ICEG EUROPEAN CENTER

NEWS OF THE MONTH

March 2007

Budapest, Hungary, Phone: +36 1 248 1160, +36 1 248 1161 Fax: +36 1 319 0628
E-mail: office@icegec.hu Website: www.icegec.org

TABLE OF CONTENTS

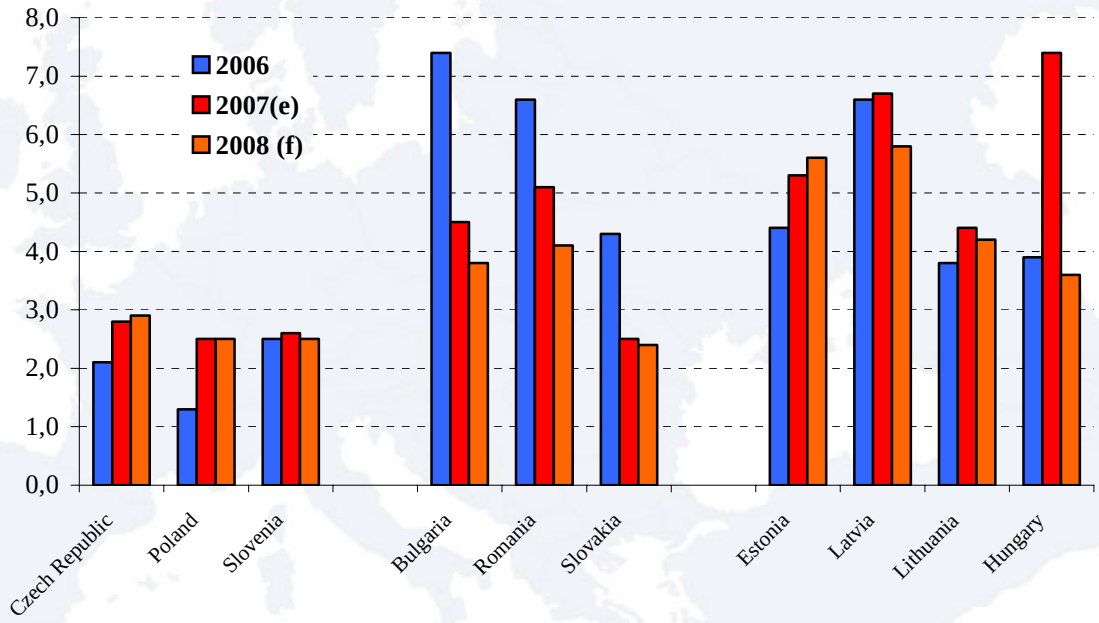
INFLATION DEVELOPMENTS OF THE EASTERN EUROPEAN EU MEMBERS

The New EU member countries disperse in development of inflation. Some of the countries experience no problems concerning inflation processes, while others do. Price developments are crucial in terms of well-designed monetary policy and sustainable growth performance. Additionally, price stability is obligatory for joining the euro area.

DIFFERENCE IN PERFORMANCE

The Eastern European members of the European Union could be separated into three groups according to the inflation tendency. The first groups includes countries where the Maastricht criteria have already fulfilled, however, the risk exposure is significant (Czech Republic, Slovenia and Poland). Economies in the second group have experienced crisp disinflation, the consumer price index declined in the past few months, but the price stability criteria have not reached yet (Bulgaria, Romania and Slovakia). There are countries in the third group, where the inflation pressure is relatively high, and price index increased (Hungary and the Baltic countries). (*See Chart 1*)

