Annex 2 - Conjunctural analysis for the New Member States

The Economic Recovery in The New Member States in Full Swing in The First Half of 2004; Likely to Continue in the Nearest Future

The entry of the New Member States into the European Union on May 1, 2004, marked the culmination of a historic process of economic transition that commenced with the fall of Communism in 1989. Fifteen years after the initiation of far-reaching reform in the East European region, eight of the formerly centrally-planned economies together with Cyprus and Malta joined the existing fifteen members in the largest EU enlargement to date. And while the combined economic weight of the New Members might seem relatively small compared to the EU-15, the dynamics of growth, commitment to internal reforms, and desire to close the income gap with the rest of the EU may well provide a key impulse to future economic development in Europe.

Even before that momentous event, most of the key economies in the region were recording improved performances, with GDP growth accelerating in the first quarter of 2004. Average annual GDP growth in the region is bound to recover from a preliminary 4.5% in 2003. According to our latest forecasts, GDP growth will jump to 5.2% this year, driven by strong performances in Poland and Slovakia, recoveries in growth in the Czech Republic and Hungary and the continued boom in the Baltics. Our projections for 2004 may well be pushed upward further based on the very positive results that were recorded in the first six months of the year. Importantly, first-quarter 2004 GDP growth was more balanced than last year across the region, thanks in part to rising gross fixed investment. Moreover, the gradual economic rebound in the Eurozone means that demand for exports from the New Members, which have been a leading source of economic growth in Poland and Slovakia and are now becoming also key to growth in Hungary and the Czech Republic, is growing more rapidly as well.

From the cyclical prospective, the New Member States are entering the EU with indisputably strong growth dynamics. Following the economic slowdown of 2001 and 2002, caused both by the unaccommodating external environment and serious domestic policy mistakes, and the moderate recovery of 2003, the first half of 2004 marks the first period of very strong growth across most of the region, in particular in the largest economies. More importantly, with only a few exceptions, the current growth recovery is overwhelmingly broad-based, combining the benefits of stronger demand in the traditional West European export markets with steady growth in private consumption, and, even more importantly, with a gradual recovery in domestic capital spending. This structure of growth makes the current recovery less sensitive to the potential reversal in European economic fortunes as global economic growth starts to decelerate next year.

The unexpectedly strong acceleration in growth rates in the largest economies of the New Member States is clearly the most positive development of the last few quarters. Poland, Hungary, Slovakia and, to a lesser extent, the Czech Republic have reported very strong growth going into 2004. Economic growth in the Baltic States and Slovenia also exceeded our preliminary expectations, boosting the annual average growth forecast for the New Member Countries to 5.2% year on year in 2004, well in excess of our current forecast of 1.8% year-on-year growth for the Eurozone.

Table 2.1: Summary of Indicators for the New Member States

	Real GDP Growth		Avg. CPI Inflation		Unemployment rate		Public Sector Deficit	
	in %		in %		in % of labor force		in % of GDP	
	2003	2004	2003	2004	2003	2004	2003	2004
Cyprus	2.0	3.5	4.1	2.0	3.3	3.2	-5.9	-3.6
Czech Republic	3.1	3.6	4.1	2.0	9.9	10.3	-13.0	-5.4
Estonia	4.9	6.4	1.3	2.3	10.0	9.5	2.6	1.2
Latvia	7.5	7.4	2.9	4.7	8.6	9.2	-1.8	-1.7
Lithuania	9.0	6.6	-1.2	0.9	12.4	11.8	-1.7	-1.3
Hungary	2.9	3.6	4.7	6.9	5.9	5.9	-5.9	-5.1
Malta	3.4	3.3	1.3	2.6	5.3	5.1	-9.7	-5.5
Poland	3.7	6.0	0.7	3.6	20.0	19.2	-5.3	-5.7
Slovakia	4.2	4.6	8.5	7.6	15.2	14.6	-3.5	-3.8
Slovenia	2.3	3.5	5.6	3.9	6.7	6.7	-1.8	-1.4

In Poland, the largest of the New Member States, economic growth has accelerated from 4.7% in the last quarter of 2003 to 6.9% year on year in the first three months of 2004, and is expected to average 6.4% in the first half and around 6.0% for the full year 2004. These rates of growth will propel Poland again to the position of indisputable pacesetter within the region, the position the country enjoyed for most of the mid-1990s. Growth in Poland has been supported by a very strong net export component of national accounts, as local exporters enjoying the benefits of a weaker currency for most of 2003, as well as through accelerated internal restructuring, found ways to increase their market share in the key EU markets. Import growth, although accelerating gradually into 2004, remained relatively subdued on the back of a still only modest pick-up in investment spending. On the other hand, personal consumption continued to expand at an average annual rate in excess of 4.0%, complementing exports as a key driver of growth.

Slovakia, another growth leader in the region, features an economy that in 2003 was driven almost entirely by exports. Personal consumption and gross fixed investment actually declined moderately. GDP still managed to expand by 4.2%, an impressive performance, although considered a disappointment by the Slovak government. The growth in consumption was severely restricted by Slovak tax reform, which raised VAT taxes and resulted in an inflationary surge, as well as by the cabinet's fiscal reform plans. While a broadening of the growth base in the coming years is expected, net exports are likely to determine Slovakia’s growth pattern in the nearest future. As elsewhere among the new member states, the success in expanding exports to the EU-15 despite rather lackluster developments in aggregate demand in that region was aided by the increasing integration of their economies with those of Western Europe. In Slovakia, this has had a particular focus in the automobile industry. In addition to the expansion of the crucial investment in the automotive sector by Volkswagen AG, two other large greenfield auto manufacturing plants will be coming on line in the next two years that will convert the Slovak economy into one of the largest car producers in the world.

Faced with a rather unaccommodating external environment with regard to its key export markets in Western Europe, the Hungarian economy turned in a rather disappointing performance in 2003, expanding by an estimated 2.9%, down from a revised 3.5% year on year in 2002. However, the first signs of more robust growth were already visible in the last three months of 2003, leading up to a 4.2% growth spurt in the first quarter of 2004, on the back of an 18.9% year-on-year surge in investment spending. And while such rates of growth are unlikely to be recorded again any time soon, they should provide the basis for solid growth in industrial production and exports that will take over as key drivers of growth into the future, with growth already accelerating to around 3.6% year on year in 2004.

A spurt in investment spending and a rebound in external sales are also likely to be responsible for a modest acceleration in growth in the Czech Republic from 3.1% year on year reported for 2003 to around 3.6% this year. Meanwhile, the 3.9% growth in household consumption reported in the first quarter is likely to moderate somewhat in the remaining months of 2004, partly due to higher value-added tax rates and rising inflation.

Among the smaller New Member States, the three Baltic economies of Estonia, Latvia and Lithuania have been by far the fastest growing for some time now. This remained the case in the first quarter of 2004, as annual growth rates ranged from 6.8% year on year in Estonia to 8.8% year on year in Latvia. The broad expansion in almost all sectors of these economies has characterized the Baltic miracle. This pattern of growth is not likely to change substantially in the coming years, although the pressures on their external accounts due to rapidly growing domestic economic activity remain severe and require the governments to address the boom in bank lending. The remaining three New Member States, Slovenia, Cyprus and Malta, continue to under-perform in terms of growth rates due to a combination of reduced inflows from tourism and moribund personal consumption.

Our growth forecast for 2004 and beyond is a bit more optimistic than in our last report to the European Forecasting Network. Growth has surprised us on the upside in the first half of 2004, mostly in the case of the economies that have relied on net exports as the key driver of growth in the last several quarters. The delayed rebound in investment spending has not precluded Poland and Slovakia from recording solid expansion, based predominantly on identifying and exploiting existing niches in West European markets despite still lackluster growth in demand for imports there. When supported by an anticipated boom in investment spending that should be at least partially supported by funding from the EU's regional and cohesion funds, the outlook for growth for all of the New Member States is very optimistic with annual rates in the 4-4.5% range in the coming years.

Inflation's Temporary Resurgence Not A Cause For Concern As of Yet

In our Spring 2004 report to the European Forecasting Network, we highlighted the emerging short-term inflationary risks prevalent in most economies in the region. Following impressive declines during 2002 and early 2003, mainly due to rapid drops in prices of food products, delays in more aggressive increases in administratively controlled prices and strengthening currencies, performance on inflation has been considerably more mixed since the summer months of 2003 and into 2004.

