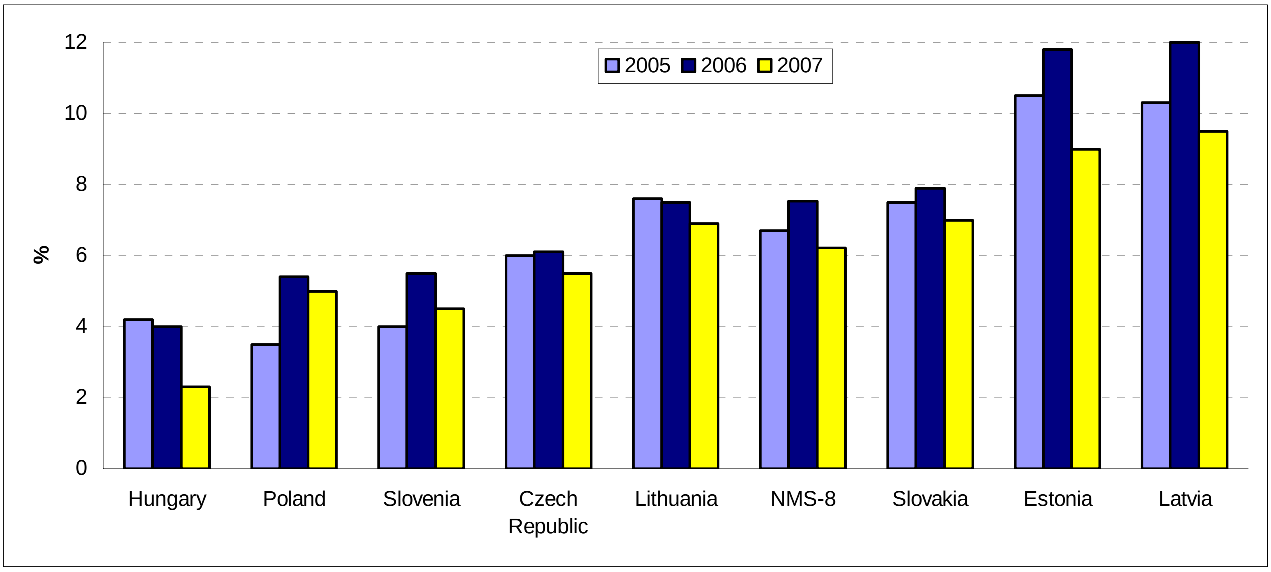
OVERVIEW OF THE NMS-8

Growth

Growth performance improved in most NMS countries in 2006. The average growth rate of the NMS-8 was 7.5% in 2006, up from 6.7% in 2005. Only Hungary and Lithuania show signs of deceleration. The three Baltic economies are still among the fastest-growing: real GDP rose by almost 12% in Estonia and Latvia in 2006; Lithuania slowed down to a still respectable 7.5%. As a result of income growth, easier access to credit and the inflow of EU funds domestic demand became a more significant source of growth in most countries. Net exports have a sizeable negative contribution to growth in the Baltics. In Central European economies the structure of growth remains more balanced. A slight slowdown is expected in some countries 2007. Overheated Baltic economies are expected to narrow their positive output gap. Hungary's fiscal austerity package will halt domestic demand growth. The rest of the region will experience broadly similar growth rates as in 2006; the average rate of economic growth of the region is expected at 6.2%.

Chart 1: GDP growth rates in the NMS-8



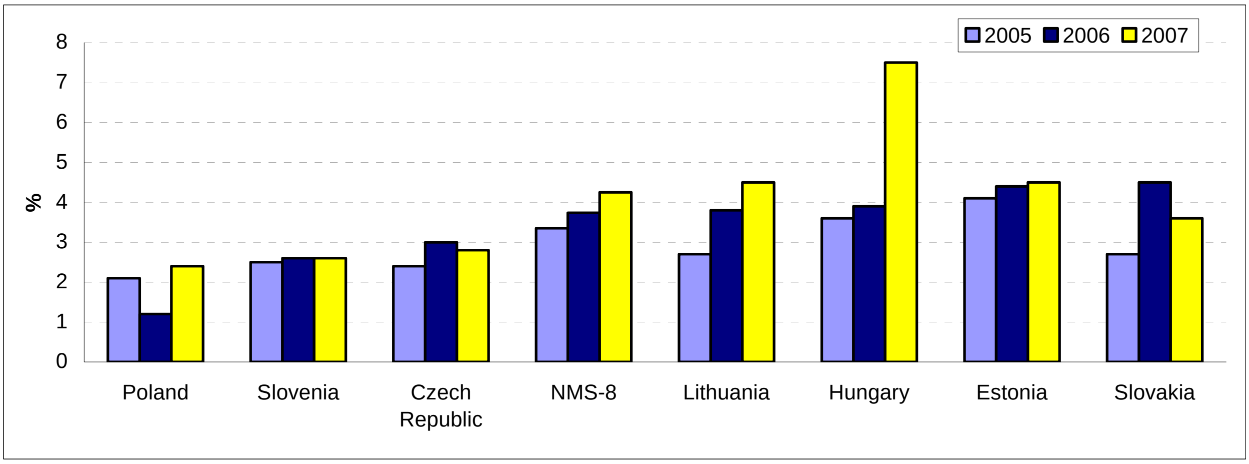
Monetary developments

Inflation was creeping upwards in 2006 in most NMS-8 countries, with the exception of Poland. The average inflation rate rose from 3.3% to 3.7%. Further increases are expected in 2007 to 4.2%. Domestic demand pressures, rising wages and external factors (mainly energy prices) are to blame. Inflation is especially problematic in Latvia, where demand side pressures are proving difficult to contain. Hungarian inflation will jump to 7.5% in 2007 as a result of indirect tax increases and rising regulated prices. Countries with flexible exchange rates saw their currencies appreciate in the last months.

Most NMS-8 countries do not meet the Maastricht inflation criterion at present. This is the main reason for the postponed euro-zone entry of Baltic states.

Slovenia became the first country of the region to adopt the common currency on January 1st 2007.

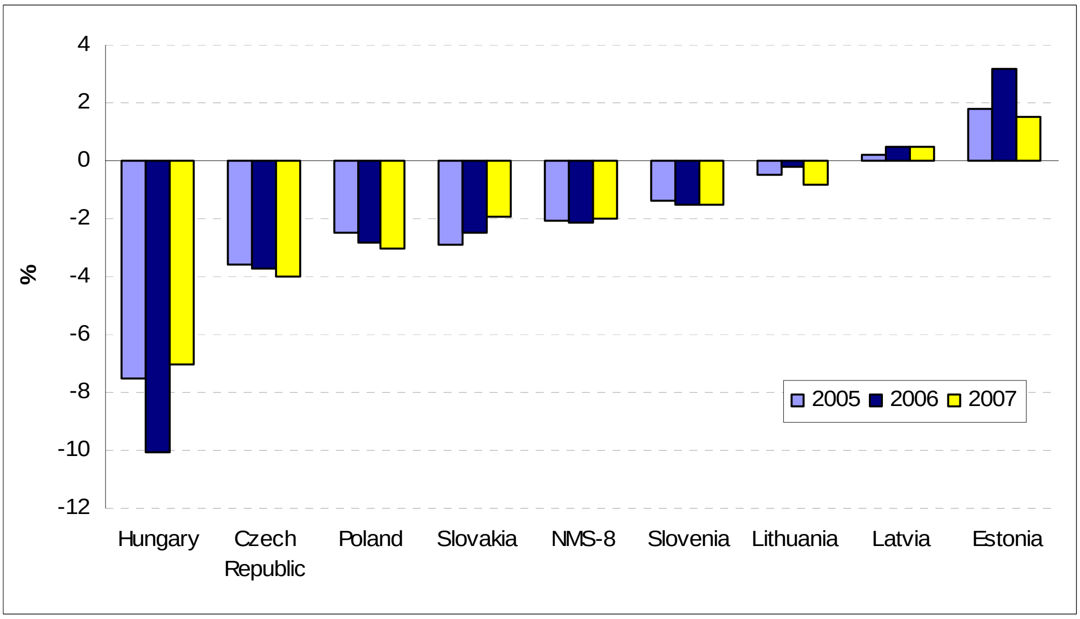
Chart 2: Inflation in the NMS-8



Fiscal policy

Budgetary positions are relatively stable in the region as a whole: the average deficit increased from 2% in 2005 to 2.1% in 2007 and is expected to decline to 2% in 2007. Individual countries show different patterns. Hungary saw ballooning deficits in 2005-2006, reaching 10.1% of GDP last year. An austerity package is expected to bring the deficit to 7%, still the largest in the region. Balances in the Czech Republic and Poland are slightly deteriorating while the balances of Slovakia and the Baltic countries are improving. Except for Hungary and the Czech Republic all countries comply with the Stability and Growth Pact. Public debt is increasing in Hungary and to a smaller extent Lithuania and Poland; it is stable elsewhere.