Chart 1. Inflation Rates of Eastern European Members of the EU



Source: Eurostat, ICEG EC

REASONS BEHIND

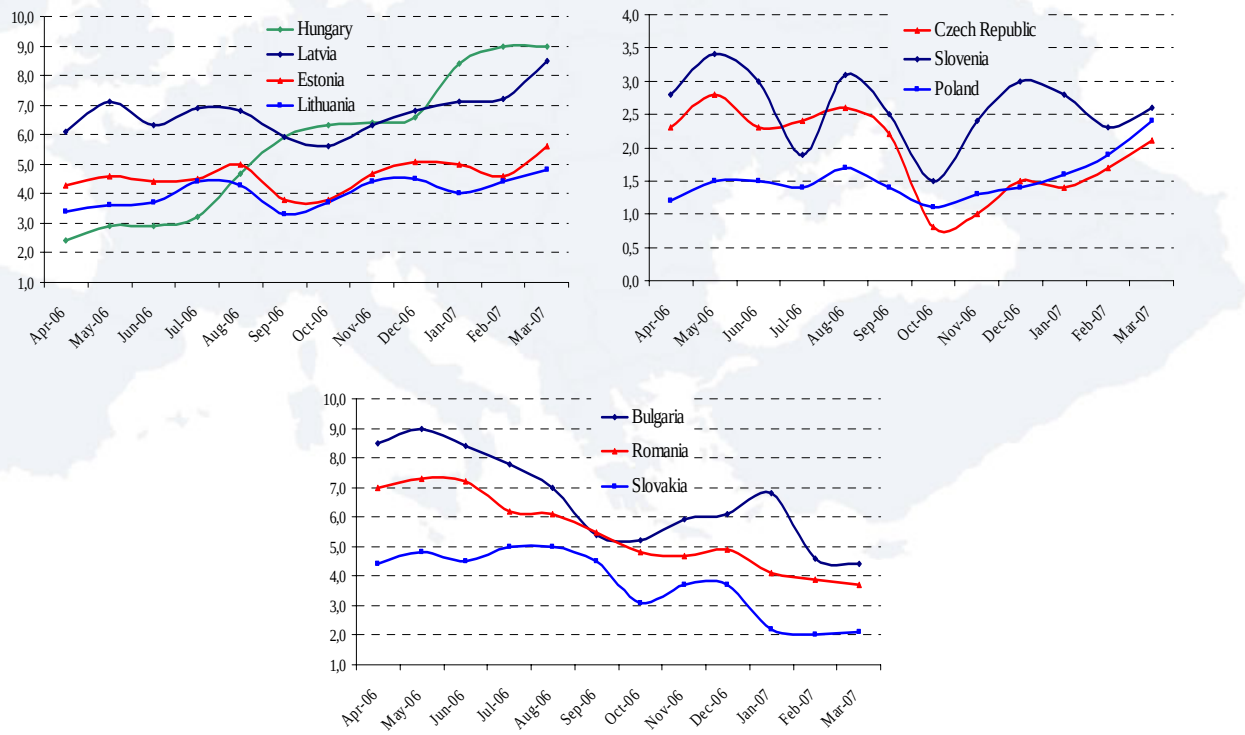
The inflation rate was approximately 2% in the past few years in Poland, Czech Republic and Slovenia. Soft inflation pressure has occurred in these countries from different reasons. Although it is not expected to exceed the rate the three percent, the price of the regulated goods and services will increase, and push up the inflation rate in Poland and Czech Republic. The strong demand may raise the CPI in Slovenia in 2007. Overall, the highest inflation pressure comes from the wage inflation is expected in Poland. The wage growth was high in

2006, and there are no signs to slow down in 2007 – mainly because of the fiscal slack (despite of the high pressure form the market).

Bulgaria and Romania have been the members of the European Union since 2007. Serious political and societal changes have carried out in the past few years that resulted in fast transition of the economic structure. The disinflation started from relatively high level, and accelerated in the second half of the previous year. Rapid disinflation is expected in Romania in medium term, while slower disinflation is shown in Bulgaria – according to the high growth of wages.

The third group includes the Baltic countries, and Hungary. The CPI increased in 2006 in these countries, and the chance for further raise is relatively high in short term. In Hungary, the fiscal tightening is ahead, the measure of consumer subsidy is on the way to decline and the tax rates increased in the past quarters. Therefore, the country is somewhat out of this group, but the price stability is far away from the criteria. On the surface Lithuania is only missed to join the euro area because of 0.1 percentage point gap, namely the inflation rate of the country was exceeded the reference indicator by the above mentioned value. In the background, the Commission has attracted attention to the structural problems in the Lithuanian economy, and forewarned of the risks on the inflation in medium term. The comment was valid, because the CPI raised and reached the 5 percent in March, while the rate was approximately 3 percent a year ago. The inflation rate increased in Estonia and in Latvia too. In Estonia, the changes of VAT rates raise the year-on-year CPI by 1 percentage point in 2007. The negative effects of the raising energy prices and the wage inflation could be emphasised in Latvia.

Chart 2. Year-on-year Inflation rate in Eastern European countries



Source: Eurostat

CONCLUDING REMARKS AND EXPECTATIONS

Overall, the Eastern European countries are very heterogenic according the inflation figures. One thing is sure: the inflation rate can be decrease only by coherent fiscal and monetary policy. There are ways to decrease the inflation rate ad interim, but these methods do not ensure the long-term price stability – as the case of Lithuania has shown us. In most of the countries, the main risk is the wage inflation, what delays the disinflation. The rapid growth of the wages and incomes push up the prices on the market in the transition countries. The effects of the energy prices are not so significant on this level. Although the raise of the oil prices has different impact on the Eastern European countries too, this is not the most important difficulty to reach the price stability, or push the inflation rate below 3%. According to the latest trends, Slovakia and the Czech Republic have the biggest chance to fulfil the criteria in medium term.

