

## **Chapter 3: Macroeconomic Outlook for the EU Accession Countries**

### **Summary Review and Policy Recommendations**

#### Introduction:

With the accession to the EU of the ten new members scheduled to take place on May 1, 2004, the attention of the policy-makers both in current member-states and in the accession countries is rapidly shifting from the political and organizational aspects of accession towards the economic challenges facing the future members. This is especially true in light of the fact that all of the new members are likely to join the Economic and Monetary Union (EMU), most likely within the next four to six years. In these discussions, the macroeconomic challenges facing the accession countries and their impact on the possible future changes in EU policies are taking an increasingly important place. Indeed, EU membership is only the first of the many major milestones that the accession countries will be facing in the next several years.

This brief report identifies the following two problem areas:

- (1) Need for fiscal restraint in the run-up to EMU membership.
- (2) Coordination between monetary and fiscal policies; the role of an independent central bank.

#### **Promoting Fiscal Restraint**

Developments in the area of public finance in the accession countries clearly constitute the biggest challenge, in particular for the largest economies in the group. The fiscal balances of four Central European candidates for EU membership—Poland, Hungary, the Czech Republic and Slovakia—have deteriorated considerably over the last two years. The reasons for the widening of state and consolidated budget deficits have differed among the countries. Some of the excessive increases in expenditures stemmed from outlays related to the implementation of pension, health care, and educational reforms. The new members of NATO also found that increased security comes at a cost, as the alliance required upgrades to military installations and equipment. Furthermore, the economic slowdown across the region that hit in late 2001 and early 2002 brought tax revenues in below expectations and resulted in short-term liquidity problems for the public sectors. Finally, the governments in Hungary and the Czech Republic introduced extensive fiscal packages to stimulate their struggling economies through large-scale investment and current spending programs.

In addition to short-term factors worsening deficits in the region, regional budgets are suffering as well from the effects of past decisions taken without proper assessment of their consequences. This applies in particular to Poland, where the past two coalition governments competed in offering entitlements to large portions of the population without taking into account the impact of future claims on public funds. In the Czech Republic and Slovakia, the lack of proper supervision of the banking system and the indirect method of dealing with the “bad loan” problems still haunts the national governments.

In many cases, decisions to increase fiscal spending from already high levels were made with the full understanding of the extent to which this would result in the build-up of deficits and, in consequence, of net public debt for the next several years. The argument used by some of the local policy-makers in the region (some of whom continue to support this view) is that while reductions in the budget deficits should be undertaken, this process should not ignore the developments in the real economy. In brief, if the movement toward greater fiscal constraint threatens to bring about a significant slowdown in economic growth, such restrictive policy should be reviewed and adjusted as appropriate. Notably, the governments of the three largest accession countries, Poland, the Czech Republic and Hungary, stated recently that while accession to the EU in the shortest possible time would be desirable, their policies with respect to fiscal deficits will take into account a variety of factors.

The actions on the part of the national governments with respect to public spending clearly confirm that such an approach is being applied. Although the fiscal position of accession countries has been affected by an economic slowdown that can be at least partially linked to the weakness of the global economy, the widening of the budget deficits was due mostly to excessive spending rather than to an unanticipated shortfall in budgetary revenues. In some cases, decisions made in the years 2001-2002 will have long-lasting consequences for budget balances. In the most glaring example, the Socialist government in Hungary approved a 50% across-the-board increase in wages of public sector employees as of October 2002. This will not only permanently increase the public wage component of the state budget by 20% for 2003 and beyond, but will also launch a wave of similar demands for increases in wages by workers employed by state-owned companies, and could also cause a ripple effect on the private sector wages. Similar decisions, indisputably undertaken for purely political reasons, could destabilize the fiscal position of some accession countries even further.

With budget revenues dependent on tax collections that, in turn, reflect the pace of economic growth, economic policy should focus on reducing expenditures. A safe way to reduce expenditures gradually and without a dampening of economic growth may be the implementation of a system of medium-term expenditure ceilings. Such ceilings, usually applied for periods of between three and five years, would set the maximum amounts of spending for all levels of expenditures that are relatively fixed and can be predicted. These ceilings should apply to spending by all branches of the government including off-budgetary funds. The ceilings can then be reviewed every three to five years, and the spending levels monitored regularly to determine the availability of funds within the preset budget. Such maximum spending targets can be flexible from year-to-year, allowing departments and agencies to roll over unutilized funds from to the next. Such a system of Departmental Expenditure Limits (DELs) is successfully applied in the United Kingdom. In addition, under the so-called Golden Rule in the British system, the government is allowed to borrow only to invest and not to finance current spending.

In many of the largest accession countries, the large share of fixed costs in the budget, mostly related to social spending, limits room for maneuvering by the governments. Sometimes the only hope left is for much stronger growth that would boost tax revenues and close the budget gap. Moreover, the willingness of national governments to reduce deficits is countered by the need to maintain at least the appearance of an intact social safety net to avoid defeat at the polls at the hands of a disenfranchised electorate.

### **Interaction of Monetary and Fiscal Policies**

The interaction between fiscal and monetary policies and the issue of independence of the central bank are becoming of increasing importance as accession countries are preparing for entry into the EU. In the recent past, decisions on the part of many regional governments to loosen monetary policy put the monetary authorities in those countries in a rather unenviable situation. In order to fight inflation, central banks have implemented tight monetary policies. As inflation has started to fall more rapidly in the last two years, the ability of the central banks to reduce interest rates more aggressively has been unduly restricted. In some countries, most notably in Poland, this unfortunate mix of monetary and fiscal policies led to a large inflow of speculative portfolio capital and to at least a temporary overvaluation of the local currency, and reducing the availability of domestic credit needed to spur growth in capital investment and the construction sector. In addition, high interest rates on domestic credit encouraged local companies to seek financing abroad, rapidly increasing foreign indebtedness.

In addition to obvious negative effects on the economy, this unfortunate lack of coordination has one more, equally if not more important aspect. The tight monetary policies of the central banks are becoming the subject of political discussions and manipulations. The governments see the independent central banks as obstacles to achieving higher rates of economic growth, reducing unemployment rates, etc. More radical parliamentarians are putting forward proposals for legislation either to widen the number of operational goals of the central bank to include promoting economic growth, or to seriously amend the system of appointing new members of the monetary policy bodies to increase the influence over their decisions by parliaments and governments. This approach could lead to serious confrontations, lead to inter-institutional

animosities and dramatically reduce the ability of the central banks to fulfill their constitutional duties. The most drastic examples of such conflicts are the developments in Poland and Hungary. In both cases, the central banks have come under fire from the government and the employers' organizations for "allegedly" keeping interest rates too high.

The European Commission and other EU representatives have already addressed in several occasions the need to maintain full central bank independence in the accession countries – the continuation and stiffening of such approach would be, in our view, warranted.

# Cyprus

## *Macroeconomic Overview and Outlook*

The Cyprus economy is relatively small compared to most EU and EU accession countries. However, it is not the smallest by a long shot: in 2001, Cyprus' \$9.04 billion nominal GDP was similar in size to that of Iceland and Liechtenstein combined. On the other hand, Cyprus is only about 0.8% the size of France's economy. Cyprus' population is also tiny, with just about 800,000 inhabitants at the end of 2002, or approximately 1.4% of France's population. On a per capita basis, Cyprus ranks amongst the richest front-runners for EU membership, surpassing even current members such as Greece and Portugal. Because of the country's small size, its large dependence on tourism revenues, and the open nature of its economy, Cyprus has always been extremely susceptible to external economic and geopolitical shocks.

Cyprus' greatest risk is a military conflict with Turkey over its unresolved political and territorial division. As long as any part of Cyprus remains occupied by the Turkish army, there will be some chance of a major war—and a much higher probability of a minor conflict. On the economic side, Cyprus' overreliance on tourism constitutes a major source of risk. With the tourism industry generating 20% of Cyprus' output, the lack of depth in its industrial structure leaves the economy overly exposed to external changes such as global economic fluctuations and political conflicts. Another risk for Cyprus derives from its vulnerability to a number of natural hazards, particularly earthquakes. The island is located in a region of high seismic activity, with considerable potential for devastating fault movements. In the case of a severe earthquake—aside from the immediate loss and devastation—Cyprus' economy would be hurt by damages to its tourism resources.

The economy of Cyprus weakened in 2002 as the result of a slow recovery in the global economy, a decline in consumer confidence and a drop in tourism revenues. Even though the September 11 terrorist attacks in the United States took their toll on the country's GDP last year, particularly through lower-than-anticipated tourism and export revenues, the economy still managed to grow by an estimated 2.3%. Inflation also remained low in 2002, a development that enabled the Central Bank to lower interest rates and provide additional economic stimulus through a more aggressive monetary easing.

Increased geopolitical tensions caused a substantial drop in tourist arrivals to Cyprus in the first eleven months of 2002. The slowdown in the tourism sector is believed to have persisted through the end of last year, with tourist arrivals estimated to have declined by as much as 11% for the year as a whole. Tourism contributes around 20% of the country's GDP, which explains to a large extent the slower economic growth last year. Cyprus' economic officials expect the country's economic growth to speed up in 2003 and expand by 4.2% in 2003. While lower interest rates and an anticipated surge in tourist arrivals may indeed spur an economic expansion this year, the increasing possibility of a war in Iraq remains a threat to the country's outlook for 2003. A prolonged slowdown of the tourism sector could spell trouble for the economy of Cyprus and hurt the country's growth prospects. Global Insight therefore expects the economy to fall somewhat short of official projections. Growth in 2003 will be dampened by several factors: the government's fiscal austerity measures aimed at meeting requirements for EU membership, a prolonged overall slowdown in world economic growth (at least in the first half of the year) that is likely to affect tourism and trade, the effects of the ongoing war on terrorism and a possible war in Iraq on tourism receipts, and downward pressure stemming from the uncertain stock market. Annual GDP growth should average around 3.2% over the medium term—significantly below the 4.4% level that was recorded in the 1990s.

## *Progress in Fiscal and Monetary Policies*

In examining the specific Maastricht criteria for accession to the Eurozone, it becomes clear that Cyprus should be able to meet all the criteria by 2006 without any special assistance from the EU. Cyprus' macroeconomic policy has generally been prudent for much of the last 20 years. Occasionally, fiscal policy

has become too loose, but the government has generally been successful in tightening monetary policy to reduce excessive liquidity and inflation. During the last four years, the government's general fiscal deficit has been shrinking—declining to 3.9% of GDP in 1999, 2.7% in 2000, and 2.6% in 2001. The fiscal gap is currently estimated to have declined to just 2.3% of GDP in 2002. Total public debt was about 60% of GDP in 2000, compared with 52% in 1995, 53% in 1996, 58% in 1997, 59% in 1998, and 62% in 1999. The debt ratio is estimated to have fallen below the European Union's 60% entry requirement in 2001 and 2002, as the fiscal deficit continued to decline and the depreciation of the Cypriot pound slowed to 4.1% in 2001, down from 6.5% in 2000. As of June of 2001, total public debt stood at 59.3% of GDP.