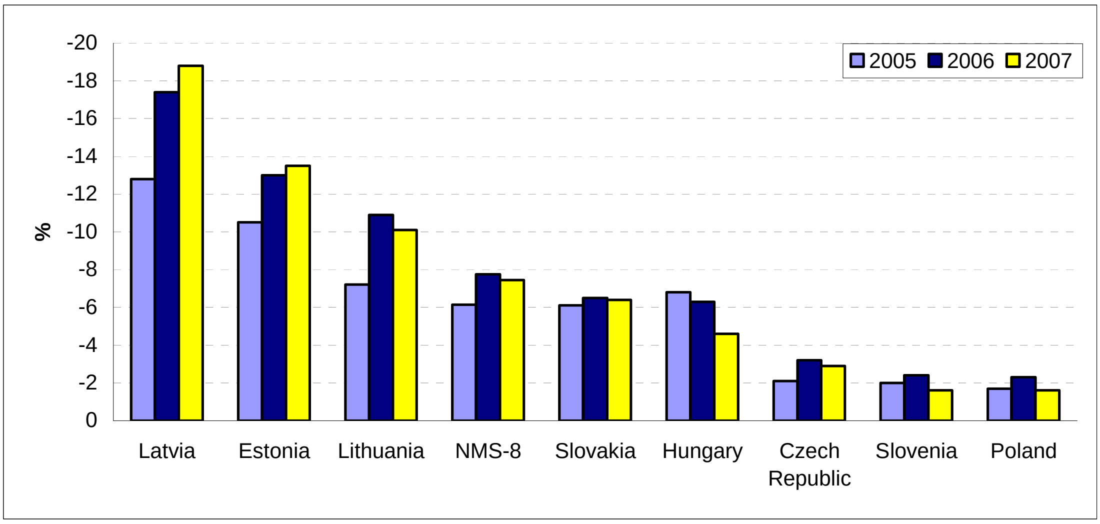
Chart 3: General government budget balances in the NMS-8



External balance

Current account deficits increased in most countries. The regional average rose from 6.1% to 7.7% and will decrease slightly to 7.4% in 2007. The Baltic countries all produced double-digit deficits in 2006. Estonia and Latvia are the only two countries where external imbalances are expected to widen in 2007. Latvia seems particularly vulnerable with a 18.8% expected current account deficit this year. The deterioration of external positions in most NMS countries is the result of strengthening domestic demand. Trade balances were improving in the Czech Republic, Hungary and Slovakia. In Hungary a trade surplus is expected to be the only significant contributor to economic growth in 2007. Gross foreign debt is rising in five countries, for different reasons. In the three Baltic economies the private sector borrows from abroad. In Hungary private borrowing is coupled with rising government debt. In Slovenia integration to the euro-zone could explain increasing foreign liabilities.

Chart 4: Current account deficits in the NMS-8



Labour market

Thanks to sustained economic growth unemployment is falling throughout the NMS-8 except for Hungary. The average unemployment rate decreased from 10.1% to 8.6% in 2006. Labour shortages are appearing in the Baltic countries. Meanwhile, modest job creation characterises the rigid labour markets of Central Europe. Still, Poland and Slovakia, countries with the highest rates of unemployment, have made significant progress in this field. Real wage growth was strong in 2006: around 4% in Central Europe and above 10% in Baltic countries. This was one of the reasons for strong domestic demand last year. Rising labour costs are beginning to threaten competitiveness and fuel inflation in the Baltic region. Wage growth is expected to moderate in 2007. Hungary will experience a sharp drop in real incomes in 2007 due to the austerity package.

Chart 5: Unemployment rates in the NMS-8

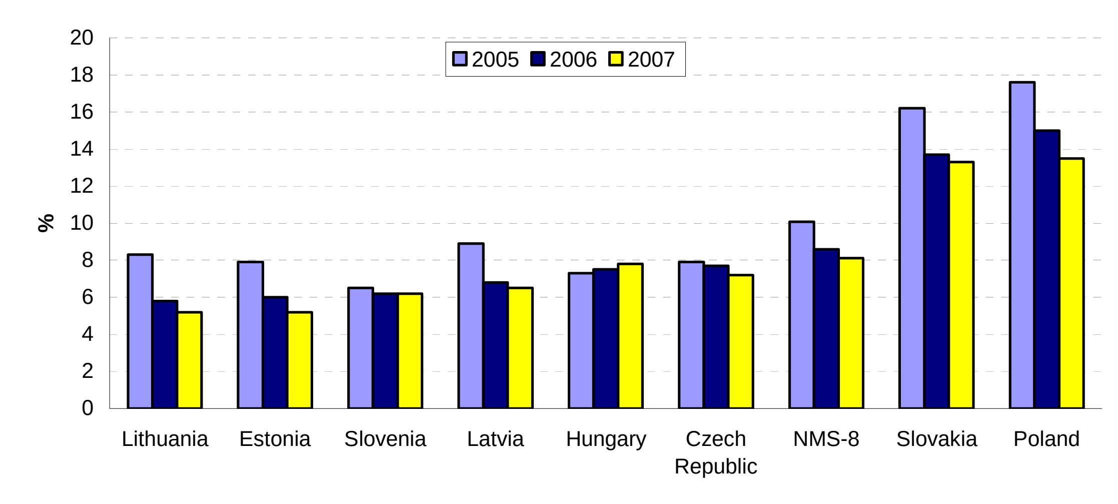


Table 1: Main macroeconomic indicators for the NMS-8, 2005-2007

	2005	2006*	2007*
GDP growth (%)	6.7	7.5	6.2
Consumer price index (average,%)	3.3	3.7	4.2
Unemployment rate (ILO, %)	10.1	8.6	8.1
General government balance /GDP (%)	-2.0	-2.1	-2.0
Current account /GDP (%)	-6.1	-7.7	-7.4

CZECH REPUBLIC

High rate of growth, low inflation and decreasing unemployment accompanied by political uncertainties and rising budget deficit

Political background

The country lacks government since the 2006 June elections, which produced no clear results. This has negative consequences on reform and on fiscal balance. A government was formed at mid-January but it may not pass the Parliamentary confidence vote. While growth rates are astonishing up till now, 2006 and 2007 growth developments are still shadowed by political uncertainty.

Growth

According to preliminary estimates, output growth in the Czech Republic amounted to 5.8% in the third quarter of 2006, signalling a downward tendency compared to the previous quarters. Growth rate for 2006 as a whole is estimated at 6% given the tendencies of the first three quarters. This is the second highest rate among the Visegrad countries after Slovakia. Expansion of net exports is still the main engine behind growth, though domestic consumption (both government’s and households’) is gaining momentum and its contribution to growth is increasing. Private consumption is especially high; it is indicated by the growth in retail sales which reached an annual 8.6% in October. This high growth rate can be explained by the increase in real wages.

Gross capital formation also accelerated during 2006. This indicates a slight change in the composition of the factors of growth from foreign demand towards domestic consumption and investments. In short, basically all components are involved in GDP growth. However, the deceleration of growth is also indicated by lower growth data of industrial production (7.6% in November), construction (7.9% in the same month) and net exports.

In November the annual growth rate of exports and imports increased to 16.1% and 14.2% in current prices, respectively. (Growth rates were even higher in euro or USD because of the appreciation of the koruna vis-à-vis these currencies.) This resulted in a higher trade surplus in the first eleven months of 2006 than in 2005. Thus, net exports continue to be the most important contributor to growth.

In 2007 net exports are expected to fuel growth again; however, their increase will probably be lower than last year, but private consumption is likely to grow at an even higher pace, due to the planned cuts in personal income taxes. Altogether in 2007 as a whole a lower growth rate of 4.8% is expected.

Monetary developments

A slight growth in inflation (CPI) characterised the end of the year, based on November and December data. Prices of goods increased by 0.9%, while prices of services rose by 3.1%. In December, the harmonised index of consumer prices increased by an annual 1.5%, which is lower than the the euro-area inflation rate (1.9%). Annual average inflation was 2.5% in 2006.

Producer prices decelerated; in December the 12-month growth rates stood at 2.6% for industrial and at 4.9% for agricultural products.

According to the Czech National Bank, inflationary pressures are low due to the strong currency and slower wage growth. The international environment can be assessed as neutral for inflation. However, some risks are present, such as strong economic growth, high investment demand, the planned rent deregulation and a rise in electricity prices in 2007. On the basis of these factors, forecasts for 2007 expect inflation above 3%, due mainly to the growth in consumption, regulated prices and indirect taxes. The National Bank does not exclude a 12-month CPI of more than 4% in September 2007.

In January, the two-week repo rate of the Czech National Bank stood at 2.5%, the lowest in the European Union (and lower the rate of ECB). It was left at that level since September 2006. The exchange rate of the koruna appreciated in real terms in the period as a whole; to a much greater extent than is was expected by the National Bank.

Fiscal policy

Preliminary data of end-2006 showed a higher than planned fiscal deficit. While the budget showed a surplus (0.5% of GDP) at the end of the first half of 2006, the second half (without government), and especially December witnessed a growing deficit. At the end of the year the budget was in the red by CZK 97.3 bn (approximately EUR 3.5 bn) against a planned deficit of CZK 74.4 bn. Tax revenues and revenues from social insurance were lower than planned, while government expenditures were higher. According to the National Bank, budget developments pose an upside risk to inflation. For 2007, similar tendencies are expected with the level of the budget deficit reaching 4%, thus surpassing the Maastricht criterion. The main reason is that unexpected revenues in 2005 were used as a basis for forecasting 2006 revenues. Thus higher social spending and a decrease in certain taxes were planned. Effects of these measures will be felt in the 2007 budget as well. Moreover, political uncertainties still surround the 2007 budget, due to the inability of the winner party to form a government.

