

# CEE REPORT

Croatia



**Bulgarien / Bulgaria**  
**Kroatien / Croatia**  
**Polen / Poland**  
**Rumänien / Romania**  
**Russland / Russia**  
**Slowakei / Slovakia**  
**Slowenien / Slovenia**  
**Tschechien / Czech Republic**  
**Ukraine / Ukraine**  
**Ungarn / Hungary**  
**Bosnien & Herzegowina /**  
**Bosnia & Herzegovina**  
**Estland / Estonia**  
**Lettland / Latvia**  
**Litauen / Lithuania**  
**Serbien und Montenegro /**  
**Serbia and Montenegro**

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## The EU goes South-East

Die lange Nacht von Luxemburg lässt sich kurz wohl wie folgt beschreiben: die Bestätigung eines bereits früher gefassten Beschlusses (Türkei) und die nächtliche Umkehr einer bisherigen Strategie (Kroatien).

Damit ist nicht notwendiger Weise eine Kritik an den konkreten Beschlüssen abzuleiten, sondern wenn überhaupt ein Zweifel an einer kohärenten Politik der EU, die möglicherweise daraus resultiert, dass es den Mitgliedstaaten ganz offenbar derzeit an einer Vorstellung darüber mangelt, welche Identität die EU in Zukunft haben soll.

◆ Die primäre Frage ist und bleibt: Ist die heutige Vorstellung einer künftigen EU noch immer Delors' Vision eines integrierten Europas und das nicht nur in wirtschaftlicher Hinsicht oder hat sich die EU still und leise in den letzten Jahren davon entfernt und entwickeln wir uns wieder „retour“? Dazu passt auch ins Bild, dass das Verfassungsprojekt durchgefallen ist.

◆ Es ist weniger die von manchen Kommentatoren beschworene „Erweiterungsmüdigkeit“ der EU, sondern vielmehr die mangelnde Vision über eine künftige Identität, die den Integrationsmotor stottern lässt. Die Bürger spüren das und daher sollte man sich auch nicht über den Ausgang der bisher stattgefundenen Verfassungsreferenden wundern.

◆ Zu den aktuellen Anlassfällen: Die Aufnahme der Türkei mit 70 Mio. Bürgern hat nicht nur Auswirkungen auf die Institutionenfrage der EU, son-

dern auch für das künftige Tempo der Integration. Dies sowohl in ökonomischer, als auch in allen anderen harmonisierten Bereichen. Kroatien ist in dieser Hinsicht relativ einfacher zu beurteilen. Weder die Größe noch die gesellschaftlichen und kulturellen Unterschiede sind von bisherigen Erweiterungsschritten abweichend. Kroatien wird aber zu beweisen haben, dass das (ex-ante) politische Vertrauen, das die EU in das Land gesetzt hat (z. B. Verfolgung von Kriegsverbrechern) auch erfüllt wird.

◆ Wirtschaftliche Konsequenzen. Kroatien ist wohlhabender als die meisten anderen der neuen Mitgliedstaaten, die Größe in Relation zur Gesamt-EU gering, Störungen der wirtschaftlichen Entwicklung der EU sind daher nicht zu erwarten. Die Aussichten der Türkei hinsichtlich eines Aufholprozesses in der EU sind besser als in so manchen neuen Mitgliedstaaten. Dennoch sollte man sich nicht von erwarteten Zuwachsraten und Durchschnitten täuschen lassen. Anatolien ist nicht Istanbul. Die regionalen Unterschiede sind enorm und daher auch der Finanzierungsbedarf seitens des EU-Budgets. Abstriche bei Transfers an bisherige Beihilfenbezieher vorprogrammiert, sicher ein weiteres Konfliktpotenzial. Das alles macht den Beitritt nicht einfacher. Dennoch mag es auch gute Gründe für einen EU-Beitritt geben. Voraussetzung dafür ist allerdings, die EU Mitgliedstaaten wissen welche künftige Identität der EU sie im Auge haben.

The long night in Luxembourg can briefly be described in the following terms: the confirmation of a resolution (Turkey) that has already been adopted and the overnight reversal of a strategy pursued to date (Croatia).

This does not necessarily infer criticism of the concrete resolutions, but possibly doubts as to whether the EU is pursuing a coherent policy, arising from the fact that the member states at the present time evidently have little idea of the identity the EU is to assume in the future.

◆ The most important question is and will remain: Is the concept of the future EU still Delors' vision of an integrated Europe – not just in economic terms – or has the EU in the last few years quietly moved away from this idea, so that we are now regressing? The picture is complemented by the failure to introduce a new constitution.

◆ It is less the EU's "enlargement fatigue" cited by some commentators than the lack of a vision for a future identity which has slowed down the integration process. The citizens sense this, so one should not be surprised at the outcome of the referendums that have taken place so far on an EU constitution.

◆ Comments on the current issues raised: The acceptance of Turkey with its 70 million citizens has implications not only for the institutional issue concerning the EU, but also for the future pace of integration in the economic field and in all the other harmonised areas. In this respect, Croatia

is somewhat easier to assess. In terms of size and social and cultural differences it is similar to other countries that have been admitted to the EU. But Croatia will have to prove that the (ex ante) political confidence which the EU has placed in the country (e.g. hunting down war criminals) is satisfied.

◆ Economic consequences Croatia is wealthier than most of the other new member states, and its size in relation to all EU countries is small. It is therefore highly unlikely that Croatia would have any adverse impact on the EU's economic development.

Turkey's prospects for catching up within the EU are better than those of some new member states. Nevertheless, one should not be deceived by expected growth rates and averages. Anatolia is not Istanbul. The regional differences, and therefore also the financing requirements for the EU budget, are enormous. Reductions in transfer payments to current recipients of EU funds would be inevitable, and this without doubt creates further potential for conflict.

These considerations do not make EU accession any easier. But there could also be some good reasons in favour of accession. A prerequisite is however that the member states know what the EU's future identity is to be.

<b>Area:</b> 51,129 sq. km
<b>Population:</b> 3.8 mn
<b>President:</b> Ivo Miro Jović
<b>Prime minister:</b> Adnan Terzić
<b>GDP (2004):</b> EUR 6.6 bn
<b>Per capita GDP (2004):</b> EUR 1,730

# Bosnia and Herzegovina

## New opportunities

### Political situation

After lengthy negotiations with the IMF, a new stand-by agreement worth approximately 50 mn euro and with a term of 18 months is now in sight. For the agreement to enter into force this autumn, the IMF requires the laying down of legal frameworks ensuring that the newly formed Fiscal Council can carry out its task of monitoring budgetary discipline in both entities and across the state as a whole. The implementation of the agreement is otherwise subject to the budget drafts for 2006, which are not expected to be ready before December. The police reform which targeted unified police forces across the entities was adopted. This is

a prerequisite for the commencement of negotiations on a Stability and Association Agreement (SAA) with the EU, which realistically have no chance of starting this year.