The government revealed a new tax reform package in November 2001, aiming at meeting key European Union requirements. The island will drop its preferential tax treatment for offshore companies as it prepares to join the EU. Another provision in the tax package sees a gradual increase in the value-added tax to 15% and an across-the-board corporate tax of 10%. The VAT was increased to 13% in the summer of last year and then to the targeted 15% as of January 1, 2003. Tax issues have been considered one of the most difficult areas in EU membership negotiations. The opposition-controlled Parliament just recently approved the government's 2003 budget. This year's budget foresees a deficit of 679.5 million pounds, some 20 million pounds more than in the 2002 deficit, but down from 2.3% to 2.1% of GDP. Revenues are expected to reach 2.4 billion, while spending is expected to stand at 3.08 billion pounds. The proposed budget sees a substantial decline in spending on defense, from 135 million pounds last year down to 105 million pounds in 2003. Despite running deficits in the past couple of years, the country expects to improve cost controls and introduce more efficient tax collection methods, which would enable Cyprus to produce a break-even budget by 2005, the year following its EU accession. The budget excludes the breakaway northern part of the island.

Inflation in Cyprus may exceed EU levels in 2003 due to increases in certain taxes, which have already pushed year-on-year CPI inflation to 4.1% in January of 2003. Interest rate movements in Cyprus are already driven by measures taken by the ECB, and commercial banks have even begun to design plans for introducing the euro as an official currency. While current interest rates are somewhat higher than those in Western Europe, the trend is steadily downward.

As in the case of several other EU accession countries, Cyprus would prefer to adopt the euro immediately upon accession to the EU in 2004. However, given the guidelines likely to be enacted by the ECB, we believe that Cyprus will adopt the euro in 2006.

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	8.8	8.8	9.0	9.9	11.7	12.2	12.8	13.6
Per Capita GDP	<i>Current Dollars</i>	11918	11270	11445	12367	14671	15020	15583	16578
GDP, Growth Rate	<i>Percent</i>	6.1	5.1	4.0	2.3	2.8	3.4	3.3	3.2
Average Annual Inflation	<i>Percent</i>	2.6	4.0	2.0	2.8	3.2	2.6	2.6	2.6
Population (end-year)	<i>Thousand People</i>	740	780	790	800	800	810	820	820
Unemployment Rate	<i>Percent</i>	NA	NA	NA	NA	NA	NA	NA	NA
Consolidated Budget Balance	<i>Percent of GDP</i>	NA	NA	NA	NA	NA	NA	NA	NA
Net Foreign Debt	<i>Percent of GDP</i>	NA	NA	NA	NA	NA	NA	NA	NA
Exports	<i>Million Dollars</i>	1231	953	974	875	926	978	1031	1084
Imports	<i>Million Dollars</i>	3694	3846	3967	3959	4164	4398	4631	4862
Current Account Balance	<i>Percent of GDP</i>	NA	NA	NA	NA	NA	NA	NA	NA

# Czech Republic

## *Macroeconomic Overview and Outlook*

The Czech Republic is among the largest and richest of the EU accession countries. With nominal GDP of \$56.7 billion in 2001 and a population of 10.3 million, the country ranks second only to Poland, although Hungary is close behind on both counts. On a per capita basis, only Slovenia has a higher level of GDP. In comparison with existing EU member states, however, the Czech economy fares far worse. While the country falls in the middle of EU states in terms of population, with approximately the same number of inhabitants as Belgium, the Czech Republic is less than one-fourth the size of Belgium in terms of GDP. In comparison with larger EU countries such as France, the Czech Republic has just 17% of the population and 4% of GDP. Although Czech GDP per capita is currently far below West European levels, convergence has gone much farther when taking purchasing power into account. At purchasing power parity, Czech GDP reached 57% of the EU average in 2001.

The Czech Republic comprises some of the historically wealthiest and most industrialized territories in Europe. Although many local firms lost their competitive edge during 40 years of communism, the country has retained certain advantages in terms of recognizable brand names and manufacturing tradition. Moreover, Prague has been revitalized since 1989, attracting foreign tourists and businessmen alike. Since 1990, the structure of the Czech economy has changed considerably, as industry has declined in importance, losing ground to trade and other services. By 2001, industry accounted for approximately one-third of GDP, while domestic trade rose to nearly 16% of the total. Sectors such as transport and communications, banking, and other market services have also grown in significance.

In the early 1990s, the Czech Republic was seen as a leader in economic reforms, moving forward rapidly with price liberalization and setting an example for the rest of the region with its much-touted coupon privatization program. Nonetheless, by 1997 many flaws had been revealed in the hands-off approach that was adopted by the drafters of the Czech reform process, and confidence in the economy declined. Coupon privatization, which was aimed at increasing popular support for reforms by making ordinary citizens into shareholders, was eventually seen as a negative phenomenon since the lack of sufficient regulation led to a situation where many Czechs put their shares in investment funds that were controlled by state-owned banks. As a result, corporate governance was absent, unemployment remained unnaturally low, and the banking system was in shambles. It was not until former Prime Minister Vaclav Klaus and his allies lost power in late 1997 that major restructuring took place. Although the Czechs were initially reluctant to sell of their “family silver” to foreigners, all major banks are now majority-owned by West Europeans.

Despite such setbacks, the Czech Republic has had no problems attracting foreign direct investment. Given its geographical location next to Germany and Austria, combined with low wages and a strong manufacturing tradition, the country is seen by foreign firms as one of the most attractive in the region. The inflow of FDI has been especially rapid since 1999, as the country nears accession to the EU. By the end of 2001, the Czech Republic had brought in nearly \$28 billion worth of FDI, compared with \$35 billion for much-larger Poland. That investment will provide the basis for continued rapid increases in industrial production and exports in the future. By November 2002, foreign-controlled firms accounted for nearly one-half of industrial sales and more than two-thirds of total exports. Still, as income levels in the Czech Republic approach those in Western Europe, the country will face the challenge of attracting investments that are not based on the wage differential.

Although the Czechs began the post-communist transition with a very low level of foreign debt and state budgets that were close to balance, fiscal policy has recently become the country’s biggest concern. That is partly because of the enormous cost of bank restructuring that resulted from the poor oversight of the banking sector through 1997; however, mandatory spending on areas such as pensions has also been rising rapidly given the aging population. While the Social Democrats have pushed forward with key reforms in

the corporate sphere since taking office in 1998, they have shown much less courage in social policy. In consequence, although the Czech Republic's foreign debt has remained fairly stable since 1996, domestic debt has been soaring.

Once the Czechs get their fiscal house in order, the country has good prospects for healthy long-term growth. The shrinking population may become a cause for concern in the future, particularly as the country joins the EU and Czech citizens are able to travel freely abroad in search of better-paid jobs. Nonetheless, the Czech Republic has already been attracting foreign workers from further East who can easily fill in the gaps, particularly given the low linguistic and cultural barriers for other Slavs.

#### *Progress in Fiscal and Monetary Policies*

According to ESA methodology, the Finance Ministry is projecting a public finance gap of 6.3% of GDP in 2003. In the absence of fiscal reform, that deficit is set to rise to a high of 7.2% of GDP by 2004 before falling back to 6.6% in 2006 – this would be far above the 3.0% limit for entry into the Economic and Monetary Union (EMU). Considerable debate emerged over fiscal reform during coalition negotiations following the June 2002 elections. While the center-right parties wanted to take the needed steps to meet the Maastricht criteria by 2006, the Social Democrats were more reluctant. As a result, the coalition agreement signed by the current ruling parties plans for only limited reform, stating that the public finance deficit may reach 4.9-5.4% of GDP by 2006. The Finance Ministry, however, appears to have since come to realize the importance of more responsible fiscal policy. In mid-December, the ministry put forward two proposals to bring down the consolidated budget deficit. Under the optimistic scenario, the country would reach a deficit of 3.7% of GDP by 2006, while the pessimistic variant would provide for a public finance gap of 4.9% of GDP that year. In order to raise revenues, the ministry is proposing an increase in excise duties and value-added tax and a decline in corporate taxes, with personal income tax remaining constant. The ministry did not propose an overhaul of mandatory spending. For many Czech economists as well as the Czech National Bank (CNB), even the more radical scenario is insufficient since the country would not be able to join the EMU until 2008 at the earliest. Prime Minister Vladimir Spidla has been quoted as saying that the country will not join until as late as 2011. In its Draft Accession Strategy that was issued in late December, the CNB argued that the Czech Republic should be prepared to adopt the euro by 2007. Even if Prague should choose not to join the EMU in that year, like bank officials have stressed, a decline in the public finance deficit is required in any event to support sustained economic growth. Although the government was scheduled to discuss public finance reform at a session in early January, it decided to delay addressing the issue. In the meantime, a dispute appears to be brewing within the cabinet over whether the reforms should rely more on expenditure cuts or on tax hikes.

Despite the Czech Republic's growing fiscal deficits in recent years, public debt remains far below the 60% of GDP level eventually required for entry to the EMU. In the third quarter of 2002, government debt reached 406.3 billion koruna, up from 390.8 billion koruna at the end of June and 295.7 billion koruna in September 2001. By December 2003, total government debt is projected to increase further, to an estimated 514.9 billion koruna. Although the rapid rise is worrying, that figure is still equal to just 21.9% of projected GDP. Other criteria are unlikely to pose an obstacle to the country's entry to the Eurozone. Given the very low rates of inflation recorded in 2002, the Czech Republic is not expected to have any problem meeting the Maastricht requirements in that area. The same is true of interest rates, particularly considering that Czech rates are currently below Eurozone levels.

Assuming that the current government stays in power until the next elections, expected in June 1996, we consider it highly unlikely that Prague will meet the Maastricht criteria by that year due

to its reluctance to tackle the fiscal deficit. The Czech Republic is now the only accession country that is not planning to meet the requirements for entering the EMU by 2006. Clearly, if all of the others are ready to adopt the euro by that time, that could put the country in a difficult position. Given the likelihood that some countries in the region will decide to postpone entry as they weigh the pluses and minuses, the Czechs may be able to avoid the negative political consequences of the delay.

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	52.0	51.4	56.7	68.3	81.3	92.9	105.2	117.8
Per Capita GDP	<i>Current Dollars</i>	5040	5010	5524	6652	7928	9064	10266	11503
GDP, Growth Rate	<i>Percent</i>	5.9	3.3	3.3	2.5	3.3	4.0	5.3	5.4
Average Annual Inflation	<i>Percent</i>	9.1	3.9	4.7	1.8	1.8	2.6	2.3	2.1
Population, End-Year	<i>Thousand People</i>	10321	10267	10270	10260	10256	10252	10247	10242
Unemployment Rate	<i>Percent</i>	2.9	8.8	8.9	9.2	9.7	9.2	8.8	8.3
Exchange Rate, End-Year	<i>CZK/\$</i>	26.6	37.8	36.3	30.1	28.4	26.0	25.2	24.3
Consolidated Budget Balance	<i>% of GDP</i>	0.3	-4.5	-5.3	-5.1	-6.3	-5.5	-4.4	-3.9
Net Foreign Debt	<i>Percent of GDP</i>	-0.8	4.5	2.3	5.9	7.8	6.2	5.2	4.9
Exports	<i>Million Dollars</i>	21680	28996	33397	38402	45395	48009	51206	54950
Imports	<i>Million Dollars</i>	25080	32110	36472	40757	48290	51077	54798	58891
Current Account Balance	<i>Percent of GDP</i>	-2.6	-5.3	-4.6	-3.1	-3.3	-3.2	-3.2	-3.2

## Estonia

### *Macroeconomic Overview and Outlook*

Estonia's economy is tiny compared to most EU and EU accession countries. However, it is not the smallest by a long shot: in 2001, Estonia's \$5.5 billion GDP was similar in size to that of Malta and Liechtenstein combined. On the other hand, it is only 0.4% the size of France's economy. Estonia's population is also relatively small, with only 1.4 million citizens at the end of 2002. That is 2.3% of France's population: given the much smaller ratio when comparing GDP, it is clear that Estonia's GDP per capita is well below West European levels. But convergence has already been significant: Estonia's average per capita income in purchasing power standards reached 42.3% of the EU average in 2001. Because of the country's small size and the open nature of its economy, it is inordinately vulnerable to external shocks. On the other hand, its small size has been a positive factor in allowing Estonia to remain economically nimble in the face of changing circumstances.