External balance

The latest balance of payments data are available for November 2006. The current account deficit is caused by a deficit in the income balance according to the data of the National Bank. The trade balance is in surplus and is estimated to remain so until the end of the year; its surplus is higher than in 2005. Moreover, services trade also has a positive balance. The growing deficit on the income balance can be attributed to the payments of dividends and to reinvested earnings for companies with foreign participation. This item is responsible for the rising deficit in consecutive quarters in 2006.

Foreign trade data are available for November, and they show 16.1% annual growth of exports and 14.2% growth of imports in current prices. The trade surplus more than doubled compared to November 2005. In terms of the product composition of foreign trade, machinery and transport equipment group still 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 largest part of FDI this year is came in the form of reinvested earnings. FDI went mainly to trade, real estate, business services and mining and quarrying, and its overwhelming majority arrived from EU countries. Portfolio investments showed a relatively high deficit, due to the strong demand of domestic investors for foreign securities.

Labour market

The unemployment rate (registered unemployed) decreased slightly in December, and stayed at 7.7% at the end of the month, which is 1.2 percentage point lower than in December 2005, according to the data of the Statistical Office. Similarly, the harmonised unemployment rate stood at 6.9% in September, which is one percentage point lower than a year earlier.

Positive developments of the labour market are the following. Consecutive quarters showed a lower and lower average rate of registered unemployment, starting from 9% in the first quarter of 2006 and decreasing to 7.5% in the fourth quarter. There was an increase in the participation rate. The share of graduates looking for job decreased substantially. However, these tendencies might not continue, given the fact that he number of vacancies decreased substantially. Wage growth slowed down in the second half of the year, average gross wages and salaries grew by 3.1% in the third quarter in real terms, on the basis of the data of the Statistical Office.

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

	2005	2006*	2007*
GDP growth (%)	6.0	6.1	5.5
- Private consumption (%)	2.6	4.0	2.9
- Public consumption (%)	-0.5	1.0	0.2
- Investments (GFCF, %)	3.7	6.7	3.9
- Export (%)	8.7	15.0	8.7
- Import (%)	6.0	13.2	8.9
Consumer price index (average,%)	2.4	3.0	2.8
Unemployment rate (ILO, %)	7.9	7.7	7.2
Real wage growth (%)	4.4	4.0	0.8
Real ULC growth (%)	-1.5	1.0	0.5
General government balance /GDP (%)	-3.6	-3.7	-4.0
Public debt /GDP (%)	30.4	30.8	30.9
Current account /GDP (%)	-2.1	-3.2	-2.9
Trade balance /GDP (goods and services, %)	0.1	2.2	-0.5
Gross foreign debt /GDP (%)	38.4	38.5	38.5
2-week repo rate (end of year, %)	2.0	2.5	2.5

** ICEG EC projections/forecasts. Sources: Czech National Bank, Czech Statistical Office, Eurostat, IMF, OECD.*

ESTONIA

Strong economic growth with external imbalances

Political developments

The last months of 2006 saw a supplementary budget spending unexpected tax revenues, the re-nationalisation of the Estonian railway company, and tensions with Russia over the planned removal of Red Army monuments. Popular new president Toomas Hendrik Ilves can bring a fresh breeze into Estonian politics. He set the tone for the preparations to the 2007 elections by criticising political parties for indecision and infighting. He also encouraged citizens to participate more actively in shaping the future of the country.

Growth

Strong growth persists: GDP growth in the first three quarters of 2006 was 11.6% compared to the same period in 2005. Domestic demand remains the engine growth. Private consumption rose by 15.6% in the first three quarters; retail sales recorded a 23.2% increase in value during the same period. Gross fixed capital formation increased by 18.8% in the first three quarters. It was particularly boosted by 20.5% quarterly growth in the third quarter.

On the other hand, growth of public consumption remained moderate at 2.4% in the first three quarters. Export growth lost momentum but still reached 13.8% in the first three quarters. Import growth climbed to 16.2% due to strong domestic demand. As a result, net exports contribute negatively to GDP growth in 2006.

Domestic demand is still fuelled by income and credit growth. Real estate investments continue to play an important role.

GDP growth is expected to reach 11.8% in 2006. We do not expect private consumption to decrease in 2007 as wage growth is expected to continue, the flat income tax rate decreases by one percentage point, and the competition of banks for individual borrowers is getting fiercer. GFCF growth is expected to dampen as 2006 is an exceptional base year, but it will remain in double figures. Public consumption growth is projected to remain moderate. We anticipate a slight slowdown in the growth of foreign trade but its negative contribution to growth will persist in 2007. These expected developments lead to a 9% GDP growth forecast for 2007.

Monetary developments

12-month inflation reached 5.1% in December, therefore annual average inflation in 2006 was 4.4%. Inflation was driven by increasing housing prices (up 10.4% from 2005) and fuel price developments. Due to persistently strong domestic demand, inflation is unlikely to ease in the near future: we expect CPI at 4.5% for 2007.

The average 3-month TALIBOR money market rate was 3.85% at the end of 2006; it has been rising all year from 2.6% at the beginning of 2006, following interest rate developments in the euro-area. Interest rates of kroon loans to the government and to enterprises were also increasing by 0.5-1 percentage points between January and November. However, lending rates to households plunged by 4 percentage points indicating cut-throat competition among banks.

Outstanding bank loans grew by 32.6% between November 2005 and November 2006. Loans to enterprises and individuals increased by 57% and 65% respectively, fuelling the consumption and investment boom of the economy. The quality of the loan portfolio deteriorated slightly: the share of loans past due increased by 0.4 percentage points to 3.1% by November 2006.

Fiscal policy

By the end of November the state budget collected EEK 61.5 bn revenues while expenditures amounted to EEK 54.3 bn expenditures. Once again, revenues surpassed targets and a significant part of windfall revenues was spent: a supplementary budget was passed on November 22, 2006. This budget channels EEK 2 bn into the pension reserve and brings forward spending targeted for 2007 including extra funds for health care and public administration. The budget surplus is expected to reach 3.2% of GDP in 2006.

The 2007 budget was passed on December 13, 2006. It targets EEK 75.9 bn revenues (up 23.2% from 2006) and EEK 74.8 bn expenditures (up 21.4%). Large increases are planned in spending on education, internal security and regional development. These include significant wage rises for civil servants, which could lend another boost to wage growth in the economy in 2007.

The state will also buy back Estonian railroad company AS Eesti Raudtee from its private owner Baltic Rail Services for EEK 2.35 bn. The deal comes after years of feuding between the company and the Ministry of Economy over the regulation of the railway sector.

We expect the budget surplus to reach 1.5% of GDP in 2007. Despite sound government finance, doubts can be raised over the effectiveness of fiscal policy in cooling down the overheated economy.

External balance

The value of goods exports increased by 26% in the first three quarters of 2006; imports rose by 29%. Exports and imports of services increased by 10% and 12% respectively. As a consequence, the trade deficit increased from EUR 467 mn to EUR 878 mn since the same period last year. We expect the trade deficit of goods and services to reach 9.3% in 2006, while the current account deficit will amount to 13% of GDP. According to our estimations the current account deficit will increase to 13.5% in 2007 because of a deteriorating trade balance.

Net FDI inflows to Estonia amounted to EUR 373 mn in the first three quarters, covering 29.5% of the current account deficit. As a result of the ongoing lending boom the value of gross foreign debt increased by an annual 29% in the third quarter of 2006. We expect its year-end value to reach 97.5% of GDP in 2006 and 99.5% in 2007.

Labour market

Job creation remains stronger than our previous expectations. The annual growth in employment was 6.2% in the third quarter of 2006; as a result, unemployment continued to decrease to 5.4% in the same period. Unemployment is expected to reach an average 6% in 2006 and will fall to 5.2% in 2007.

Gross wages rose by an annual 15.7% in the third quarter of 2006; net wage growth was slightly higher due to decreasing income taxes. Average gross wage growth is expected to reach 16% in 2006 and 15.5% in 2007. Real wages will increase by 12% in 2006 and 10.5% in 2007. Due to a decreasing tax burden on labour and productivity gains, real unit labour costs will decline by 1% in 2006 and by 0.5% in 2007.

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

	2005	2006*	2007*
GDP growth (%)	10.5	11.8	9.0
- Private consumption (%)	8.2	14.5	14.0
- Public consumption (%)	1.1	2.2	2.0
- Investments (GFCF, %)	12.7	16.8	12.0
- Export (%)	21.5	13.5	11.0
- Import (%)	15.9	15.8	13.0
Consumer price index (average,%)	4.1	4.4	4.5
Unemployment rate (ILO, %)	7.9	6.0	5.2
Real wage growth (%)	7.7	12.0	10.5
Real ULC growth (%)	-2.2	-1	-0.5
General government balance /GDP (%)	1.8	3.2	1.5
Public debt /GDP (%)	4.5	3.8	3.3
Current account /GDP (%)	-10.5	-13.0	-13.5
Trade balance /GDP (goods and services, %)	-9.2	-9.3	-10.6
Gross foreign debt /GDP (%)	90.3	97.5	99.5
3-month TALIBOR rate (end of year, %)	2.6	3.85	4.3

** ICEG EC projections/forecasts. Sources: Eesti Pank, Eurostat, Statistics Estonia*

HUNGARY

Will fiscal stabilization measures create the possibility of a more balanced growth path?