EXCHANGE RATE DEVELOPMENT IN NMS 8 COUNTRIES IN 2007

EU New Member States (NMS-8) - joined the Euro zone in 2004 - have been following fairly different economic-financial path in the recent years. Slovenia introduced the euro, four of them - Slovakia, Estonia, Latvia and Lithuania – are on the way to adopting euro and have been in the Exchange Rate Mechanism II (ERM II) system yet, however facing problems especially as of inflation, and the other three countries – the Czech Republic, Hungary and Poland remains the also run in terms of common currency adoption.

Country, which is joined the European Union has the ability, moreover obligation for adopting the common currency, the euro. To become to be entitled to adopting the single currency, the country must comply with some macroeconomic requirements – inflation, interest rate, state-debt, and deficit and exchange rate rules.

The exchange rate rule says, that the national currency must stay in a narrow, ± 15-percentage exchange rate band – fixing to the euro – at least two years, in case of entry. This is the main claim of the Exchange Rate Mechanism II.

For three states (the Czech Republic, Hungary and Poland) with quasi autonomous monetary policy, it is interesting to examine the possibility of joining the ERM II system. Would they meet the exchange rate requirement, if they were in the ERM II now?

FACTS-SITUATION REPORT

The exchange rate system situations in the NMS 8 states are disperse. ***Slovenia*** joined the ERM II - immediately after the EU-accession - on 28 June 2004 and observed a central rate of 239.640 and standard, ± 15 percentage fluctuation margin vis-à-vis the euro. The tolar left the mechanism, when Slovenia adopted the euro on 1 January 2007.

Slovakia joined the ERM II on 28 November 2005 and determined a central rate of 38.4550 and standard, ± 15 percentage fluctuation margin vis-à-vis the euro. The tendency in 2007 forced the National Bank of Slovakia and the European Central Bank for changing a lower central rate of the koruna. Thus, on 16 March 2007 the European Central Bank announced that the central rate of the Slovak koruna was set on 35.4424.

Estonia joined the ERM II on 28 June 2004 and observes the central rate of koroon 15.6466 and standard, ± 15 percentage fluctuation margin vis-à-vis the euro. Estonia unilaterally maintains a euro-based currency board.

Latvia joined the ERM II on 2 May 2004 and observes the central rate of 0.702804 and standard, ± 15 percentage fluctuation margin vis-à-vis the euro. Latvia unilaterally maintains the exchange rate of the lats within a 1 percentage fluctuation band around its central rate vis-à-vis the euro.

Lithuania joined the ERM II on 28 June 2004 and observes the central rate of litas 3.45280 and standard, ± 15 percentage fluctuation margin vis-à-vis the euro. Lithuania unilaterally maintains a euro-based currency board.

In the ***Czech Republic*** the Czech National Bank operates in loose monetary circumstances, because on 26 May 1997 it changed for free floating of the Czech koruna. In December 1997,

the CNB Bank Board decided to change its monetary policy regime as well, and at the start of 1998 it switched to inflation targeting.

In ***Hungary*** the government and the National Bank maintain inflation targeting system. On the other hand, in 2001 they introduced a semi-floating exchange mechanism – similar to the Exchange Rate Mechanism II –, where the Hungarian forint can fluctuate in a ± 15 percentage fluctuation margin around the central rate of 282.36 –HUF/EUR. It seems that the two different aims are hard to harmonise, because in some cases they are conflicting with each other. In the situation, the inflation needs to be lowered and the exchange rate is too close to the edge of the exchange rate band, the National Bank cannot do anything else, but gives up its inflation target in order to defend the exchange rate regime. The big disadvantage of this system is the decreasing confidence.