The delayed effects on prices of food products of drought conditions across the continent in the summer of 2003 and the ensuing disappointing grain harvests continued to influence inflationary pressures in early 2004. In addition, and by far more importantly, world market crude oil prices edged up to levels considered very high even by historical standards, as the tensions in Iraq and short-term supply shortages from other markets persisted. Many of the New Member States also embarked on a major process of adjustments in VAT and excise tax rates in order to harmonize their tax regimes with EU requirements. Finally, the EU accession itself resulted in a short-lived surge in prices for selected products, mostly food. All these factors together led to a modest acceleration of inflation in all of the new Member States. In the two countries that entered 2004 with the highest rates of inflation, Slovakia and Hungary, the earlier-anticipated declines in inflation levels have been delayed by as much as six months, due to the new circumstances discussed above. Even in Lithuania, which experienced consumer price deflation for most of last year, prices have been clearly on an upward trend in the last several months.

Despite these recent developments, the risk of a major resurgence in inflation in the New Member States is not significant in the short- to medium-term future. Despite the persistently high cost of oil in international markets, the inflationary pressures in the global economy remain subdued. Monetary authorities in many leading economies around the world have started to tighten monetary conditions and while the European Central Bank has not yet followed suit, the period of extraordinarily low interest rates is clearly coming to an end. The same applies to most of the economies of the New Member States. With the exceptions of Hungary and Slovakia, where excessively high interest rates are still providing the authorities with room to maneuver, other central banks are reviewing their relatively lax policies. The Czech and Polish central banks have already acted to bring interest rates up between 50 and 125 basis points since the beginning of the year.

Although much remains to be done to remove the risks of undesirable inflationary pressures stemming from deferred increases in administratively-controlled prices, predominantly in the service sector, overall inflation rates are likely to peak sometime later this year and start declining again in 2005 and beyond. In most cases, inflationary performance is not likely to constitute an obstacle in the New Member States' quest for future membership in the Economic and Monetary Union (EMU). In the longer run, however, we can not rule out that headline inflation will rise in some countries. Wage pressures could be much greater in the Central and Eastern European region than in the Euro area, as citizens in the New Member States demand purchasing power closer to that of their new compatriots. The volatility in exchange rates for some of the most open Central European economies could result in temporary drops in the value of local currencies, although this volatility would most likely be short-term in nature.

The Rush To The Euro – A Much Needed Dose of Realism

For the New Member States, entry into the European Union is considered only a stepping stone towards further economic integration that would culminate in the adoption of the euro and full membership in the Economic and Monetary Union (EMU). The obvious advantages of entering the EMU are viewed to outweigh the challenges along the way. Among these challenges, achieving the nominal convergence of key economic indicators with those of the other countries in the Eurozone is still a distant prospect for many countries. While the smaller New Member States, such as the Baltics, Slovenia, Cyprus and Malta can conceivably adopt the euro as early as in 2007-2008, the four largest, Poland, the Czech Republic, Hungary and Slovakia, have their work cut out for them for the next several years, with the prospect of adopting euro now being pushed back as far as to 2010. While it should be noted that for the current members of the Economic and Monetary Union, the Maastricht criteria with respect to government deficits and public debt have been interpreted quite flexibly, continued problems in containing fiscal deficits are nevertheless at the core of the challenge for the new member states. For these economies, the chances of bringing public sector deficits below 3% of GDP any time soon are becoming increasingly remote. Although the sources of the underlying problems (structural fiscal rigidities relating to bloated and inefficient social security systems and bureaucratic waste) are well known to them, these governments find it quite difficult to tackle the problems they are facing. In our Spring 2004 report, we indicated that the fiscal situation across the region was not very rosy. Unfortunately, the situation has not improved much in the interim.

In Poland, the 2004 budget shows a general government deficit of 45.3 billion zlotys, considerably higher than the 36.9-billion-zloty deficit reported for 2003. According to Polish officials, the increase in the deficit stems from, among other things, the need to pay EU membership fees and co-finance EU-funded projects. In reality, for yet another year, the budget fails to reflect any sizeable reduction in fixed expenditures and serious budgetary reform has been deferred until later in this decade. While the improved economic environment in the first half of 2004 permits the government to be roughly on or even slightly below target this year, this mainly reflects improved tax collection. The ratio of public debt to GDP is rapidly nearing the 55% of GDP mark, and is on track to reach the constitutionally-set maximum level of 60% by 2006. The complete package of reform presented by the Miller government, which has since left office, is aimed at cutting the deficit by 3.1% of GDP by 2007, but has not been fully approved by the parliament. In fact, some of its provision have been watered-down in order to secure the appointment of the current cabinet of Marek Belka. Under the most optimistic scenario, assuming that pre-election politics don't derail austerity measures, Poland could possibly bring the deficit under 3% of GDP by 2007-2008. That would be soon enough to adopt the euro by 2010.

The situation is even less promising in the Czech Republic. A release by Eurostat in mid-March showed that the Czech public finance deficit soared to 328.5 billion koruna in 2003, or 13.0% of revised GDP, significantly higher than in the other New Member States. The Czech finance ministry disputed these figures, claiming instead that the deficit amounted to only 5.3% of GDP, but still a much less favorable development than in the other countries. The Czech National Bank and the government acknowledged in a document approved in October 2003 that Prague will be unable to accede to the Eurozone before 2009 or 2010. The country may decide to adopt the euro even later if the euroskeptic opposition Civic Democrats (ODS) emerge as the dominant governing party after the next parliamentary election in 2006. Even the current goal of adopting the euro by 2010 would require profound fiscal reforms during the coming years. The parliament approved the first phase of the reforms in September 2003, including a rise in the retirement age, cuts in sickness pay, and increases in excise duties, in addition to a gradual decline in the corporate income tax rate. The final phase of reforms to be launched by the cabinet before the end of its current term in 2006 would involve much-delayed changes to the pension, social security and health systems. The government's proposals introduced to date have been characterized as haphazard and insufficient, as the public finance deficit is still expected to remain at 3.8% of GDP in 2006.

Following a disastrous budget performance in 2002 (the deficit reached 9.3% of GDP), and an equally disappointing deficit of 5.6% of GDP last year, which led to the resignation of Finance Minister Csaba Laszlo, the Hungarian government published a new detailed projection for the 2004 budget in late-March this year. At first glance, the projection is very optimistic, particularly with regard to revenue estimates. While it was expected that value-added-tax collection would be moderately lower in May and June immediately after the EU entry, the plan assumes that 62% of all VAT receipts will be received by the budget in the second half of 2004. It is therefore likely that the government will have to undertake major spending cuts, in addition to those already announced. The implementation of the budget in the first seven months of this year (the deficit reached 90.5% of the annual figure) does not provide us with much optimism. Furthermore, the expected shift to the left within the ruling Socialist party may signal a more lenient approach to fiscal consolidation. According to our forecast, the Hungarian budget deficit will reach 3.0% of GDP only by 2007, or even 2008, delaying the adoption of the euro until 2010.

Unlike some of its counterparts in the rest of the region, the Slovak center-right government that took the office in September 2002 seems ready for the challenge. It has put forward wide-ranging reforms in the area of taxes, pensions, health care and social policy, aimed at bringing down the public finance deficit, while at the same time simplifying the taxation system, preventing tax evasion and promoting investment. Last year, Slovakia's public finance deficit fell to a surprisingly low 3.5% of GDP. After climbing slightly to an expected 3.8% of GDP this year, the Finance Ministry is projecting the public finance deficit will rise to 4.0% of GDP in 2005, before falling to 3.0% of GDP by 2007. As a result of the reform, Slovakia is likely to be the first of the big four New Member State economies to adopt the euro in 2008-2009.

The current fiscal ills in the region are not going to disappear in the short-to-medium term unless growth reaches 4-5% annually across the region and budget spending is seriously curtailed. Furthermore, transfers from the EU will require the governments to allocate amounts of matching funds within the budget, putting an additional strain on public finances.

Fiscal Challenges Also Make the Interest Rate Convergence More Difficult

Having switched to a more cautious approach to interest rate reductions during 2003, the monetary authorities in most of the New Member States set a steady course late last year and early this year by keeping rate adjustments to an absolute minimum. While there is arguably still room for further interest rate cuts in many of the countries, most notably Slovakia and Hungary, the authorities could not ignore the first signs of gathering inflationary pressures and the fact that the region's economies are either recording robust growth or signaling that a recovery from the lackluster performance of the last two years is well underway. Countries that have successfully applied inflation targeting were watching price developments with moderate concern and trying to estimate the destabilizing monetary impact of increased credit activity or weakness in the local currencies.