Political developments

The main issues in the political and social scene with effects on economic policy are uncertainties over the next governor of the central bank (Mr Járai's mandate expires in early February and his successor has not yet been nominated) and growing tension between the ruling and opposition parties as the details of the fiscal austerity package get known. These tensions could culminate in March, when (in connection with the commemorations of the 1848 revolution) the rhetoric of the main opposition party could again ignite anti-government protests on the streets.

Growth

In the third quarter of 2006 the year-on-year growth rate of real GDP was 3.8%[1]. As was expected, private consumption growth embarks on a downward path since fiscal stabilization measures will lead to reduced disposable income as well as lay-offs in 2007. Gross fixed capital formation is still a surprise element in this slowdown: while many analysts anticipated some deceleration, few expected a sharp decline (resulting in a 4% reduction in the third quarter year-on-year). Construction-related investments suffered a particularly heavy blow, but investment into machines and equipment also produced dismal growth rates. Favourable external developments (lower oil prices and continued strong growth performance in the euro-zone), however, resulted in further improvement in net exports.

In the fourth quarter of 2006 private consumption might have slowed even further, as confirmed by retail trade data. Based on the Central Statistical Office's practice from the past, a revision of gross fixed capital formation data cannot be excluded at the end of the year, but even in that case, average annual growth will not exceed 2%. In 2007 fiscal stabilization measures will be fully felt in domestic demand. Private consumption growth, for the first time after 1996, will be in negative territory, and gross fixed capital formation will not resume its former strong dynamics. The improving trend in net trade, however, will continue, leading to significantly positive contributions to economic growth on the forecast horizon. Taken together, we estimate that real GDP might have expanded at a rate of 4% in 2006, while for 2007 we project a 2.3% annual average growth rate. Judged by contributions the engine of economic growth will almost solely be net export in this year, domestic demand will have a negligible effect.

Monetary developments

Consumer prices remained on an upward path in the fourth quarter of 2006. While the jump in September could be mostly attributed to elements of the fiscal austerity package, there is also an unexplained part especially in services prices. This might reflect that inflationary expectations also changed upwards. In the fourth quarter of 2006 the most significant increases were seen in foods and clothing prices due to changes in the VAT rate, in energy prices due to changes in administered prices and even in durable goods prices due to the weaker exchange rate of the forint. At the end of the year 12-month CPI-inflation stood at 6.5% (3.9% average annual rate), somewhat higher than we expected a quarter before.

Due to developments primarily in energy prices, the reduction of subsidies on medicines and public transport and also the secondary effects of the 2006 tax changes, inflation will rise further in early 2007. Contrary to what we expected in our October report, it might peak as early as March or April, when 12-month CPI-indices could exhibit an increase over 9%. In the remaining part of the year inflation will gradually decrease. There will also be offsetting effects, like moderating wage growth and decreasing public consumption and investments. By December, the 12-month

[1] *Due to methodological changes some items in the national accounts were considerably revised*

change in consumer prices could fall back to around 5%, but average annual inflation will be as high as 7.5% in 2007.

The base rate – set by the Monetary Council of the central bank – was raised only once in the fourth quarter (back in October) from 7.75 to 8%. Since the fiscal stabilization package might have already induced secondary effects through influencing inflation expectations, we further interest rate hikes cannot be excluded. With the easing of pressures at the end of 2007, we maintain that the base rate could fall back to 7% by the end of 2007. Still, the possibility of interest rate rises especially until March remains a real option in our view.

The exchange rate of the forint has become stronger recently, but is still rather volatile. Its flotation centre is assumed to be at around the 260-265 band vis-à-vis the euro, as long as there are no radical changes in market sentiment and economic fundamentals.

Fiscal policy

Excluding the balance of the local governments, the 2006 budget deficit reached 8.7% of GDP on cash basis. In nominal terms it amounted to HUF 2033 bn, more than twice of the previous year's figure. The more relevant accruals-based (ESA-95) budget deficit could be as high as 10.1% of GDP according to our estimates (without the usual corrections for private pensions).

The deficit could have been even higher, but fiscal measures, introduced on the course of the third and fourth quarters of last year, already exerted a downward effect on the deficit. One percentage point of the improvement is associated with revenue growth (through increased VAT and social contributions), while approximately half percentage point comes from reduced spending (freezing the amounts in the case of some expenditure items). Thus, the fiscal stabilization measures per se resulted in a 1.5 percentage point (relative to the GDP) reduction of the budget deficit in 2006. The still high deficit primarily reflects well over-planned spending on pensions and subsidies on medicines, exogenous effects (e.g. higher interest payments) and one-off items.

As the stabilization measures continue to exert their effect this year, we expect a further improvement in the budget deficit. It could finally fall to 7% of GDP, based only on the already announced measures. The composition of this improvement will be more even between expenditure reductions and revenue increases. The primary balance could exhibit an even larger improvement, but payments on outstanding government debt will still increase in 2007.

Assuming that the local governments balance will not significantly modify the estimated budget deficit for 2006, at the end of the year public debt could be around 69% of GDP. As it was mentioned above, the budget deficit will moderate somewhat in 2007, nevertheless it will still remain quite high. Coupled with slower GDP growth this will result in further increase of the public debt, to approximately 71% of GDP by the end of this year.

External balance

In the third quarter of 2006 the current account exhibited a deficit of EUR 1.1 bn thereby raising the cumulated deficit to slightly over EUR 4 bn in the first three quarters. The merchandise trade balance again showed a relatively small deficit (less than EUR 300 mn), but taken together with services, their balance was positive again for the second consecutive quarter. Because of the high errors and omissions balance, however, there is continued suspicion that imports are underreported.

The income balance still has a deteriorating trend. While net income payments on debt instruments seem to have stabilized, net income payments on non-debt (direct investments and portfolio equity investments) are rising. Of the EUR 4 bn current account deficit this latter item alone explains EUR 3.2 bn. Current transfers showed slightly positive balance in the third quarter, and are on the rise, especially compared to 2005 figures. This is probably due to increased use of the cohesion funds from EU.

Even if imports are underreported, the improving trend of the trade balance will clearly continue in 2007. While the current account deficit in 2006 could eventually be 6.3% of GDP, in 2007 it will fall below 5% as the goods and services balance will be well in positive territory.

The stock of gross external debt at the end of September reached 86.8% of GDP, while that of net external debt stood at 40.4% of GDP. As the forint considerably appreciated in December last year, these ratios might have increased only marginally by the end of 2006. Even assuming a favourable financing structure for the 2007 current account deficit, gross foreign debt could increase to 89% of GDP by the end of this year.

Labour market

Job creation, mostly in construction and services, was still relatively strong in 2006, but manufacturing employment continued decreasing. The announced lay-offs from the public sector have also started.

The slowing economy in 2007 will create considerably less jobs than it will destroy. Lay-offs will be concentrated in construction and the public sector. From its end-2006 value of 7.5%, the unemployment ratio could rise to 7.8% by the end of 2007.

High real wage growth (an estimated 3.7% in 2006) kept disposable incomes high, but rising consumer prices will erode the increase of nominal wages in 2007. Since the majority of enterprises will not compensate their employees for tax increases and rising social contributions, real earnings – assuming that our inflation projection materializes – can decrease by almost 3% in this year.

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

	2005	2006*	2007*
GDP growth (%)	4.2	4.0	2.3
Private consumption (%)	3.8	1.5	-0.5
Public consumption (%)	0.2	-4.7	-4.0
Investments (GFCF, %)	5.6	1.9	2.4
Export (%)	11.6	15.6	10.3
Import (%)	6.8	11.8	8.1
Consumer price index (average, %)	3.6	3.9	7.5
Unemployment rate (ILO, %)	7.3	7.5	7.8
Real wage growth (%)	6.0	3.7	-2.8
General government balance /GDP (%)	-7.5	-10.1	-7.0
Public debt /GDP (%)	62.3	69.0	71.0
Current account /GDP (%)	-6.8	-6.3	-4.6
Trade balance /GDP (goods and services, %)	-0.8	-0.1	1.4
Gross foreign debt /GDP (%)	77.0	86.9	89.0
Base rate (end of year, %)	6.00	8.00	7.00

** ICEG EC projections/forecasts. Sources: Cental Statistical Office, Eurostat, Magyar Nemzeti Bank*

LATVIA

Runaway growth causes massive external imbalances

Political developments

The incumbent government was re-elected in the autumn. Although politicians seem to play down risks to the economy and are happy to spend the spoils of economic growth, vigilance is needed to safeguard the economy in 2007.

Growth

Gross domestic product in the first three quarters increased by 11.9% in 2006. Growth is driven mainly by domestic demand, which is fuelled by income growth and foreign-financed borrowing.

Private consumption showed no signs of easing in 2006: it rose by 17% in the first three quarters. Retail sales data underpin consumption growth: they were increasing in volume by 19.4 percent between January and November 2006. Household indebtedness increased, the stock of outstanding consumer credit to households rose by 64% by September 2006. Government consumption did not change in real terms during the first three quarters as a result of tight fiscal policy and exceptionally high base year values.