### Economic situation

The rapid economic growth of last year has been continuing. Industrial output in the Federation has increased by almost 6 % in the first eight months, and by over 20 % in the Republika Srpska. This has all been driven by robust external demand, especially for products in the metals sector, which has improved its competitiveness following the inflow of foreign direct investment. But domestic demand has also

been an engine of growth, which has benefited from a high increase in lending. For the year as a whole we anticipate a slightly stronger increase in GDP compared to 2004, amounting to 5.5 %.

Customs administration and the levying of indirect taxes have been amalgamated into one authority. From now on, some of the indirect taxes will be levied centrally and distributed to the individual administrative units. This regulation has paved the way for the introduction of an EU-conform value added tax as of the beginning of 2006. The two-rate sales tax applied to date is to be replaced with a single VAT rate of 17 %. Introducing the VAT could put some upward pressure on inflation again.

Over the last few months the rate of inflation has crept up slightly due to the high prices of oil, but it remains under control with the exchange rate being linked as it is to the euro.

The introduction of the value added tax makes predicting the development of budgetary revenue quite difficult. It is conceivable that this will adversely affect the budget deficit. Nevertheless, recent years have seen some impressive successes with regard to consolidating the budget, and public finances may well even balance out in 2005. No change is expected to be made to the prudent budget policy in order to comply with the conditions of the agreement reached with the IMF. ■

### Bosnia and Herzegovina – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>					<i>Forecast</i>	
<b>GDP (real)</b>	4.4	5.5	3.5	5.0	5.5	6.0
<b>Industrial output (real) Federation</b>	12.2	9.2	4.8	13.2	7.0	9.0
<b>Industrial output (real) Rep. Srpska</b>	-12.9	-2.5	5.8	9.7	15.0	7.5
<b>Consumer prices (yearly average) Federation</b>	2.1	1.0	0.6	-0.4	2.5	2.5
<b>Consumer prices (yearly average) Rep. Srpska</b>	7.0	1.7	1.9	2.4	0.5	2.7
<b>Budget balance (in % of GDP)</b>	-3.4	-3.7	-1.3	-1.1	0.0	0.3
<i>in EUR mn</i>						
<b>Merchandise exports</b>	1,267	1,163	1,293	1,677	2,070	2,380
<b>Merchandise imports</b>	4,571	4,671	4,936	5,354	6,010	6,300
<b>Current account</b>	-902	-1,313	-1,528	-1,545	-1,750	-1,700
<b>Current account (in % of GDP)</b>	-16.9	-22.1	-24.5	-23.3	-24.6	-22.1
<b>FDI (inflow, net)</b>	133	280	335	400	400	480
<b>Gross foreign debt (end of period)</b>	2,850	2,624	2,289	2,250	2,390	2,540
<b>Gross foreign debt (in % of GDP)</b>	53.3	44.3	36.7	34.0	33.6	32.9
<b>Import cover (in months)</b>	3.3	3.2	3.4	4.0	3.5	3.5
<b>Average exchange rate: BAM/EUR</b>	1.96	1.96	1.96	1.96	1.96	1.96
<b>Average exchange rate: BAM/USD</b>	2.19	2.08	1.74	1.57	1.56	1.55

Sources: Bank Austria Creditanstalt Economics Department, IMF, OHR, CBBH

### Outlook

The economy is maintaining its dynamic growth. The currency board system continues to be a stabilising factor, keeping inflation low by ensuring a constant rate of exchange. Although inflation may creep up in 2006 following the introduction of VAT, it will remain at an acceptable level. In view of its far-reaching structural problems Bosnia is currently faced with major challenges. The political differences between the entities constitute a risk for the continued pursuit of the reform which will lead Bosnia out of economic dependency (current account deficit 2005 almost 25 % of GDP). Hopes for smoother collaboration are merely based on a few positive steps, such as the decision to reform the military and the adaptation of the police reform.

<b>Area:</b> 45,227 sq. km
<b>Population:</b> 1.4 mn
<b>President:</b> Arnold Rüütel
<b>Prime Minister:</b> Andrus Ansip
<b>GDP (2004):</b> EUR 9.0 bn
<b>Per capita GDP (2004):</b> EUR 6,700

## Political situation

Until recently, it seemed as if the new centre-left three-party coalition government formed by Prime Minister Andrus Ansip in April would hold out until the next parliamentary elections scheduled for early 2007. With 52 of the 101 seats in parliament, the coalition parties have in principle reached agreement regarding the political course. Since the end of September, however, Prime Minister Ansip has been under pressure to dismiss Edgar Savisaar, the Minister of Economic Affairs and head of the left-wing Centre Party. Such a step would jeopardise the continued existence of the coalition government because Mr Savisaar's appointment was part of the coalition agreement

with the Centre Party, which was previously in opposition and has the largest number of seats in parliament. Mr Savisaar is charged with being involved in a controversial real estate transaction. The situation is aggravated by the fact that the Minister of Defence, Mr Joeruut, who is a member of Mr Ansip's liberal-conservative Reform Party, has resigned in protest against the excessively close links between political and economic interests.

## Economic situation

In the second quarter of 2005, Estonia's economy achieved the highest growth rate in five years. After 7.2 % in the first quarter, GDP increased by just under 10 % in the second quarter (compared

# Estonia

## Record growth

with the same period in the previous year). On the supply side, growth is evenly spread over the main sectors of the economy, with manufacturing industry, construction and services each growing by 12 % to 13 %. On the demand side, private consumption was supported by real wage increases and remained strong, while investment in equipment, though stimulated by the inflow of EU funds for infrastructure development, increased by just under 8 %, a growth rate that was lower than in the preceding quarter as a result of a statistical base effect. Exports are becoming an increasingly important factor. This has again been confirmed by the growth of exports of goods and services (18.2 %), which was far stronger than the increase in

imports (just under 7 %). The balance of trade provided an indication of this trend as the import surplus in the second quarter, at about 360 mn euro, was one-third lower than a year before (second quarter 2004: 534 mn euro). This reflects much stronger and accelerating growth of merchandise exports (first quarter 2005: +27 %, second quarter 2005: +29 %), while imports showed lower and weakening growth (first quarter 2005: +20 %, second quarter 2005: +9 %). The strong export performance is supported by most categories of goods; a particularly large contribution comes from telecom equipment, which still accounts for about one-quarter of total exports. ■