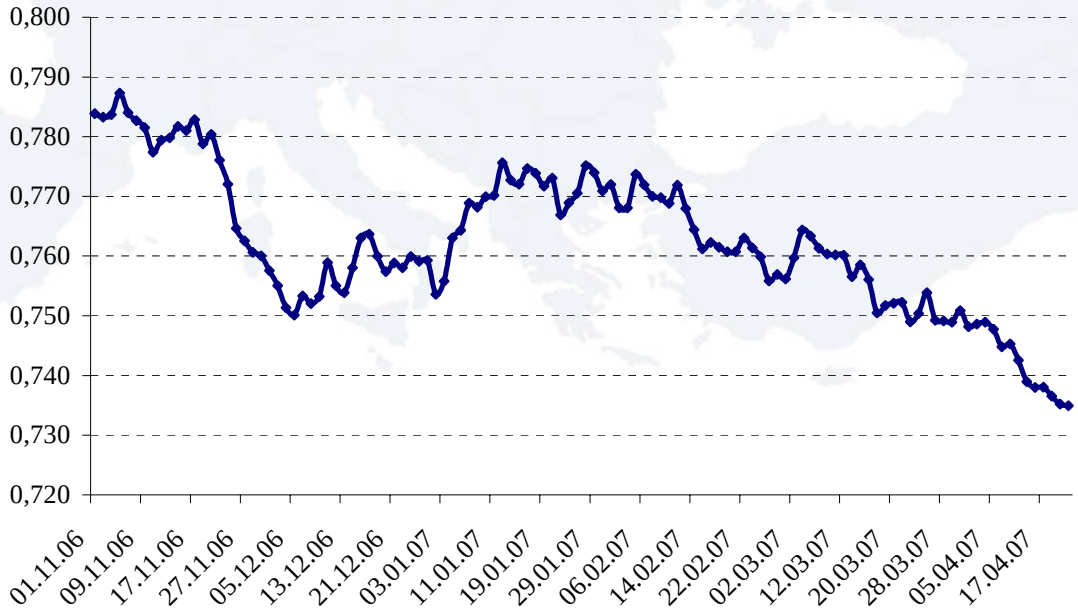
Poland is the third country, which is not an ERM II member of the eight countries. The Polish National Bank left the crawling peg and announced the free floating monetary regime in Poland on 11 April 2000. Since that time, the Polish zloty has been floating free against every foreign currency in the world.

LATEST DEVELOPMENTS

As the Baltic countries have currency board system, Slovenia is a Euro zone member now, especially the Slovak, Czech, Hungarian and Polish exchange rate developments are interesting.

First of all, the euro-exchange rate against the dollar should be examined. We could have the assumption, that the home currencies are moving together with the main European currency, the euro. The changes of the euro exchange rate have a very strong effect on the other national currencies.

Chart 3. EUR/USD Daily Exchange Rate, November 2006 - April 2007



Source: ECB

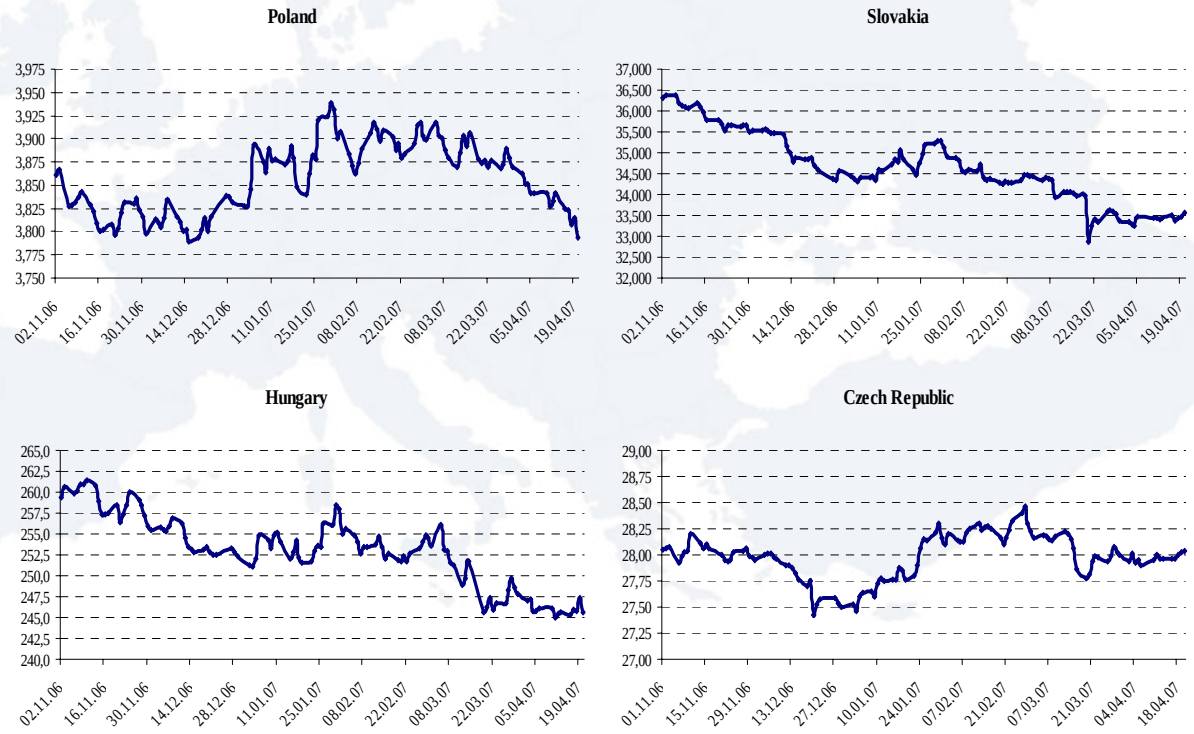
The euro is on an appreciating path since January 2007. It has a depreciating trend from November until January, but now it is changed and strengthened from EUR/USD 0.78 to EUR/USD 0.73 in the last four month. It means about 0.05 points appreciating from January. **(***See Chart 3***)**