Estonia is quickly developing a fairly sophisticated, balanced economy. Manufacturing is the largest sector in Estonia, accounting for 18.1% of GDP. But services account for about half of the economy. The transport and communications sector represents 16.4% of GDP, domestic trade, 14.5%, and real estate and other business services, 12.4%. The country has successfully installed a business-friendly climate, including zero taxation on companies' reinvested profits. In fact, Estonia is frequently rated one of the most liberal countries in the world. To a large extent, economic stabilization has been achieved in Estonia. Fiscal policies have been relatively tight, although there is room for improvement, and the pension system requires further reform. A currency board, introduced in 1992, has helped bring inflation under control and given credibility to the kroon. The banking system, largely in foreign hands, is healthy. The privatization process can be considered completed for all intents and purposes. One-third of Estonian companies now have some form of foreign equity participation. These companies account for half of exports. Finland and Sweden are the biggest investors in Estonia. As a small, open economy, Estonia will remain vulnerable to external forces, such as the 1998 Russian crisis and the current global economic slowdown, but the sound management of both domestic and external balances leaves the country well placed to quickly adapt to crises.

In the past, Estonia's very large current account deficits have been a primary threat to its economy. The country recorded current account deficits of over 12% of GDP in 1997 and nearly 10% in 1998. For the past three years, it has done better at controlling the deficit, keeping it around 6% of GDP. In the first three quarters of 2002, however, the current account deficit jumped in tandem with the foreign trade deficit, to \$544 million, or 12.9% of GDP. Assuming that the government maintains a responsible fiscal policy, we forecast that the deficit should stabilize at around 5% of GDP in the medium term. From the time of Estonia's independence through 2001, more than 70% of the current account deficit was financed by long-term capital flows, primarily direct investments and medium- to long-term bank loans. But with the completion of the privatization process, foreign direct investment has begun to slow, and policymakers will need to be more attuned to control of the current account.

Estonia was fortunate to gain independence in 1991 with almost no external debt, giving it a huge advantage over countries such as Hungary and Bulgaria. As foreign direct investment slows, and current account deficits—still relatively large—must be financed, Estonia's foreign debt is projected to continue to rise modestly in absolute terms. The biggest risk to Estonia's relatively low level of foreign debt would come from failure to control the recent expansion of the country's current account deficit. With the slowing of foreign direct investment, an increase in foreign loans will be necessary to finance future deficits: the larger the deficits, the more foreign debt will be incurred. If foreign debt is seen to be growing too fast, it might affect Estonia's creditworthiness, increasing the cost of borrowing and hence limiting financing possibilities. However, we do not foresee a worrisome rise even in the long run.

As the economy continues to grow rapidly, we project that the unemployment rate will trend downward. Already, some businesses are complaining of a shortage of highly skilled personnel. In the medium term, the baseline forecast calls for increasing levels of output for several years. Since much of Estonia's industry is still relatively labor-intensive, this will require additional labor inputs. With a shrinking population and labor force, this will translate into a noticeable reduction in unemployment rates. In fact, in October, Prime Minister Kallas told a business conference that the "shortage of qualified labor is becoming our main problem; our development will in the future be determined not by the financial environment but by the human factor." The prime minister noted that Estonia will have to accept the necessity of importing skilled foreign workers. In reality, this would involve an influx of Russians, which ethnic Estonians may find difficult to accept.

### *Progress in Fiscal and Monetary Policies*

In examining the specific Maastricht criteria for accession to the Eurozone, it becomes clear that Estonia should be able to meet all the criteria by 2006 without any special assistance from the EU. The constraint imposed by the currency board leaves fiscal policy as Estonia's main instrument for managing aggregate demand. Since independence, the government has generally run a budget surplus and has deposited some surplus funds abroad, in the Stabilization Reserve Fund, to dampen growth in aggregate demand. More recently, in light of Estonia's present rapid rate of growth in GDP and the large current account deficit, the IMF has been encouraging Estonia to maintain balanced budgets including the costs of pension reform. But some politicians have argued that the costs of pension reform are a valid excuse to run budget deficits over the next several years, and these voices seem to have held sway in the formation of the 2002 and 2003 budgets. While we believe that Estonia needs to maintain tight control of its budget, much of the planned expenditures will go toward investment in infrastructure. The previous government's EU accession program predicted that about 42 billion kroons (\$2.4 billion) will need to be spent on major reforms through 2013, of which environmental demands account for about half. Additional expenditures will be required for NATO membership. In the medium term, it is possible that the laxer fiscal habits in some EU countries could rub off on Estonia. For a small, open country with a dangerously large current account deficit, a budget deficit of 3% of GDP may be in some years in excess of what required by good fiscal policy management. As Estonia strives to catch up with the standard of living in Western Europe, Estonian authorities may be tempted to abandon their stricter fiscal habits, creating budget deficits that are not conducive to sustained macroeconomic balance. However, Estonia's public debt is well below the criteria of 60% of GDP, and we do not expect that Estonia will even approach that limit anytime in the next decade.

Inflation in Estonia is expected to exceed EU levels for several years due to increases in administratively regulated prices and excise taxes, plus increasing wage pressures. Still, Estonia should have no problem meeting the Maastricht criterion on inflation for EMU membership by 2006. The same is true of interest rates. Interest rate movements in Estonia are already driven by measures taken by the ECB. While current interest rates are somewhat higher than in the West, the trend is steadily downward.

We believe that Estonia will maintain its currency board at the present peg to the euro until EMU membership requires a change in exchange-rate regimes. Reserves are sufficient, and the country's central bank and currency board have maintained a high degree of credibility. Estonia would prefer to adopt the euro immediately upon accession to the EU. But given the guidelines likely to be enacted by the ECB, we believe that Estonia will enter ERM-2 upon EU accession in 2004, and adopt the euro by 2006.

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	3.6	5.1	5.5	6.3	7.2	8.3	9.4	10.5
Per Capita GDP	<i>Current Dollars</i>	2415	3755	4054	4615	5321	6093	6921	7747
GDP, Growth Rate	<i>Percent</i>	4.3	7.1	5.0	5.7	5.8	5.5	5.5	5.3
Average Annual Inflation	<i>Percent</i>	29.0	3.9	5.8	3.6	2.7	3.0	3.4	3.2
Population (end-year)	<i>Thousand People</i>	1507	1446	1372	1367	1361	1360	1359	1357
Unemployment Rate	<i>Percent</i>	9.7	13.7	12.6	10.1	9.1	8.6	8.4	8.2
Consolidated Budget Balance	<i>Percent of GDP</i>	-0.6	-0.7	0.3	-0.5	0.2	-0.1	-0.1	-0.2
Net Foreign Debt	<i>Percent of GDP</i>	-12.3	20.5	20.6	22.8	22.0	21.3	20.9	20.9
Exports	<i>Million Dollars</i>	1660	3169	3305	3481	3940	4401	4901	5429
Imports	<i>Million Dollars</i>	2392	4250	4290	4767	5293	5804	6342	6928
Current Account Balance	<i>Percent of GDP</i>	-5.2	-5.7	-6.2	-10.6	-7.3	-6.4	-5.8	-5.3

## Hungary

### *Macroeconomic Overview and Outlook*

Generally perceived to be one of Central Europe's most advanced economies, Hungary is relatively small in terms of GDP and population when compared with some of the larger EU countries. In 2002, Hungary's GDP was valued at just \$60.5 billion at the average market exchange rate, slightly less than that of the Czech Republic, just above one-quarter of the size of the Polish economy, and only 4.5% of France's GDP. In terms of population, Hungary at 9.9 million is similar in size to the Czech Republic and falls roughly in the middle of EU states. Hungarian GDP per capita measured at the purchasing power parity exchange rate amounted to \$11,262 in 2001, trailing Slovenia by a substantial margin and comparable to that of the Czech Republic. The economic gap between the EU average and Hungary is still quite sizeable, despite several years of impressive growth in Hungarian GDP, particularly in the late 1990s.

Hungary enjoyed a head start compared to other Central European economies in transition, as the Communist government in the 1980s had already installed some basic features of a market-oriented economy. In the early stages of transition, the Hungarian government offered domestic businesses and foreign investors alike exceptionally attractive conditions for locating their operations in Hungary, that included, among other features, tax incentives and special economic zones. Attracted by these offers, the highly qualified work force, aggressive privatization of state property and the proximity to Western Europe, investors poured into Hungary in the early 1990s, making it by far the most popular country, in which to invest early in the transition. On average, Hungary has attracted \$2 billion in net FDI annually during the last twelve years. Most importantly, Hungary attracted investments into high-valued industries such as electronics and optical equipment, the automotive industry and data processing. Major multinational corporations such as IBM, Phillips and Suzuki build greenfield plants in the country with the aim of

exporting most of their production to developed countries utilizing their internal corporate distribution channels. As of 2002, 45 out of the 50 largest multinational corporations were present in Hungary. In the process, Hungary has become the most economically integrated with the EU and the most export-oriented economy in the region. In the course of those developments, the portion of the country's GDP generated by the service sector grew to over 50% in 2001. More than 72% of total industrial sales are generated by companies at least partially owned by foreign investors.

The economic boom in Hungary translated into increased spending as consumers started to reap the benefits of years of austerity by enjoying higher wages and access to high-quality imported goods. This consumption boom has had unfortunate consequences for Hungary's open economy, resulting in a substantial widening of the deficit on the current account. By the year 1994, the current account deficit reached 9.4% of GDP, risking a currency crisis and macroeconomic destabilization. In response, the Hungarian government adopted a set of austerity measures dubbed the "Bokros program" in 1995, bringing a prolonged slowdown in economic activity, but enabling Hungary to avoid experiencing an outright post-transition recession like that in the Czech Republic in 1997. The lessons learned from the "Bokros years" provided the Hungarian government with sufficient arguments to accelerate the process of privatizing the remaining state-owned assets and permit foreign investors to take over majority stakes in key sectors of the economy.