## Estonia – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>					<i>Forecast</i>	
<b>GDP (real)</b>	6.5	7.2	6.7	7.8	7.7	6.8
<b>Industrial output (real)</b>	9.0	8.3	11.0	7.9	9.2	8.0
<b>Gross fixed capital formation (real)</b>	13.0	17.2	8.5	6.0	11.0	9.0
<b>Consumer prices (yearly average)</b>	5.8	3.6	1.3	3.0	3.7	2.6
<b>Unemployment (yearly average)</b>	12.6	10.3	10.0	9.7	9.3	9.0
<b>Budget balance (ESA 95, in % of GDP)</b>	0.3	1.4	2.6	1.7	0.6	0.3
<i>in EUR mn</i>						
<b>Merchandise exports</b>	3,750	3,728	4,061	4,796	5,500	6,200
<b>Merchandise imports</b>	4,630	4,878	5,457	6,372	7,250	8,080
<b>Current account</b>	-376	-759	-1,059	-1,117	-1,070	-1,030
<b>Current account (in % of GDP)</b>	-5.6	-10.2	-13.0	-12.4	-10.6	-9.3
<b>FDI (inflow, net)</b>	377	167	667	534	1,920	890
<b>Gross foreign debt (end of period)</b>	3,707	4,490	5,658	7,477	8,310	9,140
<b>Gross foreign debt (in % of GDP)</b>	55.5	60.1	69.5	82.7	82.3	82.6
<b>Import cover (in months)</b>	1.9	1.9	2.0	2.0	2.0	2.0
<b>Average exchange rate: EEK/EUR</b>	15.65	15.65	15.65	15.65	15.65	15.65
<b>Average exchange rate: EEK/USD</b>	17.48	16.60	13.81	12.58	12.45	12.40

Sources: Bank Austria Creditanstalt Economics Department, Eesti Pank, ESA

## Outlook

We are raising our growth forecast for 2005 to 7.7 %. The economy continues to be driven by the following factors: wage growth, an income-tax reduction and lower unemployment are supporting private consumption, while investments benefit from low interest rates and the inflow of EU funds. Moreover, the outlook for exports is good. This will have a positive impact on economic growth while also contributing to a reduction of the current account deficit, which is still relatively high due to structural factors. Large inflows of FDI are financing the current account deficit this year. While inflation has declined to a level below 3 % in the course of this year, the average figure for 2005 will be 3.7 %, reflecting the oil price effect.

<b>Area:</b> 64,589 sq. km
<b>Population:</b> 2.3 mn
<b>President:</b> Vaira Vike-Freiberga
<b>Prime Minister:</b> Aigars Kalvitis
<b>GDP (2004):</b> EUR 10.9 bn
<b>Per capita GDP (2004):</b> EUR 4,740

## Political situation

The government coalition, which continues to enjoy solid public support, approved the draft budget for 2006 at the end of September without too much internal debate. Based on the assumption that economic growth will increase by 7.5 % and inflation by 4.5 %, the draft budget calls for a deficit of 1.5 % of GDP. The government anticipates revenue of 3.23 bn lat (33.8 % of GDP) in 2006, compared with expenditure of 3.37 bn lat (35.3 % of GDP). Government spending will focus mainly on the areas of health care and education, social security and research and development. With budget revenues above expectations, this year's deficit is expected to come in at 0.8 % of GDP, well below the budgeted 1.7 %.

## Economic situation

In the second quarter of 2005, Latvia's economy expanded by an impressive 11.6 % in real terms, after +7.4 % in the first quarter. The manufacturing industry rebounded in the second quarter with 7.8 % growth after slightly contracting in the first three months of 2005 due to unfavourable weather conditions. The construction industry on the other hand, which is benefiting from the current boom in mortgage loans (+90 %), maintained its strong momentum of the previous quarters and grew by 15.8 %. The services sector also provided a significant impetus to economic growth: exceptionally strong expansion was seen in the areas of transport and communication

(+18.8 %), trade (+18.7 %), hotels and restaurants (+18.3 %), as well as financial intermediation (+10.3 %). In this context, strong growth in lending (+50 %) and real wages (+8.7 %) are supporting private consumption. Although preliminary indicators still point to strong economic growth in the third quarter, the final quarter of 2005 may see the economy slow down in light of the central bank's restrictive monetary measures (effective since 24 August 2005). Latvia will nonetheless probably achieve GDP growth of 9 % in real terms in 2005 as a whole, the highest growth rate since the beginning of the transformation process.

Despite all the euphoria over the excellent performance of Latvia's economy,

the overall picture is marred by fears of overheating. The robust domestic economy has negative implications not only for the current account, but also for consumer prices. The consumption and investment-induced high import levels continue to exert pressure on the current account, a situation which could be aggravated by higher energy imports toward the end of the year. For this reason foreign indebtedness is expected to increase, despite continuous strong FDI inflows.

Inflation averaged 6.5 % in the first three quarters of 2005 (2004: 6.2 %). Due to the interaction of numerous demand and supply-side factors there are no signs that this situation could ease considerably in the final months of 2005. ■

## Latvia – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>						<i>Forecast</i>
<b>GDP (real)</b>	8.0	6.4	7.2	8.3	9.0	7.5
<b>Industrial output (real)</b>	6.9	5.8	6.5	6.0	5.5	6.0
<b>Gross fixed capital formation (real)</b>	11.4	13.0	10.9	17.3	13.5	12.0
<b>Consumer prices (yearly average)</b>	2.5	1.9	2.9	6.2	6.6	5.2
<b>Unemployment (yearly average)</b>	13.1	12.0	10.6	10.4	9.8	9.5
<b>Budget balance (ESA 95, in % of GDP)</b>	-2.0	-2.3	-1.6	-1.1	-0.8	-1.3
<i>in EUR mn</i>						
<b>Merchandise exports</b>	2,502	2,693	2,806	3,366	3,980	4,700
<b>Merchandise imports</b>	3,993	4,255	4,577	5,581	6,260	7,110
<b>Current account</b>	-699	-653	-808	-1,353	-1,250	-1,210
<b>Current account (in % of GDP)</b>	-7.6	-6.7	-8.2	-13.1	-10.6	-9.1
<b>FDI (inflow, net)</b>	126	265	229	479	390	320
<b>Gross foreign debt (end of period)</b>	6,321	7,187	7,850	10,219	12,090	14,230
<b>Gross foreign debt (in % of GDP)</b>	68.9	73.6	80.1	93.5	99.8	103.8
<b>Import cover (in months)</b>	3.3	3.1	2.7	2.7	3.1	3.2
<b>Average exchange rate: LVL/EUR</b>	0.56	0.58	0.64	0.67	0.70	0.70
<b>Average exchange rate: LVL/USD</b>	0.63	0.62	0.57	0.54	0.56	0.56

Sources: Latvijas Banka, Latvijas Statistika, Bank Austria Creditanstalt Economics Department

## Outlook

The economy is treading a thin line between strong growth and overheating. The evident risks of a wage-price spiral and a credit-driven real estate boom, coupled with high oil prices, make combating inflation more difficult. The attendant danger that Latvia could fail to meet the inflation target required for accession to the euro zone on 1 January 2008 and the limited scope of the central bank to implement monetary policy since Latvia's entry to ERM-II on 30 April 2005 will require the government to adopt a more restrictive approach with respect to fiscal policy. This would also be desirable in view of the high current account deficit, which will persist at over 10 % of GDP in 2005.