Gross fixed capital formation decelerated in the third quarter but recorded a 13.5% increase in the first nine months. Export growth slowed down similarly and reached 11.3% in the first three quarters. On the other hand, imports surged with a 10.7% quarterly growth after seasonal adjustment in the third quarter. As a result of the widening trade deficit net exports have a massive negative contribution on growth in 2006.

GDP growth will reach 12% in 2006 according to our forecast. The structure of growth has grown unbalanced in recent years: the contribution of gross fixed capital formation decreases while that of private consumption increases. Housing investments play an important role in the fast pace of capital formation. Meanwhile, net imports remain massive. 2007 is expected to bring a slight readjustment with moderating consumption growth and an improving foreign trade balance. GDP growth in 2007 is expected at 9.5%.

Monetary developments

12-month consumer price inflation was 6.8% in December 2006 therefore the annual average rate of inflation was 6.5%. The prices of services and especially housing increased the fastest, driven by strong domestic demand, a housing bubble and the 11.4% rise of administratively regulated prices. As we expect the persistence of a positive output gap in 2007 inflation will drop only slightly to 6.1%.

The 3-month RIGIBOR money market rate stood at 4.2% at the end of 2006, up 25 basis points since the start of the year. Depending on type and maturity interest rates on loans in lats to households and enterprises typically increased by 1-1.5 percentage points during 2006. Fast credit growth continued: in September 2006 bank loans to households and non-financial enterprises increased by annual rates of 53.1% and 34.5%.

Fiscal policy

The fiscal balance improved in 2006 according to both cash-flow data from the Ministry of Finance and quarterly data from Eurostat. In the first three quarters of 2006 general government revenues increased by 24.2% while expenditures rose by 22.6% according to Eurostat. As a result the surplus of the general government was LVL 313 mn (EUR 450 mn) in the first nine months of the year, up from LVL 254 mn in the respective period of 2005. We expect the annual budget surplus to reach 0.5% of GDP in 2006.

Although the Bank of Latvia advocates an even tighter fiscal stance, the 2007 budget proposes a 26% rise in public expenditures. On the other hand, strong GDP growth can raise government revenues beyond their targeted values therefore a 0.5% surplus is feasible in 2007 as well. Government debt is expected at around 11% of GDP in both 2006 and 2007.

External balance

The cumulative trade deficit of the first three quarters of 2006 (including goods and services) amounted to LVL 1560 mn; the current account deficit LVL 1512 mn. Given the strong growth of imports and the deceleration of exports during the year, the external balance should deteriorate significantly in 2006 compared to previous years. The projected trade deficit for 2006 exceeds our previous expectations and amounts to a massive 20% while the current account deficit is expected to reach 17.4%. The external imbalance will widen further in due to robust internal demand and declining cost competitiveness of exports. The 2007 current account deficit is expected at 18.8%.

Net FDI inflows amounted to EUR 384 mn in the first three quarters, covering one quarter of the current account deficit. The most significant source of capital inflows was external borrowing by banks. Gross foreign debt reached LVL 11.7 bn in the third quarter. By the end of 2006 its value is expected to reach 110% of GDP and it will keep on increasing to 116% by the end of 2007.

Labour market

Fast economic growth creates more new jobs than expected in our previous forecasts: employment increased by an annual 7.2% in the third quarter, while unemployment decreased to 6.2%. The average unemployment rate in 2006 is expected at 6.8%. Current labour market trends will continue in 2007 and unemployment is expected to decline further to 6.5%.

Gross wage growth exceeded an annual 23% in September 2006 while real wages increased by 16.4%. Annual average real wage growth is projected at 13% in 2006 and is not expected to fall below 10% in 2007. As a consequence of runaway income growth real unit labour costs are projected to rise by 3% in 2006 and will remain stable in 2007.

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

	2005	2006*	2007*
GDP growth (%)	10.3	12.0	9.5
- Private consumption (%)	11.4	16.5	12.5
- Public consumption (%)	2.7	0.0	2.0
- Investments (GFCF, %)	18.6	14.5	12.0
- Export (%)	20.7	10.5	10.0
- Import (%)	13.5	18.0	12.0
Consumer price index (average,%)	6.7	6.5	6.1
Unemployment rate (ILO, %)	8.9	6.8	6.5
Real wage growth (%)	10.1	13.0	10.0
Real ULC growth (%)	-3.4	3.0	0.0
General government balance / GDP (%)	0.2	0.5	0.5
Public debt /GDP (%)	11.9	11.0	11.0
Current account /GDP (%)	-12.8	-17.4	-18.8
Trade balance /GDP (goods and services, %)	-15.4	-19.9	-22.0
Gross foreign debt /GDP (%)	98.4	110.0	116.0
3-month RIGIBOR rate (end of year, %)	3.95	4.2	4.4

** ICEG EC projections/forecasts. Sources: Bank of Latvia, Eurostat, Statistics Latvia*

LITHUANIA

The first serious signs of growth deceleration have emerged, while pressures from inflation and labour market are strengthening

Political developments

While developments in the domestic politics do not make headlines these days, foreign affairs of Lithuania are in focus again. The Sejmas (the Lithuanian parliament) claimed a compensation of EUR 24 billion from Russia for the damage that Lithuania suffered inder 'Soviet' occupation. There are ongoing talks about building a new nuclear power plant with the participation of the Baltic countries and Poland, since the EU fiercly opposed the possible extension of running the Ignalina Nuclear Power Plant. In response Lithuania tries to increase its stake in the project.

Growth

In the third quarter of 2006 real GDP increased by 6.4% compared to the same quarter of 2005. By examining the seasonally adjusted figures, it seems that – apart from the second quarter – a gradual slowdown has taken place. Though, still expanding at outstanding pace, both private consumption and gross fixed capital-formation have become less dynamic recently. At the same time import growth again outpaced the exports, mainly because of increased energy import. This was a consequence of capacity reductions in the oil-refining industry following an accident mid-2006. Thus, from the expenditure side both domestic demand and net exports contribute to a lesser extent to growth. On the production side construction remained buoyant, but because of the above mentioned accident in the oil-refining industry, manufacturing value added suffered a severe blow. Services, especially financial intermediation and real estates-related services, however, still expanded at close to double-digit rates.

The deceleration of growth thus has begun, and despite growing wages and lower personal income tax we maintain, that private consumption should lose even more pace. This is because households are quite heavily indebted and would soon face the need for saving more. Backed by favourable financing conditions and the availability of more EU funds, gross fixed capital formation remains strong. Net export continues to be a drag on growth, despite lowered import needs due to less dynamic domestic demand. Whereas the growth rate of export will be higher in 2007 than that of import, the trade deficit will still widen because of import's much higher base volume. We anticipate gradually diminishing quarterly growth rates in output throughout the forecast horizon, which results in a 7.5% GDP-growth in 2006, and 6.9% this year.

Monetary developments

In line with our expectations consumer prices were on the rise in the fourth quarter of 2006 mostly due to changes in the prices of natural gas and food. 12-month CPI exhibited a 4.5% increase in December, while average annual inflation was 3.8% last year. In 2007 the increase in excise duties coupled with expected wage increases will also exert an upward push on consumer prices. A further increase in gas prices is also on the table, which will only partly be offset by lower oil (and fuel) prices. We thus revised upwards our earlier forecast on 2007 inflation. Average annual consumer price increase can reach 4.5%, with an upward trend in the first part of the year, and a gradual deceleration afterwards.

The Lietuvos Bankas establishes its overnight repo rate to be equal to the ECB's marginal lending facility rate, thus since our latest analysis, this was raised by 25 basis points from 4.25 to 4.5% on December 13th. Since the previous rate hike (on October 11th) overnight VILIBOR (Vilnius Interbank Offered Rate) exhibited a rise of about 30 basis points[2] while longer-term interest rates increased to a similar extent. We expect at most one more 25 bps rate hike by the ECB in 2007, which will, of course, be automatically applied by the Lietuvos Bankas.

[2] Our dataset was closed on the 12th of January.

Since the economy is already cooling, this will have negligible effects on real developments.

The outstanding amount of credit to households exhibited an increase of 73% in November compared to the same month back in 2005. Credit to non-financial corporations also increased at a rapid pace, by close to 45%. Due to somewhat stricter conditions on the forecast horizon credit growth will moderate in 2007, but will remain relatively high.

Fiscal policy

The general government budget still look very sound, after the third quarter brought about better than planned revenues again, whereas expenditures remained well-contained. The budget surplus stands at LTL 877 mn (or 1.5% of GDP) after the first nine months of 2006. The developments on the revenue side mostly reflect vibrant economic activity, this will, however, weaken in the coming year.

On the expenditure side a pick-up is expected in government investments but in general, the ratio of expenditures to GDP remains stable. Thus it is the expected deceleration in revenue growth which will dominate developments in the fiscal balance. The official 2006 fiscal deficit could be at around 0.2% of GDP (i.e. hardly more than LTL 100 mn), but a minor deterioration in 2007 will follow (0.8% deficit).

Public debt stood at well below the Maastricht criteria at the end of 2005, and with such sound fiscal balances it will remain below 20% of GDP in both 2006 and 2007.