Among the largest economies, Poland has maintained the same policy interest rate, at 5.25%, since June of 2003. With the real rates dropping rapidly due to an increase in inflation, Polish monetary authorities first warned of the possibility of switching from a neutral to tightening bias in their interest rate outlook. That was followed by a cumulative rise in interest rates by 125 basis points in June-August 2004 and more hikes are probably on the way. In the Czech Republic, the central bank brought down the rates to the European Central Bank- equivalent level of 2.00% by August 2003. The policy rate has remained stable until very recently when two hikes moved the rate up to 2.5%. Due to the rapid rise in headline consumer price inflation due to the introduction of tax and price hikes, the National Bank of Slovakia opted to run a very cautious interest rate policy last year. However, this year, the policy rate was slashed by a cumulative 150 basis points to counteract the appreciation pressures on the koruna. In Hungary, the policy rate remains above 10% and is not likely to drop rapidly until inflation normalizes and the public finance situation is brought under control.

In all New Member Countries, the authorities are attempting to maintain balance between the expectation of nominal convergence in inflation, exchange rates, and long-term interest rates to EU levels, with the need to counteract excessive market volatility due to external shocks, the unstable situation in public finances, and the influence of the opening of local capital markets on currency stability. In all of these cases, a moderate tightening of monetary conditions would have a marginally negative effect on economic growth rates.

Country Overviews

Poland's Broad-based Expansion is Poised to Continue into 2005 and Beyond

The Polish economy has been growing very rapidly in the first half of 2004. GDP expanded by a stunning 6.9% in the first quarter and the second-quarter growth likely exceeded 6.0% year on year as well. Strong growth in industrial output, retails sales and exports continues unabated. Responding to this changed environment, we have revised growth for 2004 to 6.0% in our latest forecast. This fast-paced recovery is poised to continue throughout the rest of 2004, and into 2005 and beyond. A more sizeable rebound in investment spending will accompany private consumption and net exports as key drivers of expansion, broadening the base for growth. Public spending is also expected to expand for yet another year in 2004, a result of a rather lax budget presented by the ruling SLD-UP coalition. Poland will also benefit from a healthy outlook for the global economy. An improvement in consumer and business confidence domestically should create conditions for rapid expansion both in the industrial and services sectors.

Similar to 2003, growth in the first quarter of 2004 was driven by the continued strengthening of the net exports component of national accounts. However, domestic demand also rose in the period, by an impressive 5.7% year on year. Following a seasonal pattern, gross accumulation jumped 21.8% year on year, caused by restocking of inventories, but also due to a more substantial 3.5% year-on-year growth in investment spending. Although still below the high single-digit growth rates forecast for later this year, this development in investment spending was a marked improvement over the paltry 0.1% year-on-year growth in the fourth quarter of 2003. First-quarter investment growth confirms the long-awaited turnaround in corporate investment activity that is likely to strengthen further into the year. Even more importantly, household consumption growth maintained its pace, rising modestly from 3.9% year on year in the fourth quarter of 2003 to 4.0% year on year in the first quarter of 2004, widely attributed to a strong pre-EU spending splurge by Polish households. In terms of GDP by sector of origin, growth was clearly driven by 14.5% year-on-year growth in gross value added in industry and a 5.7% year-on-year increase in value added by market services. However, the construction sector continued to falter, with another decline in output in the first quarter this year, this time by 3.9% year on year.

In the longer term, annual growth rates should average 3.8–4.5%. The return to the extremely high growth rates reported for 1994–97 is likely to be only temporary and not stretch beyond the first half of 2004. Assuming steady growth in private consumption and a diminishing role of public spending in generating growth, the recovery in the Polish economy will have to come from renewed investment spending and expanding exports. On both fronts, the news is quite encouraging. Exports continue to grow very strongly. The improved environment in the Eurozone this year should result in an improved outlook for exports as well. The weak zloty during most of 2003 and in early 2004, continued slow wage growth, and the internal restructuring undertaken by Polish exporters in the last several years have created an excellent basis for further export expansion. Poland's share in West European markets has been expanding, and the new distribution channels are starting to bear fruit. In fact, Polish exports to the European Union grew by a stunning 18.7% year on year in January-May 2004, exceeding, in terms of the dynamics of export growth to the European Union, even the Chinese performance.

While capital spending fell sharply during the downturn and continued to contract throughout the first three quarters of last year, it did turn positive right at the break of the year and should accelerate throughout the remainder of the year and into 2005. Annual growth rates in investment should reach as high as 7.0–10.0% in the next two years, with companies rebuilding inventories, upgrading machinery and equipment, and broadening production capacity. The increased flow of foreign direct investment following Poland's accession to the EU should further contribute to rapid growth in investment spending. While the corporate credit market remains moribund, the first signs of improvement are visible. The medium-term outlook for economic growth in Poland will be increasingly determined by the country's membership in the European Union. In 2004–08, Poland's main financial indicators will gradually converge with levels currently observed in Western Europe.

After reaching all-time lows at 0.7% on an annual average basis in 2003, consumer price inflation accelerated strongly in the first half of 2004. The authorities closely monitored any attempts by producers and retailers to artificially inflate prices around the time of the EU accession in May, but were only partially successful in preventing increases, especially with respect to food prices. Finally, persistently high prices of fuels in international markets constitute yet another factor keeping headline inflation a bit higher this year than in 2003. By May, headline consumer price inflation broke through the ceiling of the central bank's 1.5%-3.5% medium-term inflation target range and reached 4.4% year on year. Core inflation indicators also jumped markedly, forcing the central bank to react with a cumulative increase in interest rates of 75 basis points in June and July.

Table 2.2: Economic Developments in Poland to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	110.6	207.3	202.4	185.4	193.7	216.8	234.5	255.9
Per Capita GDP	*Current Euro*	2863	5367	5243	4813	5032	5632	6095	6654
GDP, Growth Rate	*Percent*	6.0	1.0	1.4	3.7	6.0	5.4	4.9	4.9
Average Annual Inflation	*Percent*	19.9	5.5	1.9	0.7	3.6	3.2	2.6	2.2
Population, End-Year	*Thousands*	38639	38632	38610	38514	38500	38492	38478	38463
Unemployment Rate	*Percent*	13.2	19.4	20.0	20.0	19.2	18.5	17.4	16.0
Exchange Rate, End-Year	*Zloty/EUR*	3.62	4.03	4.71	4.50	4.52	4.45	4.40	4.40
Public Finance Deficit (ESA-95)	*Percent of GDP*	n/a	-4.8	-5.5	-5.3	-5.7	-4.9	-4.4	-3.4
Net Foreign Debt	*Percent of GDP*	20.4	24.4	28.0	23.9	19.3	16.8	15.1	13.7
Exports	*Million Euro*	18810	46535	49372	53841	59326	63681	69396	72364
Imports	*Million Euro*	25101	55090	57028	58894	63541	68205	73988	77152
Current Account Balance	*Percent of GDP*	-1.0	-2.9	-2.6	-1.9	-1.8	-1.7	-1.6	-1.6

However, even taking all of this into account, as long as inflationary expectations by households are not being bumped up markedly, the inflationary environment should be described as moderately benign. We assume that the central bank should have no problem in keeping consumer prices under control later this year and in 2005 in preparation for the accession to the EMU and adoption of the euro. Most of the factors contributing to higher inflation this year have been supply-driven. As a result, the authorities are more likely to bring inflation under control, but not earlier than in the second half of 2005. According to our forecast, average annual inflation will reach 3.6% year on year in 2004 and inch back gradually to around 2.5% year on year by 2006/2007.

The Czech Republic Must Now Rely More on External Demand and Investment to Accelerate Growth

After a moderate increase in economic growth in 2003, we are projecting a further acceleration this year. Key determinants of the country's macroeconomic development in 2004 and beyond include the success of the government's plan for public finance reform, the value of the koruna, and wage growth. External factors will also be important. While GDP was boosted in the past several years by a loosening of monetary and fiscal policy, in 2004, room for maneuvering is more limited in those areas. As a result, economic growth will depend more on external demand and business investment, both of which should be positively affected by the Czech Republic's accession to the European Union on May 1. Investment in the Czech Republic should strengthen over the coming years due in part to continued inflows of foreign direct investment. The Czech Republic remains a very attractive location for foreign firms, given its favorable geographic location, relatively good infrastructure, and skilled labor force. Gross fixed investment should rise rapidly in the coming years, based in part on lower tax rates for firms operating in the Czech Republic. In line with the government's first phase of fiscal reforms, the corporate tax rate was cut from 31% to 28% in January 2004, and is scheduled to decline gradually to 24% by 2006. Personal consumption growth is projected to moderate in 2004, as higher value-added tax and excise duties send inflation upward. In the medium term, however, household demand should contribute to driving steady economic growth. Meanwhile, government spending will be limited during the next several years, as the cabinet tries to get the country's fiscal situation under control. By sector, industry will play an important role in growth in the medium term, as production is driven by rapid inflows of FDI that have materialized over the past several years.