<b>Area:</b> 65,301 sq. km
<b>Population:</b> 3.5 mn
<b>President:</b> Valdas Adamkus
<b>Prime Minister:</b> Algirdas Brazauskas
<b>GDP (2004):</b> EUR 17.9 bn
<b>Per capita GDP (2004):</b> EUR 5,220

## Political situation

The four-party centre-left coalition (Social Democrats, Social Liberals, Labour Party, Farmer's Party) has recently gained a surer footing again under Prime Minister Algirdas Brazauskas. This has been facilitated amongst other things by a reshuffling in the cabinet, with Kestutis Dauksys replacing Viktor Us-paskich, chairman of the Labour party, who had to step down from his post as Economic Minister in the face of massive accusations of corruption. The main items on the political agenda at present include the ownership restructuring of the Lithuanian oil company Mazeikiu nafta (MN), as well as the closure of the Ignalina nuclear

power plant. Prime Minister Brazauskas recently named Lukoil, the largest producer of oil in Russia, and the Russian-British corporation TNK-BP as being the most likely contenders for the acquisition of MN. At present 53.7 % of the MN shares are held by the Russian oil firm Yukos and 40.66 % by the Lithuanian government, which is hoping to generate roughly 1 bn litas (about 290 mn euro) from the sale of 20 % of the MN shares.

## Economic situation

Although real GDP growth accelerated further to 8 % in the second quarter following 4.6 % in the first quarter, average growth for the first six months remained

# Lithuania

## Domestic demand ensuring robust growth

largely at the same level as 2004. Domestic demand has continued to drive economic growth to date, since the low rate of interest and rising household income have together exerted a positive impact on both private consumption and investments. This was supplemented in the second quarter by more expansive public consumption. Yet at the same time, the negative contribution made by net foreign demand worsened, despite the fact that import growth (goods and services) slowed (first quarter: +12.6 %, second quarter: 8.9 %) while export growth picked up (first quarter: +9.3 %, second quarter: 13.3 %). This is due to the higher volume of imports than exports. But still there

was a positive effect on the current account, as the deficit over the first six months (615 mn euro), was approximately one-fifth lower than the previous year. Flows of FDI have been rather disappointing to date, totalling only 100 mn euros during the first six months. In the basket of goods of the Lithuanian CPI, electricity, gas and fuels are weighted more heavily than in other countries, and therefore the upward trend in prices driven by the high price of oil is causing concern. But the acceleration in inflation has so far remained relatively modest: after a low of only 1.8 % in July, growth in the CPI climbed back up to 2.6 % by September (both figures compared to the previous month). ■

### Lithuania – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>					<i>Forecast</i>	
<b>GDP (real)</b>	6.4	6.8	10.5	7.0	6.5	6.0
<b>Industrial output (real)</b>	16.0	3.1	16.1	10.3	8.3	8.7
<b>Gross fixed capital formation (real)</b>	15.0	12.4	11.4	12.3	11.0	10.0
<b>Consumer prices (yearly average)</b>	1.3	0.3	-1.2	1.2	2.8	2.4
<b>Unemployment (yearly average)</b>	17.4	13.8	12.4	11.4	10.5	10.0
<b>Budget balance (ESA 95, in % of GDP)</b>	-2.0	-1.4	-1.2	-1.4	-2.0	-1.5
<i>in EUR mn</i>						
<b>Merchandise exports</b>	5,456	6,375	6,773	7,451	8,250	9,270
<b>Merchandise imports</b>	6,693	7,785	8,262	9,320	10,140	11,300
<b>Current account</b>	-640	-773	-1,116	-1,287	-1,530	-1,590
<b>Current account (in % of GDP)</b>	-4.7	-5.1	-6.8	-7.1	-7.8	-7.4
<b>FDI (inflow, net)</b>	490	754	126	412	580	640
<b>Gross foreign debt (end of period)</b>	5,879	5,945	6,670	7,682	8,690	9,850
<b>Gross foreign debt (in % of GDP)</b>	43.4	39.5	40.6	42.5	43.9	45.8
<b>Import cover (in months)</b>	2.8	3.1	3.5	3.0	2.9	2.8
<b>Average exchange rate: LTL/EUR</b>	3.58	3.45	3.45	3.45	3.45	3.45
<b>Average exchange rate: LTL/USD</b>	4.00	3.65	3.05	2.77	2.75	2.74

Sources: Bank Austria Creditanstalt Economics Department, Lietuvos Bankas, Statistics Lithuania

## Outlook

The introduction of the euro is planned for the beginning of 2007, with the government currently having to focus on inflation; all of the other criteria have been fulfilled. In Brussels recently, Prime Minister Brazauskas explored the possibilities for leniency with regard to the inflation criterion. The robust internal demand will continue to ensure that economic growth for 2005/2006 remains at the relatively high level of just over 6 %. This will be bolstered from the middle of 2006 by the reduction of personal income tax. The prospects for future export growth look encouraging, the imports of capital goods have broadened export capacities, and therefore the structurally high current account deficit should not widen any further.

<b>Area:</b> 102,713 sq. km
<b>Population:</b> 10.6 mn
<b>President:</b> Svetozar Marovic
<b>Prime Minister:</b>
Vojislav Kostunica (Serbia);
Milo Djukanovic (Montenegro)
<b>GDP (2004):</b> EUR 18.9 bn
<b>Per capita GDP (2004):</b> EUR 2,320

## Political situation

At the beginning of October the negotiations of a Stability and Association Agreement with the EU started. One of the pre-conditions was improved cooperation with the UN war crimes tribunal, which was confirmed by Chief Prosecutor Del Ponte.

The conditions set forth by the IMF for prolonging the credit agreement until the end of 2005 and in relation to this, the agreement with the Paris Club to write off a debt of 600 mn euros following fulfilment of the IMF Agreement, were met by the Serbian government. However, the minority government encountered difficulties in obtaining a parliamentary

majority to push through the legal requirements for privatising the oil company NIS and the first reforms of the pension system, such as the establishment of a voluntary funded pillar from 2006. The implementation of reforms is still being hindered by the distribution of power in parliament.

## Economic situation

The economy has weakened this year in both parts of the union. In Serbia economic growth slipped to 6.1 % in the first half by annual comparison, after surging at more than 8 % for 2004 as a whole. The way industrial output is currently heading would appear to suggest that this trend

will continue. Over the first eight months of the current year, industrial output in Serbia declined by 0.7 %, while in Montenegro industrial output over the same period stagnated. Nevertheless, looking at the union as a whole we anticipate economic growth in 2005 to reach 4.5 %.