Slovakia is the country, where the continuously appreciating national currency has forced the monetary authority for changing the monetary conditions. As Slovakia is the member of the ERM II mechanism, the Slovak koruna has a fluctuation band around its central rate. That was SKK/EUR 38.45 at the beginning of ERM II membership.

As the chart shows, the koruna had been appreciated to SKK/EUR 33.9 on 16 March 2007. It meant a 13% strengthening related to the central rate of 38.4550. The edge of the band is at the 15 percent, thus exchange rate performance made hard situation for the National Bank. In this case, the national bank and the ECB have the ability for consulting the future steps. They decided to appreciate the central rate of the exchange rate by 8.5% to SKK/EUR 35.44. Thus, the actual exchange rate became undervalued as compared to the central rate.

The Czech the koruna seems to be stable for a month around CZK/EUR 28. This is the only currency in the area that has not been strengthening in this period of time. On the other hand the currency was not volatile at all from the investigated period (from November). It stayed between CZK/EUR 27.4 and CZK/EUR 28.4, thus its highest volatility could have been 3.5%. Czech exchange rate time-series has the very similar value for the first and the last data, in this way, the average exchange rate kept stable.

Chart 4. Daily exchange rates of Visegrad Countries, November 2006 - April 2007



Source: National Banks of the Czech Republic, Hungary, Poland and Slovakia

The Hungarian exchange rate time-series is very similar to the Slovak series. As the Slovak koruna has strengthened by 8%, the Hungarian forint had resembling development, since the

forint has appreciated by 6% from November until April. The forint exchange rate started with HUF/EUR 260 in November, and now HUF/EUR 245.

The Polish exchange rate time-series gives the impression, that the polish exchange rate was more volatile, than the other countries' exchange rates. However, after calculating the exchange rate volatility, around 4% is given-which can be said an average value. From the end of January, the zloty has been appreciating as well.

CONCLUSIONS

The four relevant currencies in Central-Europe seem to have behaved the same in the chosen period of time. They had very similar exchange rate volatility, and had mostly the same exchange rate strengthening trend. As the investors alter the currency exchange rate, the former observation could show that investors handle the Central-European countries together. Like, they would be a common market, with common monetary and fiscal conditions and situations. When they decide to invest into this region, they just have some information about the countries one by one and do not really care about it. Thus, in case they are given some good news from the region, they automatically invest into the all countries in the region. It is good news for countries with poor economic developments, and bad news for the others.

By all means, these currencies have the same trend like the euro exchange rate against the dollar, which is stronger then it was in November by 6 percent. The currencies are very dependent on the performance of the euro in the international market.

SURPRISINGLY HIGH FDI IN POLAND

According to preliminary data from the National Bank of Poland, inward foreign direct investment reached a record USD 14.69 billion in 2006, which exceeds the results of 2005 by USD 7 billion. As inward FDI was expected to reach only USD 10 billion in the previous year, the high level surprised both the government and experts.

KEY INDICATORS OF THE POLISH ECONOMY

After a short deceleration of economic development after 2000, the Polish economy started to grow again at a faster pace. Although the results of 2005 were not promising concerning GDP growth, economic growth driven by private consumption and gross capital formation, reached 5.8% in the last year, which is the best result in the current decade. Inflation developed also positively and was under 2% in the last year.

Table 1. Key Indicators of Poland 2000-2006

Indicator	2000	2001	2002	2003	2004	2005	2006
GDP growth (%)	4.2	1.1	1.4	3.8	5.4	3.5	5.8
Inflation (%)	10.1	5.3	1.9	0.8	3.5	2.1	1.3
Budget balance (% of GDP)	-1.5	-3.7	-3.2	-4.5	-4.7	-2.5	-2.8
Unemployment rate (%)	16.1	18.2	19.9	20	19.1	17.6	13.8

Sources: Eurostat

The unemployment rate dropped due to buoyant economic growth by 3.8 percentage points to a record low level of 13.8% in 2006. High economic growth translated into higher budget revenues, thus budget balance could fulfil the Maastricht convergence criteria requiring 3% or smaller ESA-95 general government balance in 2006.