GDP growth accelerated in 2003 and should continue to rise during the next several years. Czech GDP figures are often subjected to substantial revision, making forecasting difficult. Although preliminary data put last year's GDP growth at 2.9%, that figure was later pushed up to 3.1%, when the Czech Statistical Office revised its figures according to ESA 95 methodology. Currently, we are projecting that GDP growth will accelerate to 3.6% this year, driven by a recovery of investment and external demand (particularly in terms of services), coinciding with the Czech Republic's accession to the European Union on May 1 and the improved economic situation in Western Europe. Investment should also be boosted by the decline in corporate tax rates. According to preliminary estimates, GDP rose 3.1% year on year in the first quarter of 2004, by far the lowest rate in Central Europe. As we had expected, gross fixed investment was the key driver of growth, rising by 9.5%, up from a revised 7.4% rate for all of 2003. That corresponded with the strong growth in the construction sector during the first quarter, as building was spurred by anticipated changes in value-added tax as of May 1. Net exports continued to have a negative impact on growth, despite the improvement in the nominal first-quarter trade deficit, with real exports and imports rising 8.3% and 11.3% year on year, respectively. Meanwhile, the growth rate in household consumption slowed somewhat, but remained relatively strong, at 3.9% year on year. Household consumption should moderate during the remainder of this year, partly due to higher value-added tax and excise duties, which are contributing to rising inflation. Higher levels of unemployment and the expected increase in interest rates in the second half of the year will also make Czech consumers more cautious.

After a deceleration in consumer price inflation during the last two years, partly in connection with the completion of major energy price deregulations, price growth is speeding up in 2004. Consumer price inflation reached an annual average of 0.1% in 2003, the lowest rate in the history of the independent Czech Republic. Prices were pulled downward primarily by falling food and recreation prices, although food prices did start to recover in the latter part of the year, partly due to the poor state of the agricultural sector.

Table 2.3: Economic Developments in the Czech Republic to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	44.4	68.0	77.9	79.2	84.8	93.4	101.0	103.9
Per Capita GDP	*Current Euro*	4306	6661	7636	7754	8310	9170	9920	10214
GDP, Growth Rate	*Percent*	4.3	2.6	1.5	3.1	3.6	4.0	4.3	4.0
Average Annual Inflation	*Percent*	8.8	4.7	1.8	0.1	2.8	2.8	3.2	3.0
Population, End-Year	*Thousands*	10312	10206	10203	10211	10201	10191	10180	10170
Unemployment Rate	*Percent*	3.5	8.5	9.2	9.9	10.3	10.1	9.6	9.3
Exchange Rate, End-Year	*Koruna/EUR*	34.6	32.0	31.6	32.4	31.5	30.7	30.2	29.1
Public Finance Deficit (ESA-95)	*Percent of GDP*	n/a	-6.5	-6.4	-13.0	-5.4	-4.7	-3.8	-3.3
Net Foreign Debt	*Percent of GDP*	8.3	13.0	4.4	8.8	9.7	10.2	11.0	12.0
Exports	*Million Euro*	17294	37301	40653	43000	50999	55045	62076	63504
Imports	*Million Euro*	21514	40736	43028	45221	53282	57921	65153	66638
Current Account Balance	*Percent of GDP*	-7.4	-5.4	-5.6	-6.3	-5.8	-5.3	-5.1	-4.6

In 2004, administrative measures are pushing up consumer prices considerably. In the first half of the year, headline inflation jumped to 2.5% on average, driven by a shift of some goods and services from the lower category of value-added tax to the upper one, as well as by a rise in regulated utility prices and a hike in excise taxes on tobacco, alcohol, and fuel, all of which took effect at the start of the year. In May, administrative prices rose again, as the VAT was hiked on certain services in connection with the country's EU entry, although the effects were not as strong as expected. Overall, the Czech Republic's entrance into the European Union has had only a marginal impact on consumer prices thus far. In terms of market prices, inflation has been particularly strong this year in automotive fuel. Czech inflation is projected to gradually rise in the second half this year, affected in part by growing producer price inflation. Consumer price inflation is widely expected to surpass 3% in the second half of the year. Nonetheless, the slower-than-expected inflation to date has already led the Finance Ministry to reduce its average inflation forecast for the year, from 3.1% to 2.9%. Given the relatively positive results for the first half, we have lowered our forecast for average annual inflation in 2004 to just 2.7%. In subsequent years, average inflation is projected to remain at close to 3.0% annually. In fact, in March 2004, the CNB set its inflation target at 3.0% for the period beyond January 2006. According to the central bank, that should allow the Czech Republic to fulfill the monetary side of the Maastricht convergence criteria, while bringing the economy toward real convergence with the rest of the European Union in the long term.

Hungary's Manufacturing Sector Is Driving Accelerated Growth as Investment Surges in to Cope with Rising Demand from the Eurozone

Following a disappointing performance in the last two years, mainly due to unaccommodating external conditions, Hungary's economic growth is likely to accelerate markedly in 2004 and beyond. After 2.9% last year, we forecast GDP growth accelerating to 3.6% in 2004 and 3.7% in 2005. This represents a slight upward revision to our growth forecast and reflects much stronger growth in investment in the first quarter of 2004. This expansion pushed GDP up by an unexpectedly strong 4.2% year on year in the first quarter. The investment boom that has begun to support the rapid expansion in the manufacturing sector took shape as companies needed to add capacity in response to growing demand from the Eurozone. Capital spending is estimated to have surged 18.1% year on year, even taking into account that the seasonal adjustment was up 4.6%. Moreover, the construction sector also rebounded strongly with a 21.9% year on year increase. Following this impressive first-quarter performance, the Hungarian economy continued to expand at a steady pace in April-June as well. The growth outlook for the next several quarters is quite positive. On the one hand, private consumption should continue to support growth, but annual rates are likely to decline in response to weaker growth in wages and fiscal tightening. On the other hand, a rebound in exports will gain traction.

The outlook for 2004 will be increasingly determined by a combination of developments in private consumption and fixed capital investment and an ongoing recovery in industrial activity. While wages are still growing strongly and retail sales continue to surprise on the upside, we expect growth in those sectors to moderate gradually. Growth in private consumption is likely to slow from 6.5% in 2003 to 4.6% in 2004. The government's plans to reduce the budget gap, while originally estimated to result in a modest 1.0% contraction in public sector spending, will most likely cut growth in this category of the national accounts to around 1.0%. As evidenced by the rising spending on new machinery and equipment in the first quarter of 2004, annual growth in fixed capital investment will likely accelerate from 3.0% reported for last year to around 5.8% in 2004. The National Bank of Hungary (NBH) will keep a close watch over the fiscal performance by the government in order to make sure that the ambitious inflation targets are met. Most of the work, however, will have to be undertaken by the government.

The 2004 rebound in exports, combined with steady increases in industrial output and investment, should secure growth in 2004 at 3.6% and in 2005 to 3.7%. Public consumption will most grow only very moderately this year, as the government is forced to curtail spending to reduce budget deficits. We expect fiscal policy to be tightened considerably in 2004-06. In the second half of 2004 and beyond, much stronger growth in Western Europe will keep Hungary on course to record annual GDP growth rates of around 3-4% during 2004-07. Thanks to extensive FDI that has modernized the manufacturing, energy, and financial sectors, Hungary's export competitiveness and performance should continue to improve, although excessive wage growth needs to be curtailed. Pressures from financial markets and the EU to keep fiscal balances in order and foreign debt under control will ensure that Hungary's external imbalances do not reach threatening proportions. Going forward, Hungarian economic policies will be increasingly determined by membership in the European Union in 2004 and the need to meet Maastricht criteria for Eurozone accession just several years later.

Table 2.4: Economic Developments in Hungary to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	34.5	57.9	68.6	73.0	80.2	89.2	96.8	102.2
Per Capita GDP	*Current Euro*	3391	5690	7130	6159	5805	6681	7508	10033
GDP, Growth Rate	*Percent*	1.3	3.8	3.5	2.9	3.6	3.7	3.8	3.5
Average Annual Inflation	*Percent*	23.6	9.2	5.3	4.7	6.9	4.6	3.5	2.8
Population, End-Year	*Thousands*	10174	10175	10154	10090	10026	9962	9899	9835
Unemployment Rate	*Percent*	9.9	5.7	5.8	5.9	5.9	5.8	5.8	5.8
Exchange Rate, End-Year	*Forints/EUR*	208.1	247.7	235.9	262.2	248.0	245.0	242.0	245.0
Public Finance Deficit (ESA-95)	*Percent of GDP*	n/a	-4.4	-9.3	-5.9	-5.1	-4.2	-3.7	-3.2
Net Foreign Debt	*Percent of GDP*	38.8	44.1	45.1	36.2	29.3	24.9	28.7	31.7
Exports	*Million Euro*	10111	34062	36268	37491	39933	42864	46178	47929
Imports	*Million Euro*	12468	37617	39727	41944	43906	46914	50658	52335
Current Account Balance	*Percent of GDP*	-2.7	-6.2	-7.2	-8.9	-8.0	-6.8	-6.9	-6.5

Headline consumer price inflation in Hungary reached its low at 3.6% year on year in May 2003, and has gradually risen ever since. In addition to the weakening of the forint, since last summer, the adjustment in VAT rates to align them with EU levels effective January 1, 2004, added a solid 1.2-1.5% to headline inflation early in 2004. The surge that started last year brought inflation to 7.6% year on year in May 2004. However, July 2004 inflation already dropped to 7.2% year on year and the outlook for inflation for the remainder of the year and 2005 is actually much more benign than it was just a few months ago. This is not to say that inflationary risks are not skewed upwards. It is currently still difficult to assess to what extent the period of higher headline inflation will translate into increased inflationary expectations among the population.