Despite the economic slowdown, inflation has risen vigorously throughout the year to date. On average over the first nine months it totalled about 16 %, influenced heavily by developments in Serbia. Only since the middle of the year has the rate of inflation slowly begun to fall. This was triggered by the reduction in tax on fuel, the revision of the budget in July which forecasts a small sur-

plus for 2005, as well as the prudent policy of the central bank.

The secondary effect of these measures which suppress domestic demand is a significant improvement in net exports in Serbia. In the first seven months of 2005 the current account deficit fell to 0.6 bn euros (1-7/2004: 1.2 bn euros). By contrast, the current account deficit in Montenegro over the same period rose to just over 100 mn euros as a result of difficult general conditions for exports. Taking the year as a whole, we anticipate that the declining trend in Serbia will lead to a marked reduction in the current account deficit for the union to roughly 6.5 % of GDP. ■

## Serbia and Montenegro – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>					<i>Forecast</i>	
<b>GDP (real)</b>	5.5	3.8	2.7	7.2	4.5	4.5
<b>Industrial output (real)</b>	0.0	1.7	-2.7	7.5	2.0	4.0
<b>Gross fixed capital formation (real)</b>	-	-	-	-	-	-
<b>Consumer prices (retail prices, yearly average)</b>	91.1	21.2	11.2	9.8	15.0	10.0
<b>Unemployment (yearly average)</b>	26.8	29.0	31.7	31.7	32.5	32.2
<b>Budget balance (in % of GDP)</b>	-0.6	-3.4	-3.1	-0.2	0.2	0.0
<i>in EUR mn</i>						
<b>Merchandise exports</b>	2,235	2,554	2,690	3,394	4,300	4,990
<b>Merchandise imports</b>	5,398	6,693	7,015	9,374	8,830	9,310
<b>Current account</b>	-589	-1,462	-1,336	-2,530	-1,270	-1,150
<b>Current account (in % of GDP)</b>	-4.6	-8.9	-7.4	-13.4	-6.6	-5.6
<b>FDI (inflow, net)</b>	184	594	1,241	827	1,510	950
<b>Gross foreign debt (end of period)</b>	13,335	12,513	12,628	11,955	11,140	11,890
<b>Gross foreign debt (in % of GDP)</b>	103.2	76.5	69.9	63.3	57.6	57.6
<b>Import cover (in months)</b>	2.7	4.0	4.9	4.0	4.9	4.8
<b>Average exchange rate: CSD/EUR</b>	59.4	60.7	65.1	72.6	83.0	88.2
<b>Average exchange rate: CSD/USD</b>	66.7	64.3	57.5	58.4	66.0	69.9

Sources: Bank Austria Creditanstalt Economics Department, WIIW, NBS, CBCG

## Outlook

Despite the difficult political situation, the economy has taken a relatively positive step in the right direction. Notwithstanding the monetary and fiscal policy restraints, economic growth remains high over the forecast period. In addition, the subdued domestic demand will ensure an improvement in the external imbalance. Impressive inflows of FDI thanks to the acceleration of privatisations, especially in the banking sector, mean that financing the current account deficit is not at risk. This also relieves some of the pressure on the foreign debt situation, which despite the impact of the second part of the debt write-off by the Paris Club still remains a challenge, as debt service payments in 2005 total more than 20% of exports.

<b>Area:</b> 110,994 sq. km
<b>Population:</b> 7.8 mn
<b>President:</b> Georgi Parvanov
<b>Prime Minister:</b> Sergei Stanishev
<b>GDP (2004):</b> EUR 19.4 bn
<b>Per capita GDP (2004):</b> EUR 2,510

# Bulgaria

*In top gear*

## Political situation

Following almost two months of negotiations, the Bulgarian Socialist Party (BSP), the National Movement Simeon II (NMS-II) and the Turkish minority party, the Movement for Rights and Freedoms, finally succeeded in finding common ground and ended the power struggle that erupted after the parliamentary elections on 25 June 2005. On 16 August, the Bulgarian Parliament first elected the head of the BSP, Sergei Stanishev, as Prime Minister by a vote of 168 to 67, and then approved the new cabinet, thus giving its seal of approval to the new social-liberal three-party coalition. Nine of the eighteen members of the government (including

the prime minister) come from the BSP; five ministerial positions are claimed by the NMS-II, and three by the MRF. In line with the three-party consensus, each party provides a deputy prime minister.

The path to a grand coalition was stony and tedious. The political deadlock not only threatened to lead to new elections, but also jeopardised the country's scheduled EU accession date of 1 January 2007 after criticism from Brussels. Now, Bulgaria has to make up for lost time. The government coalition has all the trumps it needs for this purpose. It has 169 of the 240 seats in parliament, giving it the necessary two-thirds majority to push through the reforms required for EU convergence. It remains to be seen

whether this government, a result of the exigencies of the integration process, will be able to enforce its majority throughout the entire legislative period despite the mix of evident contrasting ideologies.

According to the EU Commission, top priority must be given to fighting corruption, and to the reform of the judiciary, public administration and agriculture. The Commission's comments on the progress made in implementing reforms are published at the end of October. The elections of mayor in Sofia on 29 October 2005 are likely to provide an indication of the electorate's party preferences. The outcome of the elections in Bulgaria's region with the highest population and greatest economic potential is con-

sidered to be of particular political significance.

## Economic situation

With economic growth accelerating slightly to 6.4 % in real terms year-on-year, Bulgaria in the second quarter of 2005 maintained the strong economic growth of previous quarters. While agricultural production contracted by 5.2 % due to the severe floodings, companies succeeded in raising their output by 9.3 % over the same quarter of the previous year. The services sector (+6.4 %) expanded in line with general economic developments, generating 61.2 % of gross value added. 78.5 % of gross value added was generated by the private sector, with the public sector accounting for the remaining 21.5 %. A salient feature on the expenditure side is the continued strong growth of domestic demand. In the run-up to the parliamentary elections, public consumption rose at a very strong +7.4 %. Private consumption, growing by 5.7 %, remained robust as indicated by strong retail activity (+12.5 %), but was nevertheless slightly down on the previous quarter (+7.3 %). Gross fixed capital formation expanded by an impressive 16.8 % in the wake of the tax reform at the beginning of 2005. But the build-up of inventory was also surprisingly strong. The positive development of domestic demand was reflected in a further marked deterioration of the negative net export posi-