TENDENCIES OF INWARD FDI

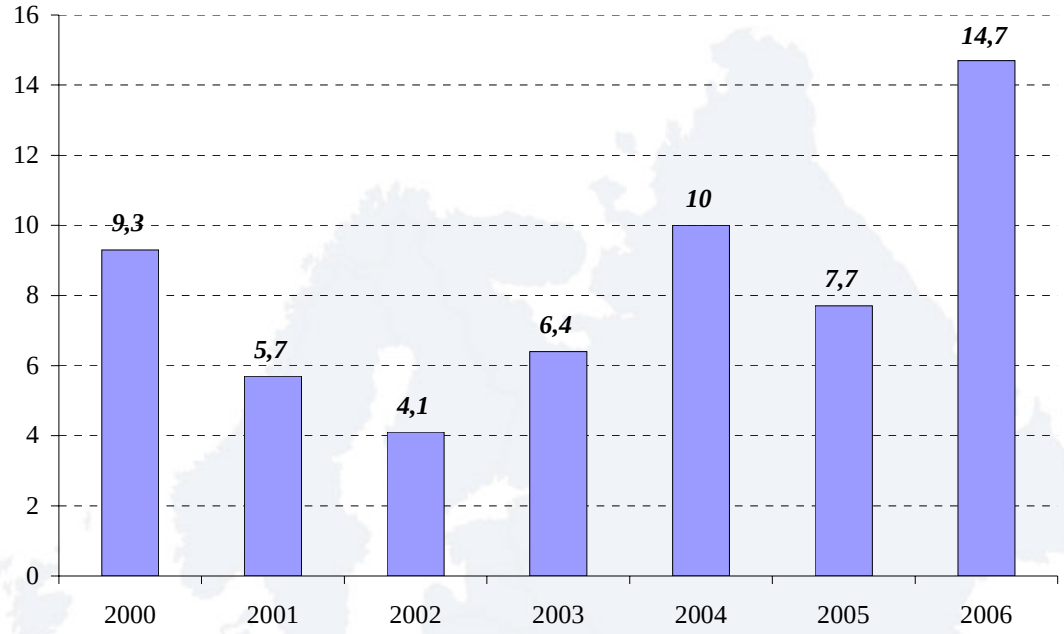
Polish economy started from a difficult position in the early 1990's. Following the country's announcement in 1990 that it could not pay its debts, inward FDI flow was limited in the first half of the decade. By 1994, the economy stabilised and inward FDI increased notably, from USD 88 million in 1990 to USD 3.7 billion in 1995 and to USD 9.3 billion in 2000. After reaching its peak in 2000, inward FDI decreased to around half of its maximum value, as privatisation slowed down and macroeconomic conditions developed unfavourably.

Parallel to the recovery of the economy, and thanks to establishing a new set of incentives for foreign investment in 2002, FDI flows increased in the following two years. During this period, the nature of foreign investment changed, as green-field projects attracted half of the investments, while the role of privatisation of strategic local enterprises shrank. Large transactions had an important impact on inward FDI, thus fewer projects in 2005 resulted in a 23% decrease.

Between 2005 and 2006, FDI grew by a surprising 50%, reaching almost USD 15 billion. The inward FDI level was strongly boosted by considerable spending on real estate and by investors from Japan discovering Poland. Japanese companies such as Bridgestone, Sharp, Toyota, Toshiba and Orion Electric decided to invest in the country. Besides green-field projects, reinvested profits accounted for a considerable part of the record-high FDI inflow, while the contribution of privatisation was minor, reaching only 11% of privatisation income

planned for 2006. By the end of the previous year, foreign companies had invested a total of USD 108 billion in the country, which is the highest amount of the region. However, in terms of inward FDI per capita, Poland is well behind its regional competitors. Polish per capita FDI of USD 2800 is not too impressive compared to USD 6300 in the Czech Republic and USD 6700 in Hungary.

Chart 5. Inward FDI to Poland 2000-2006 (USD billion)



Source: National Bank of Poland

Most foreign investors have been from the United States, giving 18% of all inward FDI projects. The United States is followed by Germany (16.6%), the United Kingdom (10%), Sweden (6%) and Japan (6%). Almost half of investments were directed to manufacturing, followed after a huge gap by retail trade (14.5%), logistics and distribution (7.5%), sales, marketing and support (7%) and construction (6%). Despite their low share, investment in sectors like business services (current share 5.5%), R&D (3.5%) and shared services centres (2.2%) is expected to increase in the coming period. International companies could use the advantages offered by competitive salaries, excellent ICT professionals, academic potential and the availability of wide range specialists in setting up business process outsourcing and R&D centres in the country. Currently there are several BPO centres functioning as accounting, consulting and call centres, and two more are planned in this year, employing 1000 people each. Additionally, there are more than 35 R&D centres owned by investors like ABB, Avio, Fujitsu, Glaxo Smith Kline, IBM, Intel, Lincoln Electric, Motorola, Oracle, Siemens, TRW Automotive, Samsung, Microsoft and Whirlpool.