The last years of the 1990s, under a ruling coalition of the Hungarian Socialist Party (MSzP) and the Alliance of Free Democrats (SzDSz), were characterized by strong export performance and an investment-driven expansion that featured double-digit annual increases in exports and ongoing modernization of the Hungarian industrial base. This government also accelerated the liberalization of the local energy markets. A side effect of those changes and the less restrictive monetary policies was inflation rate that remained higher than in the majority of the other EU candidate countries. In order for Hungarian exports to remain competitive internationally, the central bank in cooperation with the government employed a crawling-peg exchange rate regime that adjusted the reference rate for the forint downwards in line with inflation. This policy was abandoned in May of 2001 in favor of an ERM-2 mechanism featuring a plus/minus 15% fluctuation band around a reference rate against the euro. Since the introduction of the new regime, the forint has appreciated very strongly against both the dollar and the euro. When combined with the slowdown in economic activity in the main export markets in the EU, Hungarian export growth slowed considerably over the last two years, dragging down industrial output as well. The expansionary fiscal policy and exceptionally strong growth in private consumption and construction activity led to a substantial widening of the current account deficit, to 5.7% of GDP in 2002.

Despite continued weak external demand, Hungary's year-on-year economic growth accelerated from 2.9% in January–March to 3.1% in the second quarter and 3.5% in the third quarter of 2002, in line with our current revised 3.3% GDP growth forecast for 2002. This followed 3.8% GDP growth in 2001. Preliminary data for the second half of 2002 are suggesting that, while the Hungarian economy is still experiencing problems adjusting to the prolonged slowdown in its major export markets in the European Union, the worst seems to be over. Despite mixed results throughout the first half of 2002, industrial production was up 2.6% in seasonally and working-day adjusted terms last year. While this was the lowest growth rate of industrial output in nine years, it was still a sizable improvement when compared with the rapid deceleration in output in late 2001.

Hungary is on course to record annual GDP growth rates of around 3-4% during 2003-07, despite government hopes for much higher rates of growth. Thanks to extensive FDI that has modernized the manufacturing, energy, and financial sectors, Hungary's export competitiveness and performance should continue to improve. An ambitious highway construction program should help funnel investment to Hungary's relatively depressed eastern areas, thereby offsetting the effects of the tight labor markets and rising wage costs now taking hold in the western part of the country. Over the next several years, Hungarian economic policies will be increasingly determined by the upcoming accession to the EU in 2004 and the need to meet the Maastricht criteria for eurozone accession just several years later.

#### *Progress in Fiscal and Monetary Policies*

Despite the relative health and strong growth of the Hungarian economy in the last three years, the periodically unfortunate mix of economic policy resulted in an extremely high fiscal deficit measured as a share of GDP, relatively high inflation and a dangerously widening current account deficit. Indeed, from the perspective of the end of 2002, one could argue that Hungary is far removed from meeting the Maastricht criteria in the nearest future. While the risks ahead are quite high and the timetable short, an appropriate policy approach could still guarantee Hungary access to the Eurozone as early as in 2007-2008.

The situation in the budget will clearly constitute the biggest challenge. The consolidated budget deficit on a cash basis is estimated to have grown to above 10% of GDP in 2002, exceeding the annual target almost three times. Fiscal excesses can be attributed to the spending spree undertaken by two consecutive governments in an effort to win popular support ahead of the parliamentary elections in 2002. This included not only excessive spending on housing and infrastructure, but also boosting the wages of public sector employees by 50% as of October 2002. And while expenditures worth roughly 3.5% of GDP in 2003 can be classified as extraordinary and will not be repeated in 2003, reduction of the consolidated budget deficit to 4.5% of GDP this year is already unattainable. If this target is missed, Hungary will find it very difficult to fit its budget deficit under the 3.0% limit specified by the Maastricht criteria before 2006.

The relatively loose fiscal policy and high levels of inflation (at 4.8% y/y in December 2002, Hungary's inflation was the highest among all EU accession countries), leave little room to maneuver for the central bank's monetary policy. The bank has attempted to target inflation and stabilize the exchange rate of the forint with rather mixed results. The most recent (January 2003) interest rate cuts showed vividly that in order to prevent an excessive appreciation of the forint, the central bank had to compromise and permit overall loosening of monetary conditions. If the wage growth in the private sector is not curtailed and the forint remains rather weak, inflation will be resilient in 2003. As a result, the convergence of inflation and interest rates to the Maastricht criteria might take longer than originally expected. We expect that following a temporary setback in January 2003, the forint will resume appreciating against the euro through the medium term.

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	44.7	46.3	51.1	60.5	72.0	80.0	89.0	96.9
Per Capita GDP	<i>Current Dollars</i>	4374	4630	5129	6088	7271	8093	9034	9862
GDP, Growth Rate	<i>Percent</i>	1.5	5.2	3.8	3.3	3.8	3.9	3.2	3.2
Average Annual Inflation	<i>Percent</i>	28.2	9.8	9.2	5.4	4.7	4.2	3.8	3.4
Population, End-Year	<i>Thousand People</i>	10212	10005	9969	9938	9909	9880	9851	9821
Unemployment Rate	<i>Percent</i>	10.2	6.4	5.6	5.9	5.6	5.7	5.9	6.0
Exchange Rate, End-Year	<i>HUF/\$</i>	139.5	285.2	279.0	225.2	228.5	220.5	213.8	210.3
Consolidated Budget Balance	<i>% of GDP</i>	-6.3	-3.4	-3.0	-10.1	-5.3	-4.7	-4.0	-3.7
Net Foreign Debt	<i>Percent of GDP</i>	42.0	39.8	43.7	41.2	35.1	33.8	32.0	28.9
Exports	<i>Million Dollars</i>	14300	28092	30498	33426	37938	41694	45697	49124
Imports	<i>Million Dollars</i>	16593	32079	33682	36545	40285	44238	47564	50521
Current Account Balance	<i>Percent of GDP</i>	-5.6	-2.9	-2.2	-5.7	-4.1	-3.1	-2.3	-1.6

## Latvia

### *Macroeconomic Overview and Outlook*

Latvia's economy is tiny compared to most EU and EU accession countries. While Latvia's \$7.5 billion GDP in 2001 was similar in size to Iceland's, it was only 0.6% the size of France's economy. Latvia's population is also relatively small, with only 2.3 million residents at the end of 2002. That is 3.9% of France's population: given the much smaller ratio when comparing GDP, it is clear that Latvia's GDP per capita is well below West European levels. Despite recent rapid growth, Latvia remains one of the poorest EU applicant countries. In 2001, according to Eurostat, Latvia's per capita GDP was 7,700 euro in PPS

terms. That was the lowest of the 10 countries slated for membership in 2004. The average EU per capita GDP was 23,200 euro. Because of Latvia's small size and the open nature of its economy, it is inordinately vulnerable to external shocks.

Value added in manufacturing, which in 1990 accounted for 30% of GDP, now makes up only 20% due to the closure of Soviet-era industrial behemoths in the early 1990s. The share of transportation and communications in GDP has grown from 10% a decade ago to 14% now, as transportation has benefited from increased trade between Russia and Western Europe. Services, mainly domestic trade and transport, but also financial and business services, now constitute just over half of Latvia's GDP, compared with 28% in 1990. Agriculture, which was never a major factor in the Latvian economy, now accounts for under 7% of GDP. Latvia's overall economy is fairly sound, as the government continues to make the changes required for EU membership. The currency is stable, inflation is low, and privatization is nearly complete. Denmark, the United States, and Germany are the leading sources of foreign investment. GDP growth in 2001 was the highest of all EU applicants and members. However, Latvia has been more hesitant than Estonia in implementing policies needed to complete the transition to a market economy. Fiscal policy has been much looser, and privatization more complicated, while corruption is widely viewed as being more pervasive. The country's biggest risks stem from its dependence on the Russian economy, and its seeming inability to control its external imbalances.

If the government is to sustain its successes to date, it will need to adopt more restrictive fiscal policies in order to decrease the current account deficit. In the past, Latvia's very large current account deficits have been a primary threat to its economy. In 2000, the current account deficit narrowed to 6.9% of GDP, compared with 9.8% of GDP in 1999 and 10.7% in 1998. But in 2001 it re-expanded, to 10.1% of GDP (\$759 million), and it continued to grow in absolute terms in the first three quarters of 2002. Going forward, the access to the EU should help ensure that Latvia implements sounder fiscal policy, which in turn will keep current account deficits in check. Latvia is also expected to benefit from large transfers of funds from the EU, higher inflows of foreign direct investment (particularly as corruption becomes less of an issue), and increased trade with Western Europe. However, the narrower current account deficits projected over the next few years are still quite large, and can only be sustained if the authorities are able to conduct policies that encourage continued large inflows of capital.

Net foreign debt is growing, although it is not yet problematic. From \$3,160 million in 2001, we project an increase to \$4,797 million in 2006, still only 36.4% of forecasted GDP. We project that net foreign debt will continue rising for several years in absolute terms as Latvia completes the privatization process and becomes more dependent on loans to finance its current account deficits. The biggest risk to Latvia's relatively low level of foreign debt would come from continued growth of the country's current account deficit. With the slowing of foreign direct investment, an increase in foreign loans will be necessary to finance future deficits; the larger the deficits, the more foreign debt will be incurred. If foreign debt is seen to be growing too fast, it might affect Latvia's creditworthiness, increasing the cost of borrowing and hence limiting the possibilities for financing. However, we do not foresee a worrisome rise even in the long run.

As the economy picks up, we project that the unemployment rate will trend downward. In the medium term, the baseline forecast calls for increasing levels of output for several years. Since much of Latvia's industry is still relatively labor-intensive, this will require additional labor inputs. With a shrinking labor force, this will translate into a noticeable reduction in unemployment rates. By 2006, we project that the rate of registered unemployed will fall to 7.0% of the labor force. This takes into account the fact that the retirement age is being raised, which will serve to increase the size of the labor force and slow the decline in the unemployment rate. However, the share of unemployed who do not bother to register at all is estimated at 50% of the registered unemployed, since unemployment benefits are fairly low. Also, regional disparities persist: in many of the eastern counties, even the headline unemployment rate is well above 20%, while in Riga it is only 3.7%.

#### *Progress in Fiscal and Monetary Policies*

Latvia should be able to meet all the Maastricht criteria for accession to the Eurozone by 2007 without any special assistance from the EU, although constant pressure will be required to convince Latvian officials to

maintain disciplined fiscal policies. However, this issue has more to do with political will than with structural or financial constraints. For example, the 2002 budget targeted a deficit of 2.5% of GDP, well above the 1% deficit that had been agreed on with the IMF: The IMF expressed concern over the 2002 budget, saying it implied a substantial fiscal loosening and could exacerbate pressure on the current account. The Fund recognizes the need to increase expenditures associated with EU and NATO accession and supports the Latvian authorities' desire to reduce the tax burden, but also deems it necessary to improve expenditure prioritization, enhance tax administration, and implement more public sector reforms. For a small, open country with a dangerously large current account deficit, a budget deficit of 3% of GDP may be in some years in excess of what required by good fiscal policy management. As Latvia strives to catch up with the standard of living in Western Europe, Latvian authorities may be tempted to continue current fiscal habits, creating budget deficits that are not conducive to sustained macroeconomic balance.