**Bulgaria – Selected Indicators**

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>					<i>Forecast</i>	
<b>GDP (real)</b>	4.1	4.9	4.5	5.6	5.3	6.0
<b>Industrial output (real)</b>	2.5	4.7	14.1	17.7	10.1	15.2
<b>Gross fixed capital formation (real)</b>	23.3	8.5	13.9	12.0	13.0	14.5
<b>Consumer prices (yearly average)</b>	7.4	5.8	2.3	6.2	4.5	4.5
<b>Unemployment (yearly average)</b>	17.5	17.4	14.3	12.7	11.7	11.0
<b>Budget balance (central government in % of GDP)</b>	-0.6	-0.6	0.0	1.7	1.5	1.0
<i>in EUR mn</i>						
<b>Merchandise exports</b>	5,714	6,063	6,668	7,994	9,300	10,500
<b>Merchandise imports</b>	7,493	7,755	8,868	10,712	13,000	15,000
<b>Current account</b>	-1,102	-926	-1,630	-1,447	-2,400	-2,500
<b>Current account (in % of GDP)</b>	-7.2	-5.6	-9.2	-7.4	-11.2	-10.6
<b>FDI (inflow, net)</b>	893	951	1,827	1,640	1,800	2,200
<b>Gross foreign debt (end of period)</b>	11,899	10,769	10,639	12,246	14,000	15,500
<b>Gross foreign debt (in % of GDP)</b>	78.1	65.1	60.2	63.0	65.5	65.4
<b>Import cover (in months)</b>	5.1	5.6	5.8	6.1	6.0	6.0
<b>Average exchange rate: BGN/EUR</b>	1.96	1.96	1.96	1.96	1.96	1.96
<b>Average exchange rate: BGN/USD</b>	2.18	2.07	1.73	1.57	1.56	1.55

Sources: BNB, NSI, Bank Austria Creditanstalt Economics Department

tion. Imports of goods and services grew by 15.5 %, compared with approximately 12 % growth in exports.

There are signs that economic growth is slowing in the second half of 2005 on account of the floodings, the dampening effect of high oil prices, the more moderate growth of public consumption after the parliamentary elections, the central bank's efforts to rein in lending growth and the more negative impact of net exports. We consequently expect GDP to grow by 5.3 % in 2005 as a whole.

### Current account deficit approaching record levels

In the first half of 2005 the cumulated current account deficit amounted to 1.4 bn euros or 6.4 % of the 2005 projected GDP, after 960 mn euros or 4.9 % of GDP in the same period of the previous year. This increase is almost entirely attributable to the balance of trade, whose deficit at 1.7 bn euros was some 30 % up on the previous year. In this context, particularly strong import growth was recorded in mineral fuels and lubricants (+37.3 %), crude materials (+35.3 %), as well as machinery and transport equipment (+32.7 %). Given the continued strong growth of the domestic economy and significant oil price-

induced price effects on energy imports, imports are likely to grow strongly also in the second half of the year, with negative consequences for the balance of trade and the current account. The absence of a surplus normally generated by tourism in the summer months will also aggravate the current account problems. Overall, the current account deficit will widen to 11.2 % of GDP in 2005, after amounting to 7.4 % of GDP in 2004. Net FDI inflows totalled 700 mn euros in the first six months of 2005, and covered about half the current account deficit. We expect stronger inflows in the latter half of the year on account of further privatisation proceeds, Fitch's recent upgrade in Bulgaria's rating from BBB- to BBB, continued strong economic growth, and the approaching EU accession date. For the year 2005 as a whole, FDI inflows should roughly equal the current account deficit.

### Continued inflationary pressure

In the third quarter, inflation remained relatively high at an average of some 5 %. This was due to higher food prices as a result of the floodings, and the high oil prices, which pushed up prices for refined oil products (e.g. fuel). Inflationary pressures will for these reasons probably

persist in the remainder of 2005. The pressure will be strengthened by significant adjustments of controlled prices in the final quarter of 2005, which had been postponed on account of the elections. The government had decided to increase electricity prices by 16 % (commercial rates) and gas prices by 18.1 % as of 1 October 2005, coupled with significant adjustments for heating costs in November. We are consequently raising our inflation forecast from 4 % to an average 4.5 % for 2005. In light of the tax harmonisation measures (e.g. alcohol, tobacco, energy) recently passed by the government in preparation for EU accession, we expect prices to rise at a similar rate in 2006.

### Balanced budget in 2006

The new government coalition revealed its fiscal goals following the approval of its 2006 draft budget. By aiming for a balanced budget, based on economic growth of 5.3 % and inflation of 4.4 % at year-end, it is continuing the disciplined fiscal policy of the preceding government. No important tax changes are proposed for 2006. The possibility of reducing the VAT and corporate income tax rates, considered in the run-up to the parliamentary elections, has been abandoned for the

time being. But agreement was reached on a reduction of social security contributions by six percentage points, with the employer's contribution being lowered from 70 % to 65 %. At the same time, the government decided to bring forward to 2006 the increase in excise taxes on tobacco, alcohol and fuel – originally planned for after EU accession – so as to avoid inflationary problems in the period leading up to the adoption of the euro in 2009/2010. The minimum wage will be raised from a current 150 lev to 160 lev as of 1 January 2006, and the tax-free allowance from 130 to 180 lev; the other progressive tax rates of 20 % (180–250 lev), 22 % (250–600 lev) and 24 % (over 600 lev) remain unchanged. The government's budget target is realistic, although in our opinion somewhat pessimistic. The increasing efficiency of the tax administration, continued strong economic growth and the necessity for a disciplined spending policy in light of the high current account deficit will probably again result in a budget surplus next year. The 2006 budget is also dominating discussions with the IMF, which in light the surpluses of previous years view a balanced budget as too expansionary, and consequently urges Bulgaria to aim for a surplus also in 2006. ■

### Outlook

The new government coalition has a comfortable majority in parliament, which will make it much easier to push through EU-related issues. With their sights trained on EU membership, the ruling parties will for the moment probably not pay any attention to evident ideological differences with potential for conflict. Bulgaria will in 2005 again maintain the

high growth rate of previous years despite a number of adverse factors. The impetus given to employment by the favourable economic developments are reflected in the positive trend of the labour market data. Unemployment fell to 10.8 % in August, the lowest level in seven years. As in the preceding year, the budget will end 2005 with a high surplus and this is also likely to be the case in 2006. Early debt repayments and a disciplined fiscal

policy have caused public sector debt to shrink, which was acknowledged by Fitch when it upgraded Bulgaria's rating in mid-August. The tax harmonisation-related shock therapy planned for the coming year will however probably lead to stronger inflationary pressure. In addition, the current account deficit will this year even move into double-digit figures.

<b>Area:</b> 56,538 sq. km
<b>Population:</b> 4.4 mn
<b>President:</b> Stjepan Mesić
<b>Prime Minister:</b> Ivo Sanader
<b>GDP (2004):</b> EUR 27.6 bn
<b>Per capita GDP (2004):</b> EUR 6,220

# Croatia

## Economy picks up as EU accession talks start

### Political situation

The key event in the political sphere in Croatia has been the commencement of EU accession talks on 4 October. From the political perspective this is very important for Croatia especially since it removes the uncertainty which had surrounded Croatia since talks were originally postponed on March 17. Even though the opposition parties did not attempt to force a change of government, the debate on co-operation with The Hague Tribunal dominated EU-related debate in Croatia over the past six months which was reflected in falling support for the EU over this period.