External balance

In the first three quarters of the year the current account deficit hit EUR 1.9 bn, in itself EUR 430 mn more than in whole 2005. The most significant factors leading to this unprecedented current account deficit (11.2% of GDP) are rapidly widening merchandise trade deficit, smaller surpluses in services trade and continued deterioration in the balance of income on direct investment.

The last is at least accompanied by reinvested earnings. Indeed, the reinvestment ratio among foreign owned firms in Lithuania is high in international comparison. Still, net foreign direct investment is lower than in the same period of last year. The main element of current account financing in the third quarter turned out to be accumulation of long-term liabilities by the corporate sector. In addition, the banking sector – in order to provide cheap foreign currency denominated credit to its domestic clients – decreased their foreign assets markedly.

Due to more rapid widening of the merchandise trade deficit than we anticipated a quarter ago, the current account might exhibit a deficit of 10.9% of GDP in 2006. While import growth will be reduced this year due to moderating domestic demand, the current account deficit will only marginally improve to approximately 10% of GDP in 2007.

The stock of gross foreign external debt increased to close to 56% of GDP (EUR 12.8 bn) by the end of September. As in the forecast horizon the bulk 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 exceed 60% of GDP.

Labour market

Labour supply poses a continuing challenge in Lithuania, because the economy is still growing above the potential rate and the labour force is shrinking mostly due to emigration. Growing labour demand will thus lead to upward pressures on wages (even if in July 2006, net earnings increased by almost 10 percent due to lowered personal income tax rates), and falling unemployment. The official unemployment figure could be as low as 5.2% by the end of 2007.

Wage increases will nevertheless be small, and productivity growth will partly offset them. Consequently, unit labour costs will only marginally increase in 2006 and 2007.

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

	2005	2006*	2007**
GDP growth (%)	7.6	7.5	6.9
- Private consumption (%)	9.8	12.2	9.1
- Public consumption (%)	4.9	5.3	4.4
- Investments (GFCF, %)	9.2	10.6	8.5
- Export (%)	14.5	15.8	13.0
- Import (%)	16.0	16.1	12.6
Consumer price index (average,%)	2.7	3.8	4.5
Unemployment rate (ILO, %)	8.3	5.8	5.2
Real ULC growth (%)	0.3	0.6	0.9
General government balance /GDP (%)	-0.5	-0.2	-0.8
Public debt /GDP (%)	18.7	18.0	17.7
Current account /GDP (%)	-7.2	-10.9	-10.1
Trade balance /GDP (goods and services, %)	-7.3	-10.3	-9.2
Gross foreign debt /GDP (%)	51.4	57.5	60.8
3-month VILIBOR rate (%)	2.54	3.79	4.10

** ICEG EC projections/forecasts. Sources: Bank of Lithuania, Eurostat, Statistics Lithuania*

POLAND

Even though political uncertainties abound, economic performance remains strong

Political developments

Political risk is still present in Poland after the autumn events, when the majority coalition collapsed in September, and been restored in October in time to vote for the budget bill. The most popular parties among voters are still the largest party in the governing coalition, Law and Justice (PiS) and the opposition Civic Platform (PO), while public support for populist parties is on the decrease. It seems however that populist rhetoric of the governing coalition are giving way to more pragmatic policies on a number of occasions.

Growth

In the third quarter of 2006 GDP growth reached an annualised 5.8%. The main drivers behind strong growth were private consumption (which grew by 5.5% in the same quarter), and gross fixed capital formation (up 19.8%). Industrial production increased by an annual 12.3%. The financial results of non-financial companies improved again in the third quarter of 2006, continuing the favourable trend of the first half year. In addition to the substantial own funds of enterprises stemming from the good financial results of the first three quarters, the current growth in corporate lending will boost investment even further. Investment growth is expected to remain high in coming quarters. In addition to the favourable trends in the corporate sector, also FDI inflow, and the realisation of projects co-financed by EU funds will contribute to the growth of investments. As a result of rising wages and rising employment as well as the availability of loans, private consumption of households is likely to remain high. These factors will keep boosting economic growth in 2007. According to our estimates real GDP growth will reach 5.4% in 2006 and 5% in 2007.

Monetary indicators

Strong domestic demand started to show its effects on inflation from the third quarter of 2006. In November the 12-month rise of consumer prices reached 1.4 %. The main reasons behind the higher level of inflation were the increase in the annual growth of prices in telecommunications as well as recreation and culture. Producer prices rose by an annual 2.6 % in November. This is a lower rate than in previous three months when PPI rose by over 3%.

Despite rising inflationary pressures the monetary policy council decided to leave interest rates unchanged at its December 2006 meeting. Therefore the reference rate remained at the record low level of 4% (it has been at this level since March 2006). According to the council rising inflationary pressures will result in monetary policy tightening in the medium term.

Fiscal policy

In October 2006 the cumulative budget deficit reached 54.4 % of the planned amount for the whole year. High economic growth translated into higher budget revenues which grew by 9.2 % in the first ten months of 2006 compared with the same period in 200.

According to the updated Polish convergence programme the country will be able to fulfil the Maastricht convergence criteria by 2009, which would enable EMU entry in 2010 or 2011. However the convergence programme states that annual growth of budgetary spending will be only 3 % in 2009, the next election year. This assumption could easily prove to be unrealistic.

Budget deficit relative to GDP is expected to reach 2.6 % in 2006. The PLN 30 bn fiscal deficit limit (set in the budget law) will not be breached. Public debt as a percentage of GDP (ESA 95) is expected to reach 43.1%.

External balance

In the third quarter of 2006 the annual growth rate of exports remained unchanged (19.5 %), and the growth rate of imports increased from 19.0% in the second quarter to 22.3% (in euro terms). Strong demand in other Central Eastern European countries and countries in the euro zone stood behind exports, while increasing domestic demand was the main driving force behind increasing imports. The current account deficit as a percentage of GDP was 1.9 % in September, and 1.8 % in the third quarter of 2006. The low current account deficit can be attributed to the large surplus in current transfers (money transfers by Polish citizens working abroad, and EU funds). According to our estimations the current account deficit will be 2.8 % of GDP in 2006 and 3% in 2007.

Labour market

The favourable growth performance is showing its effects in the labour market. Employment creation in the corporate sector was the highest in the year in October, reaching a 3.6% annual growth rate. At October the unemployment rate stood at 14.9%.

Growth of wages has also been stronger as a result of the high rate of economic growth. Gross wages grew by an annual 4.7% in October, and by 3.1% in November. The growth of unit labour costs accelerated in the third quarter of 2006 (6.1%, up from 2.7% in the first quarter). Growth of wages outpaces labour productivity, which will eventually become a source of inflationary pressure.

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

	2005	2006*	2007**
GDP growth (%)	3.5	5.4	5.0
- Private consumption (%)	1.9	5.3	4.0
- Public consumption (%)	5.3	2.7	2.9
- Investments (GFCF, %)	6.5	15.8	14.0
- Export (%)	8.0	15.2	15.0
- Import (%)	4.7	14.8	14.5
Consumer price index (average,%)	2.1	1.2	2.4
Unemployment rate (ILO, %)	17.6	15.0	13.5
Real wage growth (%)	1.2	3.8	3.4
Real ULC growth (%)	-1.6	-0.5	1.0
General government balance /GDP (%)	-2.5	-2.8	-3.0
Public debt /GDP (%)	42.0	43.3	46.0
Current account /GDP (%)	-1.7	-2.3	-1.6
Trade balance /GDP (goods and services, %)	-0.3	-0.5	0.0
Gross foreign debt /GDP (%)	45.9	46.0	45.5
Reference rate (end of year, %)	4.50	4.00	4.25

** ICEG EC projections/forecasts. Sources: Bank Zachodni WBK, Eurostat, Narodowy Bank Polski*

SLOVAKIA

Record high growth resulted in higher employment and good fiscal position

Political background

The new government's economic policy stance does not seem to change significantly despite its rhetoric. There were a few popular measures implemented with moderate consequences on the fiscal position (abolishing visiting fee, a halt to privatisation e.g. airport). At the same time, some "investor-friendly" measures were taken, giving special last-minute grants/tax allowances to a few big FDI projects. This is expected to be translated into larger FDI inflow later this year and in the coming few years.

Growth

In the third quarter, a record high economic growth of 9.8% (in real terms) was recorded in the Slovakian economy. This indicates further acceleration of GDP growth given that the first quarter showed a year-on-year change of 6.3%, and the second quarter 6.7%. Thus, in the first three quarters of 2006, economic activity was 7.8% higher than in the corresponding period of 2005. In 2007, Slovakia is expected to keep the highest growth rate among Visegrad countries of around 7%.

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, signalling a healthier composition of growth factors: in the third quarter, net exports (24 %) contributed almost 3 times more to growth than domestic consumption (9%). The contribution of investment (GFCF) to growth is also more significant than in previous years (6.7%). High investment rate can be partly attributed to FDI, third quarter data show a considerable increase in this field. Government and especially household consumption had a slower (below 6%) growth rate, while exports accelerated again by more than 18% in a year-on-year comparison, according to the data of the Statistical Office. GFCF went up by close to 7%, according to the same source.

Growth is expected to be more than 7% for the year as a whole. The strong increase in industrial production (9.8% on a year-on-year basis) and in construction (11.7%) support these expectations. Similarly, economic sentiment indicators and consumer confidence showed an increasing tendency over the course of 2006.