Due to continuing financing needs for large budget and current account deficits, Latvia's public debt grew to 713 million lats at the end of 2001, a 25% increase from the end of 2000, but still just 15% of GDP. Of the total, 457 million was external debt, which accounted for most of the growth. The maximum level of public debt for 2002 was set at 861 million lats. Given that Latvia's public debt is well below the criteria of 60% of GDP, we do not expect that Latvia will approach that limit anytime in the next decade.

Latvia continues to keep inflation relatively low through its pegged exchange rate. It will be difficult to further reduce inflation in the near term, as remaining administered prices need to be adjusted to cost-recovery levels, an important step for Latvia to ensure its economic competitiveness. Additionally, wage pressures will intensify in the medium term. Latvia is one of the poorer EU applicant countries, and as accession nears, workers will demand appropriate wage compensation. In December, Finance Minister Valdis Dombrovskis projected that it would be impossible for Latvia to join the EMU in 2006 because Latvia will not be able to meet the Maastricht requirement for inflation by then. But trade unions are weak, and higher expected productivity increases should be sufficient to match modest forecasted growth in real wages. After peaking in 2005 at 4.4%, average annual inflation should still be over 3.0% by 2006. Therefore, we believe that Latvia should be able to significantly lower inflation in order to be ready for EMU membership by 2007. The same is true of interest rates. The Bank of Latvia noted that while yields on government bonds, at 5.6% for five-year Treasury bonds in January 2003, are still higher than the average of Western Europe, they are on a downward trend. On the other hand, if disputes within Latvia over such issues as the privatization process or how to fight corruption deter foreign investment, interest rates may have to rise in order to attract sufficient financing for Latvia's external deficits.

We believe that Latvia will maintain its present peg to the SDR until EMU membership requires a change in exchange-rate regimes. Reserves are sufficient, and the country's central bank has a high degree of stability, credibility, and independence. In January 2003, Prime Minister Repse said that Latvia wanted to enter ERM-2 upon EU accession in 2004, and adopt the euro by 2006.

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	4.4	7.2	7.5	8.2	9.0	10.3	11.7	13.2
Per Capita GDP	<i>Current Dollars</i>	1780	3012	3190	3513	3867	4434	5060	5708
GDP, Growth Rate	<i>Percent</i>	-0.8	6.8	7.7	5.7	5.9	5.8	5.9	5.7
Average Annual Inflation	<i>Percent</i>	25.0	2.6	2.5	1.9	1.9	2.6	3.6	3.8
Population (end-year)	<i>Thousand People</i>	2468	2366	2346	2337	2328	2319	2311	2303
Unemployment Rate	<i>Percent</i>	6.4	7.8	7.7	7.6	7.4	7.3	7.2	7.0
Consolidated Budget Balance	<i>Percent of GDP</i>	-3.1	-2.8	-2.1	-2.9	-2.5	-1.5	-1.5	-1.0
Net Foreign Debt	<i>Percent of GDP</i>	15.9	39.8	41.9	41.9	41.8	39.8	37.9	36.4
Exports	<i>Million Dollars</i>	1283	1867	2001	2263	2469	2688	2920	3167
Imports	<i>Million Dollars</i>	1810	3191	3506	4049	4569	4972	5407	5791
Current Account Balance	<i>Percent of GDP</i>	-0.4	-6.9	-9.8	-9.2	-7.7	-6.4	-5.6	-4.9

# Lithuania

## *Macroeconomic Overview and Outlook*

Lithuania's economy is the biggest of the three Baltic states, but is still tiny compared to most EU and EU accession countries. Lithuania's \$12.0 billion GDP in 2001 was only 0.9% the size of France's economy. Lithuania's population is also relatively small, with only 3.5 million citizens at the end of 2002. That is 5.9% of France's population: given the much smaller ratio when comparing GDP, it is clear that Lithuania's GDP per capita is well below West European levels. In 2001, Lithuania's per capita GDP was 8,700 euro in PPS terms. Of the 10 countries slated for membership in 2004, only Latvia had lower per capita GDP. The average EU per capita GDP was 23,200 euro.

After experiencing some of the largest output declines among the former Soviet republics in 1992-93, the Lithuanian economy had grown for four years prior to 1999. Monetary and fiscal policies were tight and improving. Lithuania still lagged Estonia and Latvia in the privatization process, but in most other areas it had made rapid progress. But in 1999-2000, the country's economy suffered significantly more than Estonia's or Latvia's in the aftermath of Russia's financial crisis, as more critical fiscal and external imbalances plus less progress in restructuring limited Vilnius' response. Lithuania's biggest risks are its current account deficits and its dependence on the volatile Russian economy. Sweden is the largest foreign investor, with 16.6% of the total, followed by Denmark (16.0%).

Although Lithuania is generally perceived to be the most agricultural-based economy of the Baltic states, value added from agriculture accounts for only 9% of the country's GDP. That ratio has not changed substantially over the past decade. The share of industrial value added, on the other hand, fell from around 37% of total GDP in 1992 to 26% in 2001, as inefficient Soviet-era industrial behemoths were shut down in the early 1990s. The Mazeikiai Nafta oil refinery is Lithuania's largest company, single-handedly accounting for up to 10% of the country's GDP; the country's output results are therefore often significantly impacted by circumstances peculiar to that company. The energy sector contributes about one-sixth of total industrial output, so the decommissioning of the Ignalina nuclear power plant in 2004-09 will cause a temporary dip in growth, but will not be catastrophic for Lithuania's economy. The primary beneficiary of the transition to a market economy has been services. Domestic trade now accounts for some 17% of total GDP, compared with just 8% in 1992. The transport and communications sector accounts for another 10%.

Lithuania recorded current account deficits of 10-12% of GDP in 1997-99. But the deficit then declined for three years in a row. Assuming that the government adopts a more responsible fiscal policy, we forecast that the deficit should stabilize at 4-5% of GDP in the medium term. In part, Lithuania's large current account deficits have reflected significant imports of capital goods and equipment associated with rising foreign investment. Foreign direct investment covered 78% of the current account deficit in 2001. But with the completion of the privatization process, foreign direct investment has begun to slow, and policymakers will need to be more attuned to control of the current account.

With foreign equity investment insufficient to meet Lithuania's external financing needs, the country has increased borrowing. Lithuania issued 1,370 million euro worth of Eurobonds in 1999-2002, and plans to issue a 400-million-euro Eurobond in the first quarter of 2003. In 2001, gross foreign debt rose to \$3.35 billion (28.0% of GDP), but foreign reserves rose even faster, to \$1.67 billion. This resulted in net foreign debt dropping to 14.0% of GDP. In the medium term, as foreign direct investment slows and current account deficits—still relatively large—must be financed, Lithuania's foreign debt is projected to continue rising in absolute terms. As a percentage of growing GDP, though, it should remain fairly stable. In January 2002, the government set limits to state borrowing, capping official foreign debt at 25% of GDP, and 70% of total public debt, as of the end of 2004.

The headline unemployment rate fell from 12.9% in the first quarter of 2002 to 11.2% in the second. In the medium term, unemployment should continue to fall as the economy maintains its strong expansion, and as growth in private-sector employment compensates for continuing layoffs due to the privatization and

restructuring of state-owned enterprises. We are projecting a decline in the headline unemployment rate to 9.2% in 2006. The government's European Committee estimates that the migration of workers related to Lithuania's integration with the European Union will cost the domestic economy 1.7 billion litas over 2002-09. Lithuania has some structural characteristics, such as a relatively high minimum wage and restrictions on hiring part-time employees, which will continue to make unemployment rates difficult to reduce. But Lithuania has taken a more liberal approach to this issue than Estonia. In March 2001, its parliament passed a set of amendments to the country's labor laws aimed at liberalizing the labor market. The new amendments provide for temporary terms of employment and significantly reduced severance pay.

#### *Progress in Fiscal and Monetary Policies*

In examining the specific Maastricht criteria for accession to the Eurozone, it becomes clear that Lithuania should in theory be able to meet all the criteria by 2007 without any special assistance from the EU. In practice, fiscal targets could prove problematic. However, this issue has more to do with political will than with structural or financial constraints. The constraint imposed by the currency board leaves fiscal policy as Lithuania's main instrument for managing aggregate demand. Yet the government has not proved particularly adept at managing fiscal policy. For example, Lithuania had originally agreed with the IMF to balance the budget in 2001. The government then negotiated a target deficit of 1.3% of GDP, which was later revised to 1.5% and then to 1.7%. In June 2002, officials admitted the 2001 deficit had actually amounted to 1.9% of GDP. The IMF claimed it was satisfied with the result, since the larger deficit was the result of higher expenditures on co-financing capital investment projects with the World Bank, the EBRD, and the EIB. For a small, open country with a dangerously large current account deficit, a budget deficit of 3% of GDP may be in some years in excess of what required by good fiscal policy management. As Lithuania strives to catch up with the standard of living in Western Europe, Lithuanian authorities may be tempted to continue their lax fiscal habits, creating budget deficits that are not conducive to sustained macroeconomic balance.

At the end of 2000, official public debt stood at 12,730 million litas, or 28.2% of GDP. But including other domestic liabilities, such as private debts of state-owned companies that the state does not guarantee but may end up covering, total debt was estimated at 20,152 million litas, or half of GDP. By the end of 2001, official public debt had increased in absolute terms to 12,903 million litas, 26.9% of GDP. Direct state liabilities amounted to 10,724 million litas, or 83% of overall debt, and contingent liabilities (loan guarantees issued by the state) made up the remainder. Domestic debt accounted for 24% of the total. Even using the broadest definition, Lithuania's public debt is below the criteria of 60% of GDP, and we do not expect that that limit will be breached before 2006.

Lithuania's record on price stability is impressive. The currency board has been pivotal to lower inflation. Nonetheless, inflation in Lithuania is expected to exceed EU levels for several years due to increases in administratively regulated prices and excise taxes, plus increasing wage pressures. More generally, the extremely low level of current inflation will not be sustainable in the context of a surging economy. By 2006, inflation will be peaking, with average annual inflation around 4.5%. Interest rates on short-term loans fell from 13.1% in 2000 to 9.0% in 2001, and to 6.8% at the end of 2002. While current interest rates are somewhat higher than in the West, the trend is steadily downward.

Lithuania instituted a currency board in April 1994, pegging the litas to the dollar at a rate of 4 to 1. In February 2002, the litas was re-pegged to the euro at 3.4528:1. We believe that Lithuania will maintain its currency board at the present peg until EMU membership requires a change in exchange-rate regimes. Reserves are sufficient, and the country's central bank and currency board are gaining a greater degree of credibility every year. In January, Bank of Lithuania Governor Reinoldijus Sarkinas said that Lithuania expects to join ERM-2 in 2004, and should be able to adopt the euro in 2006 or early 2007.