The central bank hopes to cut inflation down to 4.0% by the end of 2005, and we originally concurred that this target seemed realistic. However, the price developments in the first half of 2004 mean that reaching this target would require substantial discipline on the part of the government and the National Bank of Hungary to keep a very close eye on price developments, making necessary adjustment along the way. We forecast 4.2% consumer price inflation at the end of 2005, and an average annual rate of 4.6%. In the medium term, inflation will decline gradually, to 2.5-3.0% by 2007, in preparation for the Eurozone entry in 2010-11.

Slovakia's Fiscal Reforms Help to Present It as the Most Progressive Country in Central Europe, Boosting Foreign Investment and Accelerating Growth Prospects

The benefits of Slovakia's tax reforms that were implemented in January 2004, as well as the country's accession to the European Union in May will help to foster an acceleration of growth in 2004 and beyond. Although the implementation of a flat income tax is giving many consumers more room for spending this year, personal consumption will rise only moderately, as the final set of major regulated energy price hikes took effect on January 1 and the lower rate of value-added tax was raised. Meanwhile, corporate tax cuts should help trigger a jump in investment spending, spurring new hiring. Growth in government spending, in contrast, will be weak during the next several years, based on the current cabinet's fiscal reforms.

Inflows of foreign direct investment (FDI) will be particularly important in driving growth, especially in manufacturing, financial services, and communications, all of which are areas where privatization and restructuring have moved rapidly. The cabinet's fiscal reforms, which have helped to present Slovakia as the most progressive country in Central Europe, are already helping to attract higher inflows of FDI. Early in 2003, Slovakia was chosen as the location of a new PSA Peugeot Citroen plant, which at the time was the largest greenfield project in Slovak history. The plant, which is scheduled for completion in 2006, should have an annual capacity of 300,000 cars and will employ an estimated 3,500 workers, in addition to indirect employment of 6,000–7,000. The PSA Peugeot investment alone is expected to add as much as 1 percentage point to GDP by 2006. In March 2004, Slovakia again won out over its neighbors in attracting another automobile producer, Hyundai/Kia. That firm will open a plant worth 1.2 billion euro, also scheduled to begin operation in 2006.

First-quarter 2004 GDP growth reached 5.5%, the highest rate since the same period of 1998. In its February forecast, the Finance Ministry was projecting GDP growth of just 4.1% this year, rising to 4.3% in 2005, and 5.0% in 2006. However, in its most recent forecast, released on July 28, those projections were raised to 4.7%, 4.5%, and 5.1%, respectively, with growth reaching a high of 5.4% by 2007. The Finance Ministry is now roughly in line with our 2004 projection. Despite the first-quarter surge, we are keeping our 2004 GDP growth forecast steady at 4.6% for the time being, but we may revise that figure upward depending on the economic results for the second quarter. The healthier economic base should help to trigger new hiring and higher wages, thereby raising household consumption. As a result of those factors, GDP growth should gradually accelerate to a high of nearly 6.0% by 2006. In subsequent years, GDP growth should slow to more sustainable rates. Slovakia's current over-reliance on a few major firms makes the economy sensitive to fluctuation; however, in the medium term, the country will gradually become more diversified, as the government lays the groundwork for a more business-friendly environment for small- and medium-sized enterprises and the country becomes increasingly integrated with the European Union.

Fiscal reform remains the most pressing economic problem facing the country, but the center-right government that took office following the September 2002 elections seems ready for the challenge and has already made considerable headway in pushing its proposals for tax, pension, and health-care reform through the parliament. We assume that Slovakia will meet the Maastricht criteria for entry into the Eurozone by 2007, at the latest, with accession in 2009. Unemployment is another of Slovakia's most difficult medium- and long-term problems, despite a significant decline in 2003. On July 1, 2003, new changes in the labor code took effect that should make firms more flexible in hiring new employees. It is also hoped that upcoming large-scale injections of foreign investment will eventually help to bring down the jobless rate.

Table 2.5: Economic Developments in Slovakia to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	15.7	23.3	25.5	28.7	33.2	36.9	40.8	44.2
Per Capita GDP	*Current Euro*	2933	4336	4750	5334	6161	6838	7557	8200
GDP, Growth Rate	*Percent*	5.8	3.8	4.4	4.2	4.6	5.0	5.8	4.7
Average Annual Inflation	*Percent*	5.8	7.3	3.3	8.5	7.6	3.8	2.9	2.5
Population, End-Year	*Thousands*	5379	5379	5379	5380	5385	5391	5393	5394
Unemployment Rate	*Percent*	11.3	18.3	17.8	15.2	14.6	14.0	13.3	12.6
Exchange Rate, End-Year	*Koruna/EUR*	40.3	42.8	41.7	41.2	39.6	38.9	38.0	38.0
Public Finance Deficit (ESA-95)	*Percent of GDP*	n/a	-6.0	-5.7	-3.5	-3.8	-4.1	-4.0	-3.0
Net Foreign Debt	*Percent of GDP*	7.5	21.4	11.6	14.9	9.2	2.1	-1.3	-4.1
Exports	*Million Euro*	6837	14189	15292	19381	22969	24881	29917	33550
Imports	*Million Euro*	8528	16406	17564	19949	23918	26308	30745	33995
Current Account Balance	*Percent of GDP*	-10.2	-8.4	-8.0	-0.9	-2.1	-2.5	-1.6	-0.7

After surging from 3.3% in 2002 to 8.5% in 2003, consumer price inflation is forecasted to gradually slow over the next several years to reach 2.5% by 2007, as Slovakia attempts to meet the Maastricht criteria for entry to the Economic and Monetary Union (EMU). Last year, the consumer price index rose, mainly due to administrative measures that were put in place on January 1. In 2004, average annual inflation is projected to slow to about 7.5–7.8%, as the last of the major regulated price hikes are implemented and the lower rate of VAT is raised. Slovakia's accession to the European Union on May 1 had little effect on market prices in May and June. Consumer price inflation is projected to slow in the latter part of the year. That is particularly true given the strong base related to excise tax hikes that were implemented in August 2003. Nonetheless, prices will be pushed up by the recovery of domestic demand in connection with rising real wages and the recent cuts in interest rates. The Finance Ministry is projecting average annual inflation of 7.8% this year, while we are forecasting a somewhat slower rate of 7.6%.

Because this year's hikes will finally bring energy prices to cost-recovery levels, future price changes will depend purely on market factors. Inflation should drop again in subsequent years, as the country prepares for entry into the EMU. According to its medium-term outlook, the NBS expects headline inflation to fall below 4.0% by early 2005, before approaching Eurozone levels later that same year. We project that year-on-year inflation will fall to 2.5% in 2007, allowing Slovakia to meet the Maastricht criteria for entry into the Eurozone. That is precisely in line with the Finance Ministry's forecast from July 2004.

Slovenia Looks to Net Exports to Boost Growth of Aggregate Economic Output

In the medium term, Slovenian GDP growth is expected to strengthen to between 4.0% and 4.5%, allowing Slovenian GDP per capita to close the gap with the EU average. An improvement in net exports will be the primary engine behind the more vigorous economic growth through the next several years. The combination of exports and imports of goods and services is larger than the country's total domestic demand. In 2003, net exports subtracted 1.8 percentage points from overall economic growth, its first negative contribution since 1999. In the first quarter of 2004, the negative affect of net exports lessened significantly, reducing overall economic growth by 1.1 percentage points. The modest improvement contributed to an acceleration of GDP expansion to 3.7% year over year in the first quarter. Within domestic demand, a sharp acceleration of fixed capital formation growth, from 5.5% in 2003 as a whole to 8.0% year on year in January–March 2004 was a significant boost to overall economic growth. Private consumption growth, meanwhile, also accelerated, from 3.0% last year to 3.7% year on year in the first quarter of this year. Net exports will likely continue to hurt overall GDP growth in the short term, as demand for capital goods keeps import growth higher than export growth. Mitigating that negative trend, however, is a potential dip of imports from the Balkan Peninsula in the second half of 2004 through 2005. Slovenia had previously maintained several unilateral free-trade agreements with other Balkan countries, a condition not allowed in the European Union. Upon accession, Slovenia was forced to abandon these agreements, making imports from this area more expensive. After a few years in the European Union, import demand for capital goods should level off, allowing net exports to begin to exert a positive influence on the economy once again through the medium and long term.