Monetary developments

Inflation in 2006 accelerated in the Slovak Republic compared to the previous year, mainly due to an increase in the prices of certain public services. The level of consumer prices (CPI) increased by an annual 4.2% in December 2006 according to the Statistical Office. In 2006 as a whole, on average, consumer prices rose by 4.5 % compared to 2005. Mainly the prices of public services (health, and to a lesser extent energy and education), which increased the most, mainly due to a change in regulated prices at the beginning of the year (an overall increase of 4.8% in January 2006). Health prices went up by 14%, while prices of housing, water, electricity, gas and fuels grew by 10.1%. As for goods prices, alcoholic beverages and tobacco prices increased the most, by 5.9%. Predictions by international organisations assume weaker inflationary pressures for 2007, resulting in an inflation rate below 3%. This rate of inflation would not threaten the fulfilment of the relevant Maastricht criterion and would thus not delay the adoption of the euro.

Data for industrial prices are available for November; they indicate that price increases in this sphere are slightly ahead of the CPI. Growth rate of industrial prices between January-November amounted to 6%. On the other hand, agricultural prices did not change in the same period of the year.

The board of the central bank left the basic interest rate unchanged after an increase in September 2006.

Fiscal policy

At the end of 2006, the budget deficit was SKK 31.7 bn (approximately EUR 915.5 mn euros), which is lower than the 2005 deficit and the planned deficit for 2006. Strong economic growth and as a consequence, larger tax revenues helped to keep the budget deficit at a low level. Uncertainty surrounds the spending plans of the new government. 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% level.

External balance

There was an increase in the trade deficit in November 2006, compared to the previous year. Therefore previous forecasts of a lower trade deficit in 2006 are expected to prove wrong. In the first eleven months of 2006, exports grew by 24.4%, imports by 26.3%, and the deficit almost doubled. The highest trade deficit is recorded in trade with Asian countries (especially Korea, China, Japan) and Russia. At the same time a considerable surplus characterises Slovakian trade with developed countries. Exports from large greenfield FDI projects in the car industry may contribute to high growth of exports. Manufacturing of transport equipment rose by an annual 51.2% in November 2006. This may also result in a slightly narrower current account deficit in 2007.

Balance of payments data of the January-September 2006 period show a significant trade deficit (more than EUR 2 bn) and a slight surplus of the services trade. On the income balance, investment income (in form of dividends and reinvested earnings) shows the highest deficit, in the magnitude of more than EUR 2.5 bn. The financial account is slightly negative, largely due to foreign direct investments. At the end of the third quarter, it surpassed USD 3.3 bn, mainly coming from new investments (USD 1.6 bn), and to a lesser extent from reinvested earnings. The balance of portfolio investments showed a surplus of 1.5 bn USD. However, other investments counterbalanced the above items by reaching a close to USD 5 bn deficit, the major part of which is short-term investment. Experts expect further improvement of the current account, based especially on better trade performance, and forecast better position of the balance of payments in 2007.

Labour market

Due to the increased economic activity, in the third quarter of 2006, total employment increased further by an annual rate of 3.8%. This resulted in an employment rate of 59.9%, which is 1.9 percentage point higher than in the same period of the previous year. The unemployment rate fell further, and reached the lowest level since 1998: 12.8%, which is 2.8 percentage point lower than in the second quarter, according to the data of the Statistical Office. However, the unemployment rate is still among the highest among the NMS countries (together with Poland). In terms of the length of unemployment, decrease was detected in all categories. On average, over the first nine months of 2006, number of the unemployed has fallen by 16% and the unemployment rate went down by 2.7 percentage points to 13.7% compared with the corresponding period of 2005. For 2007 a further decrease in unemployment is expected due to the robustness of economic growth.

The increase of real wages decelerated somewhat in the third quarter: they have risen by 2.7%, according to the data provided by the Statistical Office. Nominal wages are expected to increase by 7.9% in 2006 as a whole, which is around 3.4% in real terms. Real wages grew in all branches of the economy and the fastest growth characterised renting and real estates, education and health. Still, employees in financial intermediation have the highest salaries, followed by workers in electricity, gas, water; renting and real estates and in public administration. Growth in real wages is expected to continue in 2007 in similar pace, due to the expected high growth rate of the economy.

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

	2005	2006*	2007*
GDP growth (%)	7.5	7.9	7.0
- Private consumption (%)	5.8	6.2	4.5
- Public consumption (%)	1.6	4.8	3.5
- Investments (GFCF, %)	11.5	7.5	8.5
- Export (%)	10.2	20.0	12.6
- Import (%)	9.3	20.8	12.2
Consumer price index (average,%)	2.7	4.5	3.6
Unemployment rate (ILO, %)	16.2	13.7	13.3
Real wage growth (%)	6.3	3.6	4.0
Real ULC growth (%)	n.d.	1.0	1.5
General government balance /GDP (%)	-2.9	-2.5	-1.9
Public debt /GDP (%)	44.2	44.0	44.0
Current account /GDP (%)	-6.1	-6.5	-6.4
Trade balance /GDP (goods and services, %)	-4.8	-4.6	-4.4
Gross foreign debt /GDP (%)	49.8	48.0	47.5
Basic interest rate (end of year, %)	3.00	4.75	3

** ICEG EC projections/forecasts. Sources: Eurostat, IMF, OECD, Slovak Ministry of Finance, Slovak National Bank*

SLOVENIA

Adoption of the euro crowns macroeconomic success story

Political developments

Strong domestic opposition forced the Slovenian government to abandon the intoduction of a flat-rate tax system from 2007. However Janez Jansa the prime minister of Slovenia had much to celebrate on the first day of 2007. Slovenia as the - first and only country among the New Member States - joined the euro-zone on 1st January 2007. Slovenia is facing an even greater challenge in 2007 as the country will hold the Presidency of the European Union in the first half of 2008.

Growth

Real GDP grew by 5.2% in the first three quarters of 2006. Quarterly GDP growth reached an impressive 5.6 year-on-year in the third quarter of 2006. Gross fixed capital formation and exports were the main drivers of growth in the first nine months of 2006, rising by 10.5% and 9.6%. Export growth slowed down by the end of 2006 thus net exports will not have significant contribution to GDP growth in 2006 as a whole. We expect real GDP growth to reach 5.5% in 2006. The pace of growth is expected to slow down to 4.5% in 2007.

Due to planned highway construction and the expected buoyant housing construction activity gross fixed capital formation will remain the main engine of growth throughout 2007. According to our forecast the growth of investments will reach 11% in 2006 and arrive at 6% in 2007.

Due to the improvements in the labour market private consumption will grow at 3.6% in 2006. The lowering of personal income tax rates will have a positive effect on private consumption in 2007 thus we expect it will continue to grow around 3.6%.

Monetary developments

After decreasing to 1.5% in October 12-month inflation increased to 2.8% in December 2006. Average annual inflation is hovering around 2.4-2.5% since May 2006. High oil prices interrupted the disinflationary trend in August 2006, when the annual rate of inflation reached 3.2%. The government could not counteract the adverse affects of oil price developments since excise duties on fuels were set at lowest level allowed by EU legislation already in July 2005.

External factors notably oil prices will remain the greatest inflation risk factor in 2007. We do not anticipate any risks stemming form labour cost growth on price developments in 2007. Average annual inflation is not expected to decrease in 2007 due to increases in various excise duties (including tobacco products where excise duty harmonisation with EU-15 levels will be completed in 2007). Thus annual inflation will remain around 2.6% in 2007.

As the first among the New Member States, Slovenia became the 13th member of the euro-zone on January 1st 2007. According to the Communication Directorate of the ECB, Banka Slovenije has received a total of 94.5 mn euro banknotes with a face value of EUR 2,175.0 mn from the banknote stocks of the Eurosystem. Similarly, following a public tender, the production of euro coins with a Slovenian national side was allocated to the Mint of Finland, which has produced a total of 296.3 mn euro coins with a face value of EUR 104.0 mn. Euro changeover procedure was smooth and successful. The Slovenian tolar (SIT) was replaced at the irrevocably set conversion rate of 239.64 SIT/EUR. The dual circulation period ended on January 15th 2007.

Fiscal policy

The central government budget closed the first nine months of 2006 with a deficit of SIT 30 bn (EUR 125 mn). Local government recorded a surplus of SIT 16 bn in the first three quarters of 2006. The pension fund recorded a balanced position, the health fund had a surplus of SIT 5 bn by the end of September 2006. General government deficit is expected to amount to 1.5% of GDP in 2006.

Several changes in the tax law entered into force in the framework of the tax reform on 1 January 2007. The tax burden on individuals was reduced by the modifications of the income tax law. The number of tax brackets was reduced from five to three. The top income tax rate was decreased by nine percentage points to 41%. Tax rates related to the remaining to brackets have been set at 16% and 27% respectively. The payroll tax was reduced and will be phased out gradually. It will be entirely abolished by 2009. The corporate income tax rate was reduced by two percentage points to 23%.

According to IMAD the share of revenue from personal income tax in GDP will decrease from 6.2% of GDP in 2006 to 5.6% of GDP in 2007, due to the amendments of the income tax act. The gradual phasing out of the payroll tax will reduce the share of revenue from this source in GDP by 0.4 percentage points in 2007. The rates of social security contributions will remain unchanged in 2007.