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	6.0	11.3	12.0	14.0	15.9	18.2	20.7	23.4
Per Capita GDP	<i>Current Dollars</i>	1623	3233	3444	4006	4558	5217	5940	6608
GDP, Growth Rate	<i>Percent</i>	3.3	3.8	5.9	6.2	6.0	5.3	5.5	5.3
Average Annual Inflation	<i>Percent</i>	39.6	1.0	1.5	0.4	1.2	3.2	4.1	4.3
Population (end-year)	<i>Thousand People</i>	3712	3491	3482	3484	3486	3489	3492	3548
Unemployment Rate	<i>Percent</i>	6.1	11.5	12.5	11.4	10.5	10.0	9.5	9.2
Consolidated Budget Balance	<i>Percent of GDP</i>	-1.8	-1.4	-1.6	-2.3	-2.4	-1.5	-1.0	-0.5
Net Foreign Debt	<i>Percent of GDP</i>	9.7	16.5	14.0	12.7	12.2	12.2	12.7	13.3
Exports	<i>Million Dollars</i>	3356	3809	4583	5403	5998	6418	6803	7483
Imports	<i>Million Dollars</i>	3649	5457	6353	7840	8428	9186	10105	10812
Current Account Balance	<i>Percent of GDP</i>	-10.2	-6.0	-4.8	-5.1	-4.8	-4.8	-5.1	-4.6

## Malta

### *Macroeconomic Overview and Outlook*

Malta's economy is among the smallest compared to most EU and EU accession countries. In 2001, Malta's \$3.6 billion nominal GDP actually made it the smallest of all West European and EU accession economies—it is only 0.3% the size of France's economy. Malta's population is also tiny, with only about 400,000 citizens at the end of 2002. That is 0.7% of France's population. On a per capita basis, Malta ranks amongst the richest candidates for EU membership, surpassed only by Slovenia and Cyprus. But the country's small size, its large dependence on tourism revenues, and the increasingly open nature of its economy have made this small Mediterranean island extremely susceptible to external economic and geopolitical shocks.

The economy of Malta has been on an impressive growth trend since 1995 with the economy registering an average annual growth of 4.6% in the period 1995-2000. After a decline of 0.4% in 2001, Malta's real GDP picked up through the first three quarters of 2002, growing 0.7%, 2.7% and 4.1% year over year in each quarter, respectively. Even though some sectors of the economy were slow to recover in 2002, with manufacturing registering negative growth in the first two quarters of last year, almost all sectors of the economy registered growth in the third quarter with manufacturing actually recording the highest growth, of 2.4% year over year.

Weak external demand resulting from a persistent weakness in the global economy, as well as a downturn in world tourism in the aftermath of the September 11 tragedy and geopolitical tensions in the Middle East, hurt Malta's economy in 2001. Despite the efforts of the central bank, which lowered the central intervention and discount rates by 25 basis points in September and December of 2001, Malta's economy still contracted in 2001. The central bank lowered interest rates by another 25 basis points in March 2002 and again in December, which helped the economy gain some ground last year. The country's commitment to balancing the budget and pushing through necessary reforms combined with expected EU accession bode well for the country's economic outlook. However, the country's 2003 growth prospects remain under threat from developments in Iraq, which will likely continue to hurt tourism revenues and keep external demand low as the

economies of Malta's main trading partners in Western Europe struggle to recover from last year's economic slowdown. Global Insight's baseline forecast projects a slightly better GDP growth rate of 3.1% in 2003 and a further strengthening to 3.8% in 2004, as a resolution to military conflict in Iraq is expected to stimulate world growth starting in the second half of this year.

Malta's greatest risks lie in the country's over-dependence on tourism revenues and the lack of diversity of its manufacturing sector, which is dominated by the electronics sector and which contributed for about half of the country's growth in 2002, following a sharp drop in 2001. Another major threat to the country's outlook comes from the fact that despite the pick-up in economic activity, domestic demand has failed to contribute to a robust recovery; it actually eased in the third quarter of last year with growth in both private and government consumption slowing from the previous quarter. The labor markets also remain subdued as capital investment has so far failed to pick up substantially, thus not allowing for ample job creation. Though the weak labor market has kept inflationary pressures low, it will also limit growth in domestic demand until a more pronounced global economic recovery improves investment sentiment and consumer confidence in the second half of the year.

Malta's current account balance shows few signs for worry. The current account deficits have been in the range of 3-6% of GDP for the past five years, with the only exception coming in 2000, when the current account jumped to 13% of GDP on the back of a substantial merchandise trade deficit, which was spurred by upbeat consumer sentiment and strong domestic consumption. Our forecast for the current account balance projects deficits of 3-5% of GDP in the next few years as the global economy and Malta's major trading partners recover and tourism revenues return to a strong growth trend.

#### *Progress in Fiscal and Monetary Policies*

In examining the specific Maastricht criteria for accession to the Eurozone, it is safe to assume that Malta should be able to meet all the criteria by 2006. While Malta's macroeconomic policy has not always been prudent, the country managed to bring the fiscal balance from a deficit of 9.9% of GDP in 1997 down to a deficit of 6% of GDP in 2001. The budget deficit actually stood as low as 3.6% of GDP in 1999, but increased in 2001 as the government tried to boost economic growth through a more expansionary fiscal policy. In the first nine months of 2002, the budget deficit stood at around 7% of GDP. Estimates for 2003 suggest that the overall fiscal stance may remain expansionary in the short term until there is enough evidence that a more pronounced economic recovery is on the way. While the looser fiscal stance in 2001 and 2002 caused an increase in the budget deficit as a percentage of GDP, there is little reason for excessive concern as fiscal consolidation is set to remain a primary objective of budgetary operations in the coming years. The government's medium-term projections show that greater emphasis is to be placed on expenditure rationalization and a number of measures are to be undertaken to balance the government's accounts.

The debt ratio remained below 60% until last year, when an expansionary fiscal policy and growing deficit took their toll on total public debt. Total public debt, based on the Maastricht definition, was about 62% of GDP in 2002, having grown steadily from 52% in 1997. Given the strengthening of the Maltese lira in recent months and the expected strengthening of the global economy following the second quarter of this year, Malta should not be hard pressed to keep its outstanding public debt close to 60%.

Inflation in Malta has remained low in the 2-3% range over the past five years and is expected to remain around 2-2.2% in 2003-06. The increase in the value of the lira as well as persistently weak domestic and external demand are likely to keep inflationary pressures low in coming months. Malta, therefore, should have little trouble meeting the Maastricht criterion on inflation for EMU membership by its planned date for joining the monetary union in 2006. The same is true of interest rates, which in Malta have remained relatively stable in the last decade. While current interest rates are slightly higher than the EU average, the trend is steadily downward.

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	3.3	3.5	3.6	4.0	4.7	5.2	5.8	6.3
Per Capita GDP	<i>Current Dollars</i>	8613	9082	9239	10132	11762	13023	14422	15815
GDP, Growth Rate	<i>Percent</i>	6.2	4.9	-0.4	2.9	3.1	3.8	4.2	4.0
Average Annual Inflation	<i>Percent</i>	4.0	4.5	2.0	2.2	1.9	2.2	2.0	2.0
Population (end-year)	<i>Thousand People</i>	380	390	390	390	400	400	400	400
Unemployment Rate	<i>Percent</i>	NA	NA	NA	NA	NA	NA	NA	NA
Consolidated Budget Balance	<i>Percent of GDP</i>	NA	NA	NA	NA	NA	NA	NA	NA
Net Foreign Debt	<i>Percent of GDP</i>	NA	NA	NA	NA	NA	NA	NA	NA
Exports	<i>Million Dollars</i>	1914	2336	1917	1971	2098	2200	2305	2412
Imports	<i>Million Dollars</i>	2944	3417	2592	2724	2901	3041	3182	3326
Current Account Balance	<i>Percent of GDP</i>	NA	NA	NA	NA	NA	NA	NA	NA

## Poland

### *Macroeconomic Overview and Outlook*

Poland is by far the largest of the EU accession countries, both in terms of its economy and population. GDP at current market prices amounted to \$182.5 billion in 2001. This was more than three times that of the Czech Republic, the second largest economy among the EU accession countries. When compared with the economies of current EU members, Poland's GDP would rank 11<sup>th</sup>, roughly 14% that of France calculated using market exchange rates. Poland's population of 38.6 million will be the sixth largest in the enlarged EU, and almost four times that of the Czech Republic the second largest EU accession country in terms of population. Despite the size of its economy, Poland ranks only sixth among the Central European accession economies in terms of GDP per capita. With GDP per capita at purchasing power parity of only \$8,122 in 2001, Poland is well behind Slovenia, the Czech Republic, Hungary, Estonia and Slovakia. Poland's GDP per capita is also substantially below the EU average, despite many years of economic growth at rates far exceeding those of the EU during the most of the 1990s.

Partially because of its size, Poland features the least open economy among the EU accession countries, with total external trade in goods (export plus imports) equal to only 41% of GDP at current prices. The shares of exports, valued at \$30,275 in payments-based terms in 2001 directed to developed economies and to the EU were 75% and 69%, respectively, marking a dramatic shift in the direction of exports since the transition began in 1990. Exports are concentrated to the largest EU economies, with Germany alone accounting for 33% and 24% of Polish exports and imports in 2002, respectively. Although the Polish economy features the largest agricultural sector among the accession countries, with approximately 17% of the economically active population still employed in this sector, according to data for 2000, agriculture's contribution to GDP was capped at 4.8% in that year. Value added in the manufacturing sector, which in 1990 accounted for 58% of GDP, now accounts for only 37%. The majority of Poland's GDP is now generated in the booming services sector.

During most of the 1990s, Poland was considered to be the undisputed leader among the European transition economies. Thanks in large part to administering radical "shock therapy" to its economy in 1990,

Poland was the first country in the region to come out of the transition recession, reporting positive growth in GDP already in 1992 (2.5% y/y). It was also the first country to regain the pre-transition level of GDP in 1997. Poland's booming economy and its vibrant private sector (over 2 million new businesses were registered during the first five years of transition) has attracted large inflows of foreign direct investment. Overall since the beginning of transition, Poland has attracted over \$60 billion in net FDI, by far the most among the transition economies including Russia. However, on a per capita basis, Poland's FDI still lags behind that reported by the Baltic States, Hungary, the Czech Republic and Slovakia. Although a large portion of the FDI was directed towards manufacturing, in particular the automotive industry, the size of the Polish market has also attracted substantial investment aimed at satisfying domestic demand rather than export-oriented production. This, in turn, meant that despite the large amount of FDI in Poland over this period, FDI contributed less to increasing the export competitiveness of the manufacturing sector than in the case of any of the other countries in the region.

Poland's average annual GDP growth substantially exceeded that in the EU during 1992-2000, as the economy benefited from opening export markets in the West and dramatic increases in productivity brought about by very substantial FDI and industrial restructuring. Domestic demand, both in the form of capital investment and private consumption, boomed as private and corporate consumers reaped the first benefits of lower inflation and more affordable credit. This expansion, which exceeded growth in real GDP by a wide margin during the 1994-1997, led to substantial external imbalances (at its height, the current account deficit reached 8.3% of GDP) and relatively high inflation. Growth in domestic demand was also supported by rather lax fiscal policy on the part of the social-democratic government. As a result, in an effort to cool off the economy, the National Bank of Poland considerably tightened monetary conditions. Unfortunately for Poland, this policy adjustment coincided with the Ruble crisis in Russia in 1998 and the slowdown in growth in Poland's main export markets in the EU. Poland's economic growth slowed to a crawl in 2001-2002 as evidenced by GDP growth rates of 1.0% and 1.3% in 2001 and 2002, respectively. And while Poland avoided a post-transition recession, the signs of a gradual economic recovery became visible in late 2002 and early 2003.