The commencement of EU accession talks will shift the sphere of public debate

away from speculation on EU accession, to concrete policy measures in a raft of fields as the focus shifts to determining the best way to fulfil the requirements of the EU's *acquis communautaire*. In addition, the economy has picked up, as the second quarter GDP figures showed, which should provide the government with addition confidence and scope for reform initiatives entering the new-year. Overall, the outlook for the political situation is more positive than it has been for a number of quarters.

### Economic situation

After a very slow first quarter which registered only 1.8 % growth, with one percentage point achieved through the build-up in in-

ventories, the second quarter recorded much faster growth of 5.1 %. Over the first half of 2005 the economy grew at a rate of 3.5 % yoy. Domestic demand clearly continues to drive GDP growth. In the first half of 2005 it contributed 4.2 percentage points to growth, while net exports contributed -0.7 percentage points. Private consumption accelerated in the second quarter to 4.4 %, up from 2.5 % in the first quarter. In the first half of 2005 private consumption rose 3.4 %, which is down on the 3.9 % yoy rate of growth it recorded in the same period last year. We do not find this surprising, especially as the data on wages for the first 7 months of the year point to little impetus to domestic demand, with real net wages

having grown only 1.6 % in this period. Although unemployment has fallen over the summer months to 16.9 % in August, the lowest rate since August 1998, and the internationally comparable survey data also point in that direction, the labour market remains loose. Credit growth to households in the second quarter also rose but at a slower rate.

The most interesting lending trends are found in the business sector. In the second quarter loans to the business sector increased 6.9 % yoy in real terms, continuing a trend seen over the last few months. Investment growth in the second quarter was a much higher 3.3 % yoy compared to each of the previous three quarters where investment activity grew by less than 1.0 % yoy. The next two quarters of the year should see a further acceleration in investment activity. Apart from the increase in credit activity in recent months which will support corporate investment, heavy infrastructure investment in the first half of 2004 will no longer be in the base.

Industrial production data for the first eight months of 2005 show an increase in activity of 4.8 % yoy. After the large second quarter increase of 8.9 % yoy in industrial production, activity slowed over the summer months in line with expectations, but remains brisk. The increase in the stock of finished goods in the industrial sector over the first eight months of the year

### Croatia – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>						<i>Forecast</i>
GDP (real)	4.4	5.2	4.3	3.8	3.5	3.7
Industrial output (real)	6.0	5.4	4.1	3.3	4.6	3.8
Gross fixed capital formation (real)	9.7	10.1	16.8	4.4	3.2	4.5
Consumer prices (yearly average)	4.9	2.3	1.8	2.1	3.3	2.9
Unemployment (yearly average)	22.3	22.5	19.5	18.2	18.3	18.0
Budget balance (in % of GDP)	-6.4	-5.2	-6.3	-4.9	-5.0	-4.5
<i>in EUR mn</i>						
Merchandise exports	5,311	5,312	5,572	6,602	7,160	7,730
Merchandise imports	9,888	11,309	12,546	13,327	14,480	14,920
Current account	-810	-2,029	-1,841	-1,273	-1,690	-1,650
Current account (in % of GDP)	-3.7	-8.4	-7.2	-4.6	-5.7	-5.3
FDI (inflow, net)	1,743	1,195	1,788	975	1,100	1,500
Gross foreign debt (end of period)	12,630	16,305	20,885	24,289	25,200	27,250
Gross foreign debt (in % of GDP)	57.0	67.6	82.1	88.1	85.6	87.0
Import cover (in months)	5.2	5.4	5.7	5.2	5.1	4.9
Average exchange rate: HRK/EUR	7.47	7.41	7.56	7.50	7.40	7.36
Average exchange rate: HRK/USD	8.34	7.86	6.70	6.04	5.89	5.83

Sources: Bank Austria Creditanstalt Economics Department, CNB, CBS

suggests that industrial production may slow moderately in the remainder of 2005 to an average 4.6 % growth rate, notwithstanding stronger merchandise export growth. The manufacturing sector's growth has been noticeably stronger this year.

One of Croatia's more encouraging indicators in recent quarters has been the increase in merchandise exports excluding ships, which have increased 9.1 % yoy in the first 8 months of 2005, reflecting the cumulative effects of improved access to markets, finance and, above all, private sector restructuring. Although this period in 2005 has seen imports of oil derivative products rise by an approximate 425 mn euros, reflecting the impact of higher oil prices this year, the better merchandise export figures have helped to limit the impact of higher oil prices on the merchandise trade deficit.

Revisions to the balance of payments data have pushed up the current account deficits of the past couple of years and for the current year. The current account deficit for the twelve months to June 2005 amounted to 2.0 bn euros, or approximately 6.8 % of GDP.

Given the lack of major privatisation deals in the second quarter, the increase on the capital account side of net FDI inflows of 650 mn euros was the result of reinvested profits. The capital account also revealed that debt financing in the second quarter rose almost 800 mn euros. At the same time, the Croatian National Bank (HNB) released foreign debt figures for the end of July which revealed that gross foreign debt had risen to 24.1 bn euros (80.8 % of projected 2005 GDP). Due to the government's strategy of meeting its financing needs mainly through the domestic market, the government's share of foreign debt has fallen, while that of the banks has risen. Not surprisingly, net claims on the government by the banking sector have risen sharply in recent quarters. While the structure of foreign debt is changing and the rate of growth of foreign debt has slowed, domestic demand is still too strong to lead to a halt in the growth of foreign debt.

### Reforms will reduce budget deficit

As monetary policy has been progressively tightened

over the last two years, the focus remains on fiscal adjustment, which had been limited during this time to achieve the policy goal of halting the increase in foreign debt. After poor revenue growth during the first quarter, the budget has seen current revenues increase by over 4 % yoy in real terms in the first half of 2005. At the same time total expenditures rose 2.5 % yoy. Public debt is in any event continuing to rise, having amounted to kuna 117.6 bn at the end of June (53.3 % of projected 2005 GDP). The bottom line is that public spending has to fall further if public debt is to stop climbing as a percentage of GDP. The recently signed PAL agreement with the World Bank contains reform initiatives for the troubled health sector, subsidies, etc. which if implemented by the ambitious 2007 target deadline, would go a significant way to lowering the budget deficit below the Maastricht criterion of 3 % of GDP.