A number of factors including strategic location, cheap and well-educated human capital, flexible employment conditions and available incentives determine attractiveness of Poland for foreign firms. The country's geographic location enables investors to easily access 500 million people in Western Europe and 250 million in Eastern Europe. No wonder, that 80% of modern warehouses are located around Warsaw. Concerning the time required to start up a company, Poland (31 days) provides advantages compared to Hungary (38 days) or the Czech Republic (40 days).

The country welcomes foreign investors with a number of incentives like grants, tax abatements and exemptions. The investment incentive schemes limit the total amount of tax exemption or financial grants provided to an investor, but make a difference between regions. The intensity of aid cannot exceed 30% in the area of Warsaw and Poznan, 40% around Gdansk, Wroclaw and Kraków and 50% in other regions. In case of small and medium-sized enterprises, the maximum intensity can be increased by 15 percentage points. Additionally, 14 Special Economic Zones (SEZ) with a total area of 6300 hectares offer further benefits for foreign investors including land at competitive prices, free assistance in dealing with formalities, exemption from real estate tax, grants for employee training programmes and for creating new jobs. SEZs will operate until 2015-2017.

EXPECTATIONS

Since Poland has recently become the number one target of foreign investment in Europe, it can be expected that high investor interest will further boost inward FDI. According to the Minister of Economy, negotiations are underway concerning 30 large investment projects, including 8 in the electronics sector, 13 BPO, 7 automotive and two aviation projects.

However, in case the dependence of the amount of inward FDI on large projects will continue in the future, drops like that of 2005 can occur in the coming years. As competition in the region is growing, Poland has to increase efforts to attract FDI. After the accession of Bulgaria and Romania to the EU, the country gained two more competitors besides the Czech Republic, Hungary and Slovakia. The two new member states can compete with lower labour costs; Poland has to focus on attracting investment in the field of BPO and R&D centres, by tailoring incentives to the needs of quality investors.

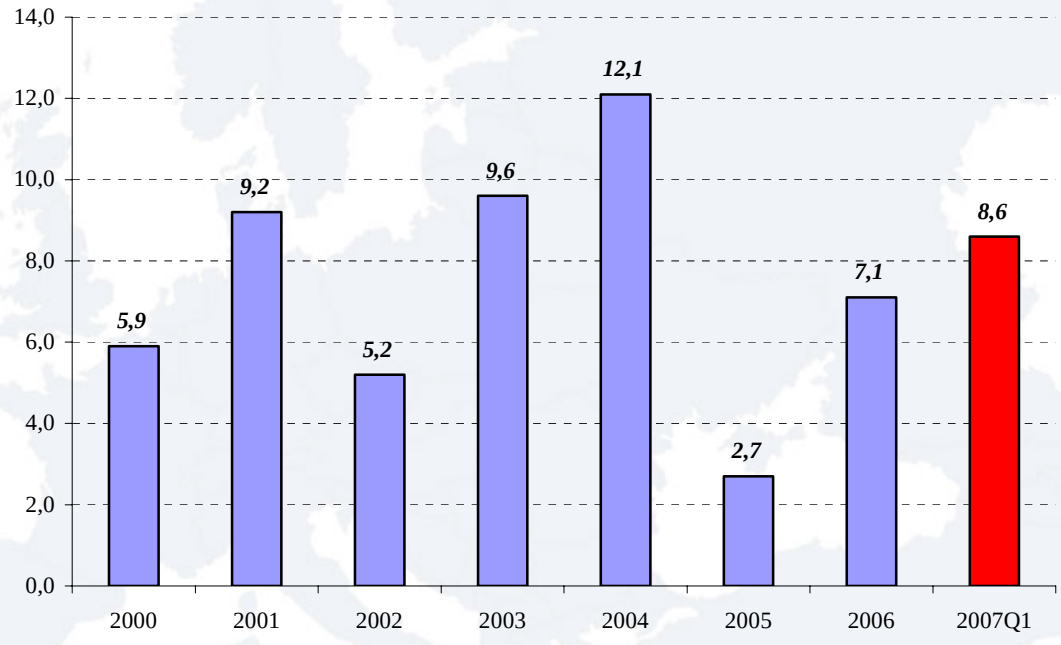
REVIVING GDP GROWTH IN UKRAINE

Despite low expectations of 2.3% and a low annualised growth rate (2.4%) in the first quarter of 2006, Ukrainian GDP grew by 7.1% in the previous year. Due to the dynamic growth, GDP exceeded USD 100 million for the first time since the independence of the country. The positive trend continued in the first quarter of 2007, as real GDP growth reached 8.6% compared to the same period of the previous year.