While inflation was clearly the weakest point of Poland's economy in the early stages of transition (Poland consistently featured the second highest consumer price inflation levels in Central Europe after Hungary), growth in prices have been slowing consistently and fell below 1.0% year on year in the last months of 2002. According to our forecast, Poland's monetary and fiscal authorities should have no problem keeping inflation under control in the next several years. On the other hand, following two years of sub-par economic growth, unemployment (at 18.1% of the labor force in December 2002) is now by far the most important medium-term problem facing the Polish economy.

According to our most recent forecast, Poland's economic growth should accelerate in the next several years. Following two years of mediocre growth, GDP is expected to expand 2.9% in 2003 and 4.0% in 2004. The acceleration in growth will be achieved with low levels of inflation (2.5% plus/minus 1%) and only moderate increases in deficits on trade and on the current account. As the economy picks up, we also project that the unemployment rate will trend downward. However, much more substantial changes to the labor market structure and employment taxation and regulations will be necessary to reduce the unemployment problem more decisively. Poland's economic integration with the EU will continue to proceed quite smoothly. The country is to become a full member of the EU as of May 1, 2004 and its economy and infrastructure should benefit from large transfers of structural and cohesion funds. Alone in the years 2004-2006, Poland is slated to receive 11.4 billion euros in structural support, an amount that will be then increased by close to 25% in matching funds from Poland's national budget.

#### *Progress in Fiscal and Monetary Policies*

Among the largest EU accession countries, Poland is the most likely candidate to meet all criteria for accession to the Eurozone as soon as in 2006. Consumer price inflation has been below Eurozone levels throughout most of 2002 and the interest rates have been slowly, but gradually converging with the EU levels. The monetary authorities should have no problems keeping inflation under control, especially that Poland is among the relatively most advanced countries in the region in terms of adjustment of administratively-controlled prices to cost recovery levels. In light of the above, reduction in fiscal deficits

and a further stabilization of the Polish zloty constitute the biggest challenges for the Polish authorities in the EMU convergence process.

Although the deficits in Poland's consolidated budget in the last two years have been considerably lower than those in the Czech Republic and Hungary, they are still well above the levels required by good fiscal policy management. Poland's public finance deficit exceeded 5.3% of GDP in 2002 and is expected to fall to just 5.1% of GDP this year. Moreover, further reductions in the deficit, although made much easier by the expected recovery in GDP growth, will require a substantial restructuring of the expenditure side of the budget. In 2002, close to 68% of total budget expenses was essentially fixed and determined by schemes that linked payments under several state-sponsored social programs indexed to inflation. A reduction in social expenses will not be popular, and therefore the presentation of the program of reform of public finances has been postponed to the second half of 2002, immediately following the likely popular approval of EU accession process in the nationwide referendum scheduled for June 2003. It is also expected that the current Polish government is likely to restore to some creative budget accounting to fit the deficit under the 3% of GDP level when calculated using the ESA-95 methodology. Such attempts would be counterproductive in the medium-term, shifting the burden of budgetary tensions into the later post-accession years. Poland's public debt is not likely to near 60% of GDP in any of the coming years despite relative looseness of fiscal policy environment.

We believe that Poland will maintain its free float regime for the zloty until the entry into the EU in May 2004. At this point, Poland is likely to install an ERM-2 mechanism setting a reference rate for the zloty against the euro and a plus/minus 15% fluctuation band around this rates. Assuming that Poland will meet all of the Maastricht convergence criteria by 2005, in our view, the earliest possible date for an entry into

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	127.1	157.5	176.4	182.5	200.0	221.4	262.1	277.6
Per Capita GDP	<i>Current Dollars</i>	3292	4075	4567	4725	5179	5735	6789	7189
GDP, Growth Rate	<i>Percent</i>	7.0	4.0	1.0	1.3	2.9	4.0	4.5	4.2
Average Annual Inflation	<i>Percent</i>	27.8	10.1	5.5	1.9	1.7	2.6	2.8	2.6
Population, End-Year	<i>Thousand People</i>	38609	38644	38632	38620	38614	38597	38605	38617
Unemployment Rate	<i>Percent</i>	14.9	15.1	17.4	17.9	18.3	17.8	16.0	15.5
Exchange Rate, End-Year	<i>PLN/\$</i>	2.47	4.14	3.98	3.91	3.82	3.70	3.58	3.47
Central Gov. Budget Balance	<i>% of GDP</i>	-3.3	-2.2	-4.5	-5.3	-5.1	-4.6	-3.8	-3.3
Net Foreign Debt	<i>Percent of GDP</i>	22.8	26.8	24.7	28.6	25.5	23.0	19.4	18.3
Exports	<i>Million Dollars</i>	22878	28255	30275	32582	35351	38887	42775	46197
Imports	<i>Million Dollars</i>	24790	41423	41950	42923	46142	49834	55814	60837
Current Account Balance	<i>Percent of GDP</i>	4.2	-6.3	-4.1	-3.7	-3.4	-3.3	-3.8	-4.1

the Eurozone is 2007.

## Slovakia

### *Macroeconomic Overview and Outlook*

Slovakia ranks fourth among the ten EU accession countries in terms of both population and GDP, putting it behind the other Visegrad countries. With a nominal GDP of \$20.5 billion in 2001, Slovakia is near the bottom of the bunch in terms of per-capita income. However, the country fares much better in purchasing power parity terms, where per capita GDP is above that of Poland and the Baltic states. In relation to the existing EU member states, the Slovak economy is comparatively poor. At 5.4 million, the country has approximately the same number of inhabitants as Denmark; however, Slovakia is only about one-eighth its size in terms of nominal GDP. Compared with France, Slovakia has just 9% of the population and less than

2% of the GDP. Slovakia's convergence with EU member states has gone further when taking purchasing power into account, however, reaching 47% of the EU average in 2001.

Historically, Slovakia was much more rural than the neighboring Czech Republic, although the differences were to some extent evened out during the communist era, when the former was developed in line with the demands of the socialist state. Many of the firms built in Slovakia during that period were dedicated to the production of heavy industry and weapons that were intended for export to the Soviet Union. Once trade with the USSR collapsed after 1989, Slovakia was in a tough position, and unemployment quickly surged. Observers were skeptical about whether the Slovaks could make it economically after they split from the Czechs in 1993. However, after a period of political posturing that included considerable wavering over the need for economic reform, Slovakia has emerged as a positive surprise. That is particularly true after the September 2002 parliamentary elections produced one of the most cohesive reformist governments that has been voted to power anywhere in the region during the last 13 years. Since 1990, the structure of the Slovak economy has changed considerably, as industry declined in importance, losing ground to trade and other services. By 2001, industry accounted for just about one-fourth of GDP, while domestic trade reached nearly 17% of the total. Sectors such as communications, banking, and other market services have also grown in significance.

Having begun economic reforms under the realm of Czechoslovakia, the Slovaks also launched coupon privatization in the early 1990s. However, the program was discontinued after the split, being replaced by so-called "crony capitalism," where firms were sold to domestic allies of the ruling parties at rock-bottom prices. That approach ended with the 1998 parliamentary elections, when a pro-Western government consisting of a broad range of parties took control of the country, saving it from imminent collapse. As was the case in the Czech Republic through 1997, bad lending practices at state-owned banks were a major factor contributing to macroeconomic imbalance. Although the 1998-2002 government took steps to stabilize the economy and privatize major banks and energy companies, the left-wing parties in the cabinet blocked deeper reforms in such areas as fiscal policy.

Considered as something of a pariah state until 1998, Slovakia has attracted far less foreign investment than many other countries in the region, despite lower wages and relatively good infrastructure. By the end of 2001, Slovakia had brought in less than \$5 billion worth of FDI, compared with \$28 billion for the Czech Republic, which is somewhat less than twice its size. Nonetheless, that situation is now changing, as demonstrated most markedly by the decision of PSA Peugeot Citroen in January 2003 to build a 700 million euro assembly plant in the western Slovak town of Trnava, which won out over competing locations in Poland, Hungary, and the Czech Republic. The plant, which will produce small vehicles starting in 2006, should have an annual capacity of 300,000 cars, and will employ 3,500 workers. Such investments will provide the basis for continued rapid increases in industrial production and exports in the future.

Slovakia was fortunate in that it began the post-communist transition with a very low level of foreign debt. While foreign debt rose substantially prior to the 1998 elections to finance the rising current account deficit, it has since stabilized. As in the Czech Republic, fiscal policy is among the most pressing problems facing the current Slovakia government, in part because of the lingering costs of bailing out the banking sector prior to its privatization. However, unlike the Czech cabinet, the Slovak government appears eager to meet the challenge and is currently planning a significant overhaul of the pension, healthcare, social welfare, and education systems. Assuming that reformist parties remain in control of the Slovak government during the next several years and manage to implement the necessary changes, the country has good prospects for healthy long-term growth. Slovakia's small size gives it added flexibility, and even an investment as small as that recently announced by PSA can add as much as 1% to annual GDP. The main danger facing the Slovak economy is its current reliance on a few large firms, making it vulnerable to external shocks. However, in light of the positive approach of the current government and Slovakia's imminent accession to the EU, the diversity of the country's economy should soon improve.

#### *Progress in Fiscal and Monetary Policies*

Slovakia's current government is aiming to meet the Maastricht criteria for accession to the Economic and Monetary Union (EMU) by 2006. As in the case of several other countries in the region, the most difficult challenge for the Slovaks will be the fiscal criteria, as the cost of bailing out the banking sector has put undo strain on the country's finances. Slovakia's 2003 state budget is the first to adopt the EU's ESA 95 standards and therefore takes bank restructuring expenses into consideration. Although the budget includes both spending cuts and increases in indirect taxes, the deficit remains large, at 4.85% of GDP. The current government is also starting to use ESA standards to calculate the public finance deficit. According to its revised medium-term financial outlook that was published in November, the Finance Ministry estimates that the public finance deficit totaled 7.8% of GDP in 2002. The ministry plans to bring that deficit down to 3.3% of GDP by 2005 and 3.0% in 2006. The continued cuts will be hard for the population to swallow, and the cabinet may be tempted to loosen spending toward the end of its term as the next parliamentary elections approach in the fall of 2006. However, given that most of the fiscal cuts will come at the beginning of the government's term, the ministry's plan appears to be achievable. Starting this year, the cabinet is planning an ambitious overhaul of public spending, including the pension and social welfare systems, and it is using a portion of privatization revenues to help finance those reforms. Assuming that the current cabinet remains in power for a full four years, we believe that the government will succeed in meeting its goals.