A recovery of demand from Slovenia's primary export market, the European Union, will provide impetus to export growth through the medium term. At the same time, import growth should slow from its recent highs, as investment demand eases and world energy prices cool. These factors should lead to a slow improvement of the current account balance through the medium term, as well. In 2004, the balance is expected to fall into deficit, but begin to improve in 2005. In the short term, any modest current account deficit should be easily financed by growing investment inflows. Domestically, fixed capital formation will drive economic growth, as new opportunities for foreign investors have been opened now that the country has entered the European Union, eliminating previous restrictions on foreign capital inflow. Private consumption will be a drag on overall economic growth, as labor market improvements will be modest and monetary policy will be tight.

The importance of trade movements to Slovenia's economic health has driven Slovenian officials to set an aggressive timetable for the adoption of the euro. In June 2004, Slovenia entered an ERM II exchange rate regime, with an eye towards adopting the euro at the beginning of 2007. While in the ERM II, the tolar is vulnerable to speculative attacks. However, the Bank of Slovenia is well positioned to defend such attacks, and will focus monetary policy through the medium term on the stabilization and protection of the tolar/euro tie. Adopting the currency of its single largest trade partner will reduce Slovenia's risk exposure to foreign exchange movements. Prior to adopting the euro, however, the country must meet all of the Maastricht criteria. Although Slovenia is arguably among the best prepared of the newest EU accession countries to meet the criteria, the primary problem going forward is an inflation rate that is 1–2 percentage points too high.

Table 2.6: Economic Developments in Slovenia to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	14.5	21.8	23.2	24.2	25.7	27.3	29.1	31.0
Per Capita GDP	*Current Euro*	7293	10939	11646	12101	12908	13751	14713	15706
GDP, Growth Rate	*Percent*	3.5	2.9	3.2	2.3	3.5	3.7	3.9	4.1
Average Annual Inflation	*Percent*	9.9	8.4	7.5	5.6	3.9	3.5	2.8	2.3
Population, End-Year	*Thousands*	1991	1994	1995	1997	1990	1984	1979	1974
Unemployment Rate	*Percent*	7.3	6.4	6.3	6.7	6.7	6.6	6.7	6.6
Exchange Rate, End-Year	*Tolars/EUR*	178.6	221.4	230.3	236.7	239.5	239.7	239.6	239.5
Public Finance Deficit (ESA-95)	*Percent of GDP*	n/a	-2.7	-1.9	-1.8	-1.4	-1.5	-1.6	-1.9
Net Foreign Debt	*Percent of GDP*	-0.8	17.6	17.3	23.9	29.8	33.9	33.3	29.8
Exports	*Million Euro*	6425	10435	11060	11410	12895	12805	13850	14296
Imports	*Million Euro*	7060	11127	11322	11960	13597	13514	14575	14958
Current Account Balance	*Percent of GDP*	0.2	0.2	1.4	0.1	-0.4	-0.2	-0.1	0.0

Although inflation has cooled substantially in the past 12–18 months, more progress must be made. In order to meet the targets, monetary policy will likely be reined in from its slightly more accommodative phase of recent months and fiscal policy will remain tight. In recent years, the government has shown admirable fiscal restraint, keeping budget deficits to less than 2% of GDP. This year, it is keeping prices down on all administratively controlled prices in hopes of reaching its inflationary target. Despite these positive steps, upward pressure on prices from stronger consumer demand and high world energy prices will prevent the country from meeting its 2004 inflationary target. In addition, lingering structural problems, such as an inflexible labor force and continued wage indexation, will make the reduction of inflation difficult both in 2004 and over the next couple of years, until these problems can be addressed. The country will not enjoy true success at significantly reducing inflation to the targeted level until 2006 at the earliest.

The Baltics Again Will Set the Pace for Economic Growth Among the New Member States

Estonia

Estonia's economy is currently in good shape as it becomes aligned with the business cycle of the European Union to an increasing extent. Remaining a healthy margin above the EU's average GDP growth in the medium to long term, Estonia will continue to catch up with Western Europe in terms of per capita income. On the production side, the share of transport and communications in total value added will increase further. European Union membership, as well as Estonia's sophisticated Internet penetration, which is already quite high, will propel growth of transport as well as communication services.

On the expenditure side, the development of private consumption is crucial for the medium-term sustainability of Estonia's external balances. Demand pressure on the current account will be alleviated gradually over the next three years, and private consumption is forecasted to grow around 5% at the same time, significantly lower than in 2000–02. Gross fixed capital formation almost stagnated in the first quarter of 2004, but will nevertheless resume strong expansion in the remainder of this year and beyond, while growth of government consumption will decelerate again in the medium term. However, due to fiscal obligations to NATO, as well as those related to EU membership, public expenditures will be kept growing despite the government's efforts to curb the spending spree.

A major revision of national accounts data lifted GDP growth for 2003 upwards, to 5.1%. Exports grew quite robustly in 2003, yet somewhat slower than imports, so that net trade continued to be a drag on economic growth. According to our current projections, GDP growth will equal 6.4% in 2004, as Estonia's key export markets will further recover in the second half of the year. The overall growth outlook for Estonia is favorable in the medium term as well. According to our projections, GDP will record 5.7% average annual growth in 2005–07. We believe that the benefits of privatization and restructuring will result in higher productivity and rapid growth in industrial output for several years. Estonia's manufacturing sector already appears to be well positioned for the strong competition of the European Union's internal market as well as for the world market. Manufacturing will remain strong, but will nevertheless record declining growth rates, roughly at parity with overall GDP expansion. During the next three years, we forecast annual growth rates in industry at 5.2% on average. Services, including transport and communications, generate around half of Estonia's GDP, and we assume that these sectors will enjoy higher rates of growth through the medium term, supplanting manufacturing as a key driving force for economic growth to some extent. Domestic trade is projected to grow at least 7% each year until 2007. The construction sector will continue to grow rapidly in line with strong investment. Transport and communications, as well as construction, will rise faster than GDP, at 7.5% and 6.9%, respectively, on average during that period. The Estonian government is more pessimistic about this year's economic growth, forecasting 5.3% real GDP expansion, but its projections for 2005–07 almost match our own, according to the 2004 Convergence Program released in May.

Estonia has recorded comparably low inflation during the transition period, in large parts due to the successful currency board arrangement for the kroon. Average annual inflation reached a record-low 1.3% in 2003. However, while upward adjustments for administratively regulated prices, energy prices, and certain kinds of excise taxes had already taken place before Estonia's EU accession, common EU rules require further adjustments.

Moreover, the government has noted that the continued harmonization of Estonia's tax regime with that of the European Union will make further increases in value-added tax rates necessary. In addition, Estonian Energy will need to achieve significant price increases over the next few years in order to finance the level of investment needed. For 2004, the company has already sought to increase its electricity tariff by 15%. While adjustments of regulated prices as well as excise taxes will lead to an increase of the headline inflation rate, core inflation measures will indicate that consumer price changes remain quite moderate and only slightly above the average of the European Union and Eurozone, in particular.

We forecast consumer price inflation to slightly accelerate to 2.3% in 2004, and reach 3.6% on average in the three years beyond, peaking in 2006 with 3.8%. While this inflation rate is supposed to come close to the ceiling of the applicable Maastricht criterion, we nevertheless believe that Estonia's EMU membership will not be impaired by too high an inflation rate at any time during 2006–08. Moreover, changes in the monetary environment related to the accession to the Economic and Monetary Union are quite unlikely to have any negative effects on price stability in Estonia, since the country is already a de facto a member of the Eurozone as the kroon was tied to the euro under the currency board arrangement.