TENDENCIES OF REAL GDP GROWTH

The economy of Ukraine experienced major fluctuations during the 90ies, accompanied by hyperinflation and drastic falls in economic output. As the implementation of structural reforms was limited, real GDP dropped to 40% of its 1990 level by the end of 1999. After a struggling decade, the country first experienced GDP growth in 2000. The economy continued expanding in 2001 however, growth was more moderate in the following year, reflecting faltering growth in developed countries. Despite decelerating economic reforms, GDP growth exceeded 10% in 2004, and real GDP was more than 50% higher than in 1999.

Chart 6. Real GDP growth rate in Ukraine, 2000-2007 (%)



Source: State Statistics Committee of Ukraine

In 2005, real GDP grew by almost 10 percentage point slower than in the preceding year, because of slowing down capacity usage of traditional industries, higher natural gas prices and lower international metal prices, fall of investment demand caused by political uncertainty and attempts to renegotiate privatisation deals. Because of the Ukrainian-Russian gas dispute, expectations of real GDP growth for the year 2006 were down by 2 percentage points to 1.5-3.5%. Thanks to developing economic situation, continuing reforms, increased investment interest the real GDP growth accelerated and reached 7.1% in 2006. The Ukrainian economy seems to maintain the current pace of growth. Real GDP grew by 8.6% in the first quarter of 2007 compared to the same period of the previous year however, it is only 7th out of 9 CIS economies.

THE COMPOSITION OF GDP GROWTH

In the beginning of this decade, growth was mainly driven by export. In 2002 strong domestic demand, low inflation and solid consumer and investor confidence supported dynamic growth of the economy. In the following two years rapid privatisation of state-owned enterprises contributed to GDP growth, thus investment activities became the engine of economic growth. As a result of political instability and strong re-privatisation rhetoric, the share of GDP devoted to gross fixed investment dropped from 25% in 2003 to 21% in the first half of 2005. Rising steel prices worldwide, growing domestic consumption and accelerating fixed investments boosted economic growth in 2006.

Table 2. Decomposition of GDP Growth on Demand and Supply side (% change)

	2003	2004	2005	2006Q3
Supply side				
Agriculture, hunting, forestry, fishing	11.2	18.4	0.6	-2.7
Mining	8.8	7.9	0.5	5.4
Manufacturing	17.4	14.8	2.5	3.9
Production/distribution of energy	4.6	-6.2	5.1	5.9
Construction	28.2	21.1	-5.5	6.1
Trade and repair	21.4	13.8	-7.8	13.2
Transport	11.2	11.5	12.9	10.6
Education	10.4	0.3	-1.9	3.6
Health and social security	8.9	1.7	1.2	1.9
Demand side				
Final household consumption	11.2	12.9	16.8	18.6
General government final consumption	6.8	1.7	2.7	1.7
Gross capital formation	22.3	20.4	-0.4	11.8
Net export	-83.6	623.6	-223.6	-343.7

Sources: State Statistics Committee of Ukraine

Concerning GDP composition on supply side, construction, manufacturing and trade and repair were the main sectors contributing to GDP growth in 2003 and 2004. After a decline in 2003 agriculture was also one of the main driving sectors according to its potential in 2004, while the branches of energy, mining and services grew below average. The tendencies of the last two years show a shift towards services sector concerning main contributors to economic growth, as transport, trade, and repair sectors grew by 6 to 10 percentage points faster than the average.

EXPECTATIONS

According to the results of the first quarter of 2007 the Ukrainian economy is likely to expand in 2007 as well. However, despite extensive human capital, natural resources and industrial potential, there are several risks in short- and long term perspective that could threaten sustained growth. Energy intensity in Ukraine is approximately 22 times higher than in Germany and one of the highest in the region, thus increasing energy prices could shock the economy and depress growth. In order to reduce the risks due to energy-inefficient production structure, the government should support the improvement of energy efficiency and technological modernisation.

Besides energy inefficiency the lack of reforms in crucial sectors such as energy, transportation and education are another threat on future economic growth. Low quality infrastructure and poor investment climate are further barriers of development. Additionally, continuing political uncertainty, governmental plans of reinstating taxes, trade and customs privileges and maintaining of restrictive grain export quotas are slowing down growth and scaring foreign investors. Besides political events, future changes in gas prices and steel prices can have dramatic effect on the Ukrainian economy, making future growth expectations unpredictable. In case structural reforms will advance annually, a 5.5% growth is projected on average.