Slovakia is not expected to have any major problems meeting the other Maastricht criteria. Following a surge in public debt in 2001, consolidated public debt is estimated to have reached 385 billion koruna in 2002, or 36.4% of GDP. That represents only a 5.2% increase over the 2001 level in absolute terms, as a portion of privatization revenues was used to pay down public debt last year. Public debt is scheduled to rise in absolute terms over the coming years but will remain fairly constant as a percentage of GDP, well below the 60% level. In regard to inflation, Slovak consumer prices are surging this year due to hikes in regulated prices and indirect taxes. However, core inflation remains low, signaling that inflation should subside considerably by next year. In regard to interest rates, Slovak rates are currently above Eurozone levels, but they are set to fall considerably this year given the low core inflation and expected improvement in the trade deficit.

Both the government and the National Bank of Slovakia (NBS) support meeting the criteria for EMU entry as soon as possible, allowing the country to decide freely on the ideal date for entry. Although Slovakia is likely to be ready for EMU membership by 2006, the question of when the country will choose to join remains open. Finance Minister Ivan Miklos has said that analysis is still needed to determine the most appropriate time for Slovakia to join, but he considers 2008 to be the earliest possible date for entry. The NBS, on the other hand, would like Slovakia to join the Eurozone as soon as possible after accession to the EU, arguing that Slovakia's open economy would be vulnerable through currency movements if it tried to keep its own currency. Some analysts prefer a slower approach since prices of goods in Slovakia are currently far lower than those in the EU. A delayed entry would permit the Slovak currency to gradually appreciate, allowing individuals' savings to grow. We believe that Slovakia's ultimate decision on entry will depend partly on that of neighboring countries. Given that the Czechs are unlikely to meet the Maastricht criteria before 2008, the Slovaks may decide to wait as well.

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	19.1	19.7	20.5	23.4	30.9	34.8	39.2	43.6
Per Capita GDP	<i>Current Dollars</i>	3564	3641	3804	4342	5752	6469	7281	8113
GDP, Growth Rate	<i>Percent</i>	6.5	2.2	3.3	4.0	3.9	4.7	5.3	6.0
Average Annual Inflation	<i>Percent</i>	9.9	12.0	7.3	3.3	7.6	4.1	3.0	2.3
Population, End-Year	<i>Thousand People</i>	5368	5403	5379	5379	5377	5375	5377	5374
Unemployment Rate	<i>Percent</i>	13.1	18.2	18.3	17.8	16.7	16.2	15.7	15.3
Exchange Rate, End-Year	<i>SKK/\$</i>	29.6	47.4	48.5	40.0	37.8	41.0	42.0	34.0
Consolidated Budget Balance	<i>% of GDP</i>	0.4	-3.2	-3.1	-7.8	-5.0	-3.8	-3.3	-3.0
Net Foreign Debt	<i>Percent of GDP</i>	1.2	23.4	21.9	6.6	2.4	2.2	2.2	4.7
Exports	<i>Million Dollars</i>	8595	11908	12641	14459	18327	19665	21249	23177
Imports	<i>Million Dollars</i>	8787	12660	14763	16626	20219	21856	23647	25775
Current Account Balance	<i>Percent of GDP</i>	2.0	-3.6	-8.6	-8.4	-5.8	-5.7	-5.3	-4.9

# Slovenia

## *Macroeconomic Overview and Outlook*

Slovenia's economy is characterized by both its small size—although it is much larger than the smallest of the EU and EU accession countries—and its relative per capita wealth compared to the EU candidate countries. In 2001, Slovenia's GDP totaled \$18.8 billion, only 1.4% the size of the French economy. Slovenia's population at that same time was only 2.0 million people, 3.3% of the number of French inhabitants. GDP per capita at the end of 2001, then, totaled \$9,433. Although only about 42.5% of the French level and 44.9% of the EU average, Slovenia's per capita GDP ranked as the highest among the EU accession countries, save Cyprus, and was comparable—above 85% of their levels—to EU members Greece and Portugal. Among EU candidate countries from Emerging Europe, only the Czech Republic and Hungary's GDP per capita in 2001 equaled even half of Slovenia's level. Furthermore, the economic gap between Slovenia and the EU is closing. Since 1995, economic growth in Slovenia has outstripped that of the European Union's in every single year, averaging 4.1% per annum in those seven years compared to the European Union's average of 2.5%.

Slovenia's small size and relative ethnic homogeneity have provided for a dearth of political problems, allowing the government to concentrate on supporting economic growth and reform. Emerging from the former Yugoslavia in 1991, the country's historical ties to Western Europe laid the groundwork for rapid economic development. More than half of GDP in 2001 came from services, with real estate (10.7% of total GDP), retail trade (10.0%), and transport and communications (6.9%) the largest service sectors. Tourism is a key industry in the country, a vital element of most of the service sectors. The largest single sector, however, remains manufacturing, which accounted for 23.7% of GDP in 2001. While initially suffering from low productivity and relatively poor international competitiveness, widespread restructuring, government-sponsored employment retraining, and administrative limits on wage growth since the late 1990s have substantially boosted the prospects for the country's manufacturing sector. Overall, macroeconomic stability has been achieved in Slovenia, and the economy is well poised to maintain at least moderate economic growth, meeting the challenges of membership in the European Union.

The notable weakness in the Slovenian reform effort has been the slow pace of privatization, and, more generally, lingering protectionist policies. The Slovene public and, subsequently, the country's politicians, have been wary of the inflow of foreign capital, fearful of potential foreign domination of the small economy. The government was slow to remove capital inflow restrictions, and thus foreign direct investment (FDI) into the country was modest before rapidly expanding in 2001 and 2002. Cumulative FDI per capita in the country remains among the lowest of the EU accession countries. Likewise, the government has been guarded in its implementation of privatization. The state still accounts for roughly half of the economy, either directly or indirectly, prominently operating in the insurance and banking sectors, plus industrial sectors such as electricity and steel making. Progress is being made, however, with privatization underway and accelerating in most key sectors. The banking sector, while still dominated by state banks and operating in a relatively sheltered environment, is in generally good shape.

Slovenia's external accounts are healthy, with the current account either nearly balanced or in surplus in every year except 1999 and 2000. In 2001, the current account recovered and was nearly balanced, thanks to strong export growth despite a slowdown of demand from the European Union, Slovenia's largest export market. Based on data through November 2002, the current account likely pushed into surplus last year—by more than 1% of GDP—thanks to a substantial reduction in the foreign trade deficit. The continuation of strong export growth—augmented by improved market access to both Western and developing Europe—will likely result in a current account surplus for the foreseeable future. With low inflows of FDI until 2001, Slovenia had to increase its long-term borrowing in order to finance its current account deficits in 1999-2000. The country's foreign debt level, therefore, rose by more than a quarter in that period. Slovenia's foreign debt level poses little threat to economic stability, however, as it remains quite low. The country has long enjoyed the highest credit rating in the region.

The unemployment rate in Slovenia, as measured according to the ILO definition, is currently near its lowest historical level of around 6.0%. With most industrial restructuring nearly finished and production projected to expand, we expect unemployment levels to begin to edge downward after a slight worsening in 2003. The country's main labor challenge is the transformation of a work force geared toward a relatively low value-added economy to a more high-tech work force. Already, though, the country has made strong gains, with post-secondary education and secondary education relatively high, and the government instituting aggressive re-training programs.

### *Progress in Fiscal and Monetary Policies*

Despite some potential difficulty, Slovenia will most likely meet all of the Maastricht criteria by 2006 or 2007. Fiscal policy has kept budgetary deficits below the 3% of GDP level since 1997, with the exception of 2000 when the deficit rose to 3.2% of GDP. The most recent two-year budgetary outlook anticipates deficits of only 1.2% of GDP in 2003 and 0.9% of GDP in 2004. However, upward pressure on those deficits may soon require corrective action by the government. In particular, economic growth and revenue targets in the two-year budget may be overly optimistic. Despite progress, the government may need to more aggressively reduce its expenditures in order to limit its budgetary deficits. In particular, the expansion of government spending on goods and services and public sector wages will need to be curtailed from current levels if budgetary targets are to be met. Increased spending on defense as Slovenia joins NATO and the continuing expense of economic reform (including planned pension reform in the medium term) will place additional upward pressures on the budget deficit. As the government works toward limiting expenditure growth, the IMF has suggested that Slovenia allow its deficits to grow somewhat in the short term rather than raising taxes, arguing that the country's medium-term strategy of EU integration would not be harmed by a short-term rise of the budget deficit, and that such action would be less inflationary than raising taxes in the small economy. Relatively tight fiscal policies kept Slovenia's public debt at 14.4% of GDP in 2001, well below the criteria of 60% of GDP, a limit that we do not see the country reaching in the foreseeable future.

Inflation has remained stubbornly high in Slovenia, at 7.5% in 2002. This is well above the current Maastricht limit and remains the largest question mark regarding the country's preparations for EMU membership. In late 2002, Bank of Slovenia Governor Mitja Gaspari publicly announced that reducing inflation would become the central bank's top priority, though he admitted that inflation would not be substantially reduced until the second part of 2003. Gaspari pledged that the country would be able to attain 4% inflation by the first half of 2004, and be able to meet the Maastricht criteria by 2006. A renewed commitment by the government as well, combined with the strict policies by the Bank of Slovenia, should allow the country to successfully reach those goals. In the middle of 2002, interest rate targets began to be shifted away from an exchange-rate base to an inflation base. As this process continues and inflation is reduced to its target rates, interest rates should begin to fall.

The Bank of Slovenia currently maintains the tolar in a managed float against the euro, implementing coherent monetary policies designed to lower inflation and ensure the stability of the real exchange rate. In October 2002, Gaspari outlined his expected timeline for the country's entry into both the ERM-2 and the EMU. Slovenia intends to join the ERM-2 immediately upon EU membership in 2004, with the intention of entering the EMU by 2007. Despite lingering inflationary problems, a history of coherent monetary policy and stable foreign exchange rate patterns along with plentiful reserves auger well for the fulfillment of these expectations.

		1995	2000	2001	2002	2003	2004	2005	2006
GDP, Total	<i>Billion Current Dollars</i>	18.7	18.1	18.8	20.9	25.9	28.4	31.4	34.1
Per Capita GDP	<i>Current Dollars</i>	9348	9105	9449	10506	12974	14199	15689	17041
GDP, Growth Rate	<i>Percent</i>	4.1	4.6	3.0	3.2	4.1	4.4	5.1	4.6
Average Annual Inflation	<i>Percent</i>	13.5	8.9	8.4	7.4	6.2	4.6	3.8	3.5
Population (end-year)	<i>Thousand People</i>	1988	1990	1991	1994	1997	1999	2002	2004
Unemployment Rate	<i>Percent</i>	7.4	7.0	6.1	6.3	6.4	6.3	6.0	5.5
Consolidated Budget Balance	<i>Percent of GDP</i>	0.0	-1.4	-1.4	-1.2	-1.4	-1.3	-0.8	-0.4
Net Foreign Debt	<i>Percent of GDP</i>	-7.6	2.9	3.1	2.8	2.3	2.1	1.9	1.7
Exports	<i>Million Dollars</i>	8350	8808	9342	10291	12242	12918	13872	14884
Imports	<i>Million Dollars</i>	9303	9947	9964	10535	12575	13295	14364	15356
Current Account Balance	<i>Percent of GDP</i>	-0.5	25 -3.4	-0.4	1.3	0.9	0.8	0.5	0.6