Table 2.7: Economic Developments in Estonia to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	3.4	6.7	7.4	8.0	8.8	9.5	10.4	11.4
Per Capita GDP	*Current Euro*	2288	4892	5482	5935	6483	7095	7798	8549
GDP, Growth Rate	*Percent*	3.9	6.4	7.2	4.9	6.4	5.9	5.7	5.6
Average Annual Inflation	*Percent*	23.1	5.8	3.6	1.3	2.3	3.4	3.8	3.6
Population, End-Year	*Thousands*	1476	1367	1361	1356	1351	1344	1338	1331
Unemployment Rate	*Percent*	10.0	12.6	10.3	10.0	9.5	9.3	9.1	8.9
Exchange Rate, End-Year	*Kroon/EUR*	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6
Public Finance Deficit (ESA-95)	*Percent of GDP*	n/a	0.3	1.8	2.6	1.2	0.3	-0.2	-0.2
Net Foreign Debt	*Percent of GDP*	7.3	41.8	45.9	53.8	48.9	46.6	45.4	43.3
Exports	*Million Euro*	1576	3691	3633	3997	4661	5069	5448	5857
Imports	*Million Euro*	2446	4791	5080	5738	6460	6896	7309	7749
Current Account Balance	*Percent of GDP*	-9.2	-5.7	-11.4	-12.6	-10.4	-8.5	-7.9	-7.3

Latvia

Among the three Baltic states, Latvia still has the lowest per-capita income. In order to approach per-capita income levels recorded in other new EU member countries, not to mention Western Europe, Latvia has to grow significantly faster for an extended period. In 2003, GDP growth picked up to 7.5%, after a slowdown in 2002. We have raised our forecast for this year, to 7.4%, but currently maintain our projection of 6.1% average GDP growth during 2005–07.

Manufacturing, a key driver for growth in 2003, will decelerate slightly in 2004, while domestic services, in particular, retail trade, will continue to record robust growth in the medium term. Value added from the transport sector, which still depends heavily on transit of goods to Russia, is expected to accelerate expansion in the medium term, outperforming the services average. Modernization of infrastructure, adjustment in charges, and higher quality services will make Latvia a more competitive trade route for goods to and from Russia. Competition from ports in Russia will result in better services and lower prices in Latvia rather than reduced trade. Moreover, the country could benefit significantly from enhanced cooperation and integration with Russia, mainly because of its geographic location, as a bridge between Russia and Western Europe in terms of oil transport.

We forecast gross fixed capital investment to increase at an average of 7.0% in 2005–07. Net exports, on the other hand, will continue to serve as a drag on GDP growth into the medium term, as the import of capital goods and, with increased significance, consumption goods will remain strong. The current account deficit will remain a threat to the country's external stability in the medium term. Yet, the government has ignored calls for a tightening of the fiscal budget in order to rein in domestic demand. However, with even closer economic integration after EU accession buoying Latvian exports, we believe that the deficit will be kept at bay. Moreover, Latvia expects to receive sizable funds from the European Union's structural programs. After a current account deficit of 8.6% of GDP this year, we project a gradual decline in 2005–07. On average, the current account deficit will total 8.4% of GDP, and an accelerating inflow of foreign direct investment will finance roughly 60.00% of the deficit in that period.

Despite strong growth in revenues, the general government's budget recorded a deficit of 2.0% in 2003. Claiming social responsibility as a top policy priority, the government is unlikely to significantly reduce the deficit in the medium term. NATO and EU membership will add further spending pressure. Having in mind that GDP growth remains robust in the medium term, we forecast the budget deficit to record an average of 1.6% in 2005–07.

Table 2.8: Economic Developments in Latvia to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	3.9	9.2	9.7	9.8	10.7	11.3	12.3	13.3
Per Capita GDP	*Current Euro*	1588	3885	4147	4198	4604	4928	5376	5862
GDP, Growth Rate	*Percent*	3.7	8.0	6.4	7.5	7.4	6.3	6.1	5.9
Average Annual Inflation	*Percent*	17.6	2.5	1.9	2.9	4.7	3.5	2.3	2.1
Population, End-Year	*Thousands*	2468	2366	2346	2332	2319	2303	2287	2271
Unemployment Rate	*Percent*	7.2	7.7	8.5	8.6	9.2	9.0	8.8	8.7
Exchange Rate, End-Year	*Lats/EUR*	0.702	0.561	0.610	0.674	0.687	0.687	0.687	0.687
Public Finance Deficit (ESA-95)	*Percent of GDP*	n/a	-1.6	-2.7	-1.8	-1.7	-1.8	-1.5	-1.5
Net Foreign Debt	*Percent of GDP*	18.9	52.9	61.2	69.5	63.4	63.5	63.7	61.9
Exports	*Million Euro*	1110	2235	2408	2556	3002	3272	3616	3855
Imports	*Million Euro*	1784	3915	4268	4632	5324	5747	6188	6455
Current Account Balance	*Percent of GDP*	-5.5	-8.9	-7.0	-8.6	-9.0	-8.9	-8.5	-7.7

Inflation has returned recently as a cause for concern. A mix of supply-side factors as well as strong domestic demand has driven consumer prices upwards. Upward price and tax adjustments will continue to influence inflation significantly, and we have raised our inflation forecast for this year to 4.7%. The government still regulates prices on one-quarter of all goods and services in the consumption basket, including energy, water, and telecommunications. Going forward, 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 in the medium term to ensure that its economy is competitive. In April 2003, for example, the public services regulatory panel noted that a 16.5% increase of natural gas tariffs over the following three years could push up overall inflation by 0.5%. Additional inflationary pressures will come from wages. However, while consumer price inflation will remain a considerable margin above the EU average, we believe that it will not rule out membership in the Economic and Monetary Union (EMU) within the medium term. According to our projection, inflation will average 2.7% per year in 2005–07.

Lithuania

Lithuania achieved a stunning 9.0% growth rate in 2003. Surprisingly, the strong growth was achieved along with a modest decline in the level of consumer prices. In fact, consumer prices decreased at 1.2% on an annual average basis last year. The overall economic expansion will moderate hereafter and inflation will turn positive again this year, but there are no signs pointing toward a major change in the underlying trends. For 2004, we have maintained our projection for GDP growth of 6.6%. In the medium term, economic growth will slow slightly, but remain strong. We are forecasting 5.6% annual GDP growth during 2005-07, as further economic rebounds in key export markets, as well as the high price of oil, will give the economy an additional boost. The Finance Ministry was even more upbeat than our projection, forecasting 7.0% growth for this year, and 6.7% during 2005-07, based on the favorable external environment and strong consumer demand at home.

Industrial output growth should fluctuate around 6% annual through 2007, due to continued privatization and restructuring, further boosted by growing integration with the EU market. Growth will remain strong in the medium term due to the restructuring that has already taken place in Lithuania's industry and the impact of foreign investment on the economy. In addition, continuing privatization will benefit the overall economy by attracting better management and more investment. However, economic expansion in 2005/06 will be negatively impacted by the planned closure of the Ignalina nuclear power plant. Construction activity will continue to experience robust growth rates. Indeed, we forecast construction value added to rise 7.3% on average in 2005-07, thanks to inflows of structural funds from the European Union. Growth of aggregate demand will decline, from 10.7% in 2003 to an average 5.7% during 2005-07. At the same time, however, structural changes within domestic demand are underway: while personal consumption growth is projected to decelerate considerably, gross fixed investment will pick up, with growth rates ranging from 7.0% to 9.5%. Over the long term, though, investment growth will fall back again below 5%.

Our medium-term forecast assumes that fortunes of Mazeikiai Nafta, Lithuania's sole petroleum refinery and a very significant contributor to aggregate output, improve further, recovering from the low operating margins and the disruption at the company's Butinge terminal in 2002. Nonetheless, in case of falling oil prices, the performance of Lithuania's oil refining sector, and hence industry, would have to be downwardly revised again. But at present, a major drop in oil prices is not in the cards. Global Insight does not expect a decline in the currently extraordinarily high world market price of crude oil before the second half of 2005 and even then the decline will be at only a moderate pace.

Lithuania's current account deficit relative to GDP was just half the size of Estonia's, but was nevertheless a concern at 6.8% in 2003. Foreign direct investment inflows contracted sharply last year, so that financing the deficit has become more difficult. Nevertheless, we expect the gap to decline gradually during the medium term, as export growth accelerates and, as a result of relatively low import growth, the trade deficit shrinks. Transfers from the EU's structural funds will also help to reduce the deficit. According to our forecast, the current account balance should equal 5.4% of GDP in 2007.

Without doubt, a more restrictive fiscal policy stance would help to rein in domestic demand and, as a result, the large trade deficit too. Despite sustained strong overall growth, though, the fiscal deficit will unlikely be reduced to somewhere near balance in the medium term. Indeed, the upgrading of administrative and military capacities in line with EU and NATO accession, as well as the requirements for the co-financing of EU-related structural projects, will put additional pressure on fiscal expenditures.