General government expenditure is planned to be cut by 1.6 percentage points by 2008. The decrease in central government revenues will not be fully compensated by the expenditure cuts and the still robust economic growth expected for 2007. Thus we forecast that the general government deficit will remain around 1.5% of GDP in 2007. Similarly to recent years general government debt is expected to stay somewhat below 30% of the GDP in 2007.

External balance

We have made a slight 0.1 percentage point revision in our forecast for the current account balance for the years 2006 and 2007. This was mainly due to the deterioration of the current account deficit in the third quarter of 2006. The widening of the deficit was caused by the income and current transfer balances. The deficit of the income balance deteriorated in the third quarter of 2006 due to a rapid rise in capital income outflows. Dividend payments and profits from inward FDI reached EUR 223 mn in the third quarter of 2006. The current transfers balance deterioration was a result of the increase in the deficit of the private sector's transfers. We expect that the current account deficit will narrow from 2.4% of GDP in 2006 to 1.6% of GDP.

Labour market

Labour market developments reflected the robust growth of the economy in 2006. ILO unemployment declined to a record low rate of 5.6% in the third quarter of 2006. Employment was almost 1% higher in the first 9 months of 2006 compared to the same period of the previous year. The highest increase in employment was registered in the construction sector.

Employment is forecasted to grow in the next years due to lower personal income tax rates, the phasing out of payroll tax and changes in the legislation regulating unemployment benefits. According to a recent IMF working paper generous benefits and high taxes were the key factors explaining lacklustre labour participation. The large positive gap between the registered and the labour force survey unemployment rate reflects this situation since registration was a condition for receiving benefits. Under the previous unemployment legislation many registered unemployed were likely not searching for work and therefore would not be counted as unemployed by the labour force survey. We expect that the unemployment rate will decrease to 6.2% in 2007.

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

	2005	2006*	2007*
GDP growth (%)	4.0	5.5	4.5
- Private consumption (%)	3.4	3.6	3.6
- Public consumption (%)	2.2	3.1	2.8
- Investments (GFCF, %)	1.5	11.0	6.0
- Export (%)	10.5	9.6	8.5
- Import (%)	7.0	9.3	8.0
Consumer price index (average,%)	2.5	2.6	2.6
Unemployment rate (ILO, %)	6.5	6.2	6.2
Real wage growth (%)	2.1	2.3	2.5
Real ULC growth (%)	0.1	-0.2	-1.3
General government balance /GDP (%)	-1.4	-1.5	-1.5
Public debt /GDP (%)	29.3	29.5	29.8
Current account /GDP (%)	-2.0	-2.4	-1.6
Trade balance /GDP (goods and services, %)	-0.6	-0.3	-0.1
Gross foreign debt /GDP (%)	71.4	76.8	82.5
Basic interest rate (end of year, %)	3.00	4.75	3

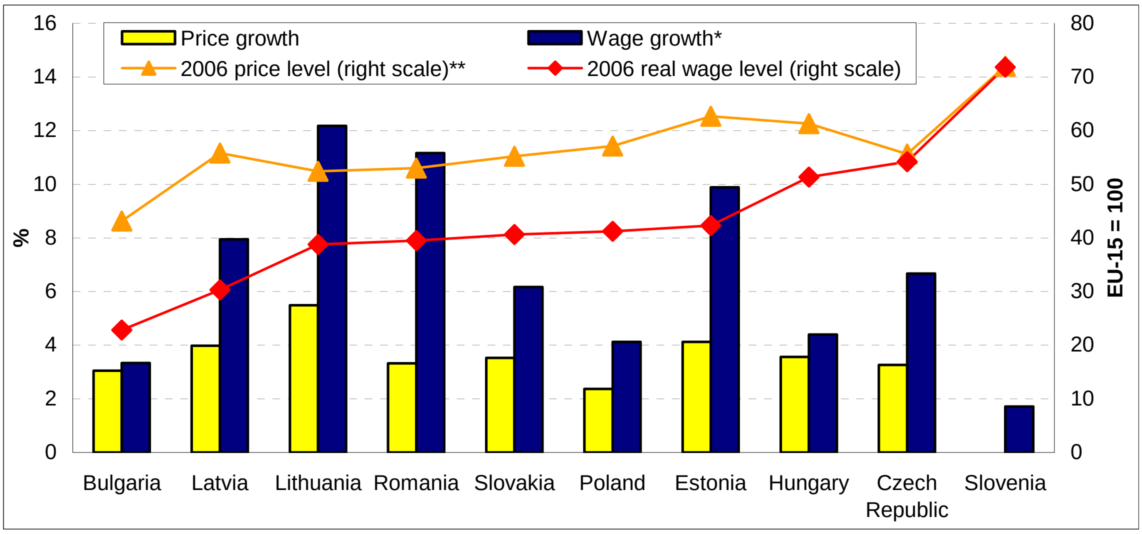
** ICEG EC projections/forecasts. Sources: Bank of Slovenia, Eurostat, IMAD, Statistical Office of the Republic of Slovenia*

PRICE AND WAGE CONVERGENCE IN THE NEW MEMBER STATES

Gábor Pellényi

Prices and wages in Central and Eastern European New Member States are known to be lower than in most Western European countries. In the NMS the price level of a typical household consumption basket is only 50-60% of the 'old' EU-15 average. Wages adjusted for price levels are even lower, usually in the range of 40-50%. However, it is also clear that prices and wages are catching up. Within the last decade the gap was narrowed by 10-20 percentage points in every country bar Slovenia as prices increased by an annual 3-4% relative to the EU-15. Relative nominal wages grew by at least 4% a year in most countries, and by over 10% in the Baltic states. As a result, real income levels are also catching up everywhere. A number of questions arise from these observations. What forces are driving up prices? When will prices and living standards reach western levels? And finally, what are the policy implications of price and wage convergence?

Chart 6: Consumer prices and wages relative to EU-15



*Notes: * 1998-2006 for Romania. ** estimation. Annual average growth rates of the prices of household consumption and nominal labour compensation per employee, relative to EU-15. Real wage: labour compensation per employee divided by price level. Source: DG ECFIN, Eurostat*

The causes of rising price levels

The observed differences between price levels across countries and have been studies exhaustively by economists. A number of theoretical explanations are available; they all add to our understanding of the phenomenon.

Convergence of real income levels is part of the process of real convergence. As poorer countries develop, the productivity their of workers increases. As they produce more, they earn more as well.

A typical starting point for price convergence is the law of one price, a cornerstone of classical models of international economics. The theory states that as a result of free trade prices in a common currency should be equal in all countries, save for taxes, transport costs and such. Evidence does not entirely support this thesis; remaining differences in prices are often attributed for example to inflexible prices, imperfect product market competition and strategic pricing by multinational companies.

The law of one price cannot explain differences in the prices of products that are not internationally tradable; it does not predict as large price differentials as experienced between the eastern and western parts of Europe.

Another group of theories links economic development (real convergence) to price levels. The best-known of them, the Balassa-Samuelson model explains international price differences with productivity differences. The development of poorer countries is usually driven by the fast catch-up in the productivity of their tradable sector (in essence, industry). As a result, tradable productivity relative to the productivity of the non-tradable sector (construction, services, etc.) grows faster than in richer countries. Productivity growth in the tradable sector raises wages in both sectors, increasing the producer prices of non-tradables. William Baumol and William Bowen argued along similar lines: they suggested that the productivity of labour-intensive services rises slower than that of capital-intensive industries: therefore any increase of industrial productivity relative to services productivity results in rising services prices. The propagation mechanism is again the equalisation of wages across sectors. A third, similar theory emphasises relative endowment with factors of production. Rich countries have more capital per employee; as labour is relatively more scarce, it is more expensive. This in turn raises the prices of labour-intensive products (again, typically services). As poorer countries develop, they accumulate capital; their rising capital-to-labour ratio implies price increases.

Subsidised utility prices are also typical of less developed countries – especially those with a communist heritage. As these prices rise to cost-recovery levels, production costs for a wide range of goods and services increase as well. Finally, demand also evolves as income levels grow: consumers turn to products of higher quality which are of course dearer as well.

Slow enough? Fast enough?

Price convergence in the NMS is fairly quick. If recent trends continue, most countries would reach the EU-15 price level within a couple of decades. Nominal wages and real income levels start from lower levels therefore they need 20-30 years for complete convergence almost everywhere. There is good reason to believe that as prices and wages get nearer to western levels, convergence slows down – still, the bulk of the gap should be closed within a generation. This tempo is too fast for some, but may be too slow for others.

Monetary authorities in the NMS can worry because rapid price convergence brings either higher inflation or exchange rate appreciation. Meanwhile, exceptional wage growth boosts domestic demand. If wage growth is not backed by increasing productivity, a wage-price spiral can arise and the competitiveness of exports declines. This can make the fulfilment of the Maastricht inflation criterion difficult and threaten the external balance as the Baltic countries can testify. Politicians can make things worse if they try to force the catch-up of incomes. Increasing minimum wages, public sector salaries or pensions is popular and often necessary. But more effort should be directed into boosting productivity. This route eventually leads to better living standards, too, but is more sustainable in the long term. Western Europe might also wish that convergence was faster. As long as large price and wage differences remain, fears will arise of jobs moving east and cheap labour moving west.