Table 2.9: Economic Developments in Lithuania to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	6.1	13.3	14.8	16.1	17.6	18.7	19.9	21.4
Per Capita GDP	*Current Euro*	1635	3809	4288	4665	5131	5457	5803	6249
GDP, Growth Rate	*Percent*	4.7	6.4	6.8	9.0	6.6	5.3	5.1	6.3
Average Annual Inflation	*Percent*	24.6	1.5	0.3	-1.2	0.9	1.1	1.2	1.2
Population, End-Year	*Thousands*	3712	14444	16152	18413	20250	21390	22411	23935
Unemployment Rate	*Percent*	7.1	12.5	13.8	12.4	11.8	11.2	10.9	10.5
Exchange Rate, End-Year	*Litas/EUR*	5.0	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Public Finance Deficit (ESA-95)	*Percent of GDP*	n/a	-2.1	-1.4	-1.7	-1.3	-0.8	-0.3	0.0
Net Foreign Debt	*Percent of GDP*	19.7	30.3	26.9	28.4	26.0	27.3	28.9	29.3
Exports	*Million Euro*	2581	5119	5864	6397	6467	6689	7389	7848
Imports	*Million Euro*	3507	7096	8126	8692	8686	9238	9884	10306
Current Account Balance	*Percent of GDP*	-9.2	-4.8	-5.2	-6.7	-6.1	-5.9	-5.6	-5.4

In 2003, Lithuanian consumer price deflation was achieved thanks to increased competition and greater productivity which offset the impact of robust domestic demand.
However, consumer prices will rebound in 2004 due to administrative and EU-related price changes. Increases in excise tax rates on cigarettes and fuel will exert upward pressure on prices this year. In addition to rising taxes, administered prices need to be raised toward cost-recovery levels. Rising wages and convergence with EU prices will also put modest upward pressure on prices. Consumer price inflation will end up at 1.6% year on year in December, but prices are projected to rise only 0.9% for the year on average. A peak will be reached in 2006 and 2007, at an annual average of 1.2%. Lithuanian officials project somewhat more significant upward pressure on consumer prices in the medium term: the Finance Ministry forecasts a 1.4% rise in consumer prices in 2004, and in 2005-07, consumer prices are projected to rise 2.3% on average.

Cyprus and Malta

Cyprus

The medium-term development of Cyprus's economy will be largely shaped by the country's recent accession to the European Union. While further integration of the Cypriot economy with Western Europe will help to boost exports and tourism, growth will be tempered by several factors, including the government's need to take fiscal austerity measures aimed at meeting EMU membership targets, as Cyprus will be committed to adopting the euro within the medium-term horizon. The country will remain highly dependent on tourism revenues, which currently generate around one-fifth of Cyprus' GDP. The performance of the agricultural sector, which is highly dependent on weather conditions, will also remain an important factor in the country's growth outlook.

In line with the slow recovery in the global economy, GDP growth slowed to 2.0% in both 2002 and 2003, compared with a revised 4.0% for 2001. Declines in tourism and export revenues contributed to the weaker performance. Tourism revenues fell 10.96% in 2002, and remained weak in 2003, decreasing by a further 4.8%.

Growth in 2004 is benefiting from the pickup in the global economy, but the growth of the Cypriot economy will be tempered by several factors: the government's fiscal austerity measures aimed at meeting the Maastricht requirements for EMU membership and reining in a surging fiscal deficit and the uncertain geopolitical environment that has continued to affect tourism. Growth is projected to rebound to 3.5% in 2004 but will moderate slightly to a more sustainable growth rate of 3.0-3.2% in the medium term and beyond.

Table 2.10: Economic Developments in Cyprus to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	6.8	10.2	10.7	11.3	11.9	12.0	12.7	13.3
Per Capita GDP	*Current Euro*	9241	13394	13887	14626	15266	15286	16059	16770
GDP, Growth Rate	*Percent*	1.9	4.0	2.0	2.0	3.5	3.3	3.2	3.2
Average Annual Inflation	*Percent*	3.0	2.0	2.8	4.1	2.0	2.2	1.9	1.9
Population, End-Year	*Thousands*	738	762	768	773	778	783	788	793
Unemployment Rate	*Percent*	3.4	3.1	3.5	3.3	3.2	3.2	3.1	3.1
Exchange Rate, End-Year	*Pounds/EUR*	0.592	0.579	0.516	0.526	0.596	0.625	0.604	0.613
Public Finance Deficit (ESA-95)	*Percent of GDP*	-3.4	-2.8	-3.6	-5.9	-3.6	-3.1	-3.0	-1.8
Net Foreign Debt	*Percent of GDP*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exports	*Million Euro*	1070	1090	891	812	838	862	903	913
Imports	*Million Euro*	3064	4398	4313	3961	4466	4589	4796	4852
Current Account Balance	*Percent of GDP*	-9.2	-4.8	-5.2	-6.7	-6.1	-5.9	-5.6	-5.4

Cyprus' annual inflation rate has generally been relatively low, averaging less than 4.0% during the 1990s and only 2.7% during 1995–2001. In 2002, inflation increased to 2.8%, up from 2.0% a year earlier, but still below the 4.0% inflation rate registered in 2000. Inflation was subsequently boosted by crude oil prices and increases in certain taxes, including VAT rates, resulting in a rebound in the average rate of increase of consumer prices in 2003 to 4.1%. Consumer prices were not under substantial upward pressure in the first half of 2004, but with industrial producer price inflation boosted by record-high world market prices for oil and metals, some acceleration in CPI growth is anticipated in the succeeding months. We project average annual consumer price inflation at only 2.0% in 2004, however, accelerating modestly to 2.2% in 2005, but decelerating slowly thereafter through the medium term in line with trends in Western Europe.

Malta

Malta's economic performance faltered in 2003, with GDP declining in real terms after moderate growth in 2002. While 2002 growth was driven by net exports and consumer spending, both of those categories recorded disappointing results last year, particularly in the latter case, as exports declined. On a positive note, gross fixed investment surged in 2003, following two years of declines, signaling that overall GDP growth should pick up this year. That is particularly true in light of the projected revival of external demand and tourism. Malta's accession to the European Union on May 1 has provided the basis for sustained growth in the medium- to long-term. Nonetheless, the country must deal with its fiscal challenges, as its public debt was the highest among all ten accession countries last year, while its public finance deficit was second highest as a percentage of GDP.

Malta's National Statistical Office has revised its GDP data in line with ESA 95 standards, and figures for the first quarter of 2004 have yet to be released. However, after the decline in GDP registered last year, we are projecting a recovery in 2004, with growth reaching a rate of 3.4%. That revival should be based on a recovery in external demand and tourism. A recovery of exports will be crucial in 2004 and beyond. Customs data for the first four months of 2004 revealed a 3.6% year on year rise in lira exports and a 1.5% decline in imports.

Table 2.11: Economic Developments in Malta to 2007

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	2.5	4.1	4.1	4.0	4.3	4.5	4.8	5.0
Per Capita GDP	*Current Euro*	6754	10313	10371	10050	10611	11222	11822	12353
GDP, Growth Rate	*Percent*	4.0	-1.1	2.3	-1.7	3.4	3.3	3.2	3.1
Average Annual Inflation	*Percent*	2.5	2.9	2.2	1.3	2.6	2.3	2.5	2.0
Population, End-Year	*Thousands*	380	393	396	399	401	403	406	408
Unemployment Rate	*Percent*	5.0	5.2	5.6	5.3	5.1	5.1	5.0	5.0
Exchange Rate, End-Year	*Lira/EUR*	0.454	0.400	0.418	0.432	0.425	0.418	0.414	0.417
Public Finance Deficit (ESA-95)	*Percent of GDP*	-7.7	-6.4	-5.7	-9.7	-5.5	-4.5	-3.5	-3.0
Net Foreign Debt	*Percent of GDP*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exports	*Million Euro*	1331	2239	2383	2213	2322	2570	2779	2839
Imports	*Million Euro*	2150	2873	2821	2818	2892	3134	3397	3480
Current Account Balance	*Percent of GDP*	-12.2	-4.5	-1.2	-6.0	-5.1	-4.6	-4.1	-3.5

Retail price inflation reached an annual average of 1.3% in 2003. Nonetheless, price growth sped up significantly in the last months of the year, to a year-end rate of 2.4%. So far this year, prices have continued to rise relatively rapidly, with year-on-year inflation reaching 2.7% in the first half. For the full year 2004, we now project inflation on an annual average basis at double the 2003 rate, reaching 2.6%.

Malta's public finance deficit jumped to 9.7% of GDP last year, far above the 3.0% limit required for entry to the Economic and Monetary Union (EMU). That was the second highest deficit among the ten EU accession countries. Prior to the release of the latest figures, the budget deficit was projected to fall to 5.4% of GDP in 2004, and to 2.8% by 2006. However, there remains considerable doubt as to whether the budget targets can be reached, particularly in light of last year's worse than expected results. Another problem facing Malta in that regard is that end-2003 public debt rose to 1.3 billion lira, or 72% of GDP, the highest of the ten accession countries and far above the 60% requirement for entry to the Eurozone.