Inflation stood at 3.1 % yoy in August and has climbed steadily during the course of the year to average 3.1 % in the first 8 months of the year, largely as a result

of this year's oil price increases. Increases in administered prices such as electricity have also contributed to this development. As mentioned earlier, wage developments in the economy are not a source of inflationary pressure. Producer prices have also increased during the course of the year, even though the trend is downward, which augurs well also for consumer price developments in 2006. Croatian National Bank core inflation data show that the core inflation rate fell in August for the first time this year, to 2.9 % yoy. This is a positive development, although it cannot disguise the fact that core inflation has risen since the second half of the previous year, implying slightly higher rates of inflation than those seen in Croatia in 2001–2004. With foreign reserves covering over 5 months of imports the Croatian National Bank should have little difficulty maintaining a stable exchange rate, and it intends to adhere to its tight monetary policy. Therefore low inflation should continue to characterise the Croatian economy in the forecast period. ■

### Outlook

There is no doubt that the economy picked up in second quarter 2005. Still, over the course of first half year 2005 economic growth amounted to 3.5 % yoy, a slowdown compared to last year's 4.0 % yoy. We are keeping to our view that growth will moderate slightly in 2005, to an average 3.5 %. While gross fixed capital formation will accelerate in the remainder of the year, the significant increase in inventories in the first half of this year will slow somewhat, limiting the upside potential on growth. Revised figures for the current account have revealed weaker-than-expected tourism revenues,

which by extension imply somewhat weaker growth of exports of goods and services. The current account deficit for 2005 is expected to amount to 5.7 % of GDP, with the usual impact of the peak tourist season and continued favourable developments in merchandise exports reflecting positively on the current account deficit. In the absence of larger privatisation revenues FDI inflows will remain low, increasing the reliance on foreign debt financing.

Although the Croatian National Bank has been running a tight monetary policy over the last two years, domestic demand remains robust and foreign debt continues to rise (albeit at a slower rate). The

government has already increased its budget deficit forecast from 3.7 % to 4.2 % of GDP, and with the growth of recurrent expenditures exceeding that of revenues in real terms in the first half of this year, the risk that the government may not meet its revised fiscal target remains. In any event, fiscal policy remains too loose, given the increase in public debt as a percentage of GDP. The stronger growth in the second quarter has once more demonstrated that demand is not a constraint on growth in Croatia. With EU accession talks already underway, the main focus in Croatia in the economic sphere will remain the pace of economic reforms and the structural constraints on higher growth.

# Czech Republic

## Growth driven by exports and infrastructure investment

<b>Area:</b> 78,866 sq. km
<b>Population:</b> 10.2 mn
<b>President:</b> Vaclav Klaus
<b>Prime Minister:</b> Jiri Paroubek
<b>GDP (2004):</b> EUR 86.2 bn
<b>Per capita GDP (2004):</b> EUR 8,430

### Political Situation

The approval ratings of the CSSD, the senior coalition party, have been improving since Jiri Paroubek took over the post of Prime Minister. The improvement is chiefly at the expense of the Communists (KSCM). Hence, the left bloc, represented by the CSSD and the KSCM, still appears in principle to have equal chances as the centre-right partner of the ODS with the KDU-CSL of obtaining a majority in next June's general election. Unlike his predecessor, Paroubek is more open to co-operation with the KSCM, the clearest evidence being that the draft of a new labour code was approved at the first Lower House reading with the votes of the CSSD and the KSCM. The draft, opposed not

only by the ODS but also by the government's junior coalition partners, leaves in place high standards of employee protection and gives more power to trade unions. Apart from tension in the coalition, political bickering was underway also between the CSSD and the ODS. This prompted the leading politicians to reiterate their calls for an early election. However, the calls turned out to be tactical more than anything else, as shifting the election forward by just a couple of months would hardly benefit any of the actors. The approaching general election also influenced the government's decision to raise state pensions by 4.9 % from 2006, more than the legal requirement. The rise in pensions would burden the state budget by an extra

Czech crown 12 bn in 2006. Central government expenditures are budgeted at Czech crown 959 bn, bringing the assumed deficit to Czech crown 74.4 bn. The parliamentary debate over the draft budget will start in mid-October.

### Further acceleration of GDP growth

Real GDP growth further accelerated to 5.1 % year-on-year in second quarter from the upward revised figure of 4.7 % registered in the first quarter. Net exports of goods again proved to be the key contributor to growth in second quarter, with the size of contributions corresponding to 7.2 % of GDP measured in second quarter 2004. However, the improvement in net

exports was based on declining imports (-0.1 % yoy) rather than accelerating exports (7.6 % yoy, down from 19.4 % yoy seen in first quarter). The positive net exports were accompanied by a significant inventory adjustment (taking away 2.9 % from the base period GDP). Growth in private consumption remained subdued, whilst government consumption was boosted only by a one-off purchase of fighter planes (the one-off effect will also be felt in third quarter). Gross fixed capital formation grew at its slowest pace in five years (2.3 % yoy), as only publicly financed infrastructure investments maintained the momentum whilst construction activity in other areas slowed sharply. The combination of rising oil and declining steel prices put pressure on the terms of trade, the result being the all-time low GDP deflator at 0.2 %.

The series of higher growth rates of exports relative to import growth has changed the year-to-date balance of trade into a surplus. A surplus was actually recorded in each of the first seven months of the year, which brought the cumulated figure to 1.4 bn euro for the period. The outcome looked even more remarkable in light of the crude oil and gas import bill rising by 750 mn euro year-on-year. The solid trade performance squeezed the current account deficit below 1 % of GDP in the first half of 2005. Demand for exports helped industrial output and sales to grow by

### Czech Republic – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>						<i>Forecast</i>
<b>GDP (real)</b>	2.6	1.5	3.2	4.4	4.8	4.2
<b>Industrial output (real)</b>	6.8	4.8	5.8	9.5	6.0	6.0
<b>Gross fixed capital formation (real)</b>	5.4	3.4	4.7	7.6	2.0	5.0
<b>Consumer prices (yearly average)</b>	4.7	1.8	0.1	2.8	1.9	2.9
<b>Unemployment (yearly average)</b>	8.5	9.2	9.9	10.2	9.7	9.3
<b>Budget balance (ESA 95, in % of GDP)</b>	-5.9	-6.8	-12.5	-3.0	-3.5	-5.0
<i>in EUR mn</i>						
<b>Merchandise exports</b>	37,267	40,701	43,110	53,715	62,390	70,950
<b>Merchandise imports</b>	40,690	43,014	45,305	54,415	61,350	69,260
<b>Current account</b>	-3,654	-4,426	-5,050	-4,492	-2,640	-3,190
<b>Current account (in % of GDP)</b>	-5.4	-5.6	-6.3	-5.2	-2.7	-3.0
<b>FDI (inflow, net)</b>	6,114	8,791	1,682	3,156	6,790	3,620
<b>Gross foreign debt (end of period)</b>	25,368	25,738	27,599	33,258	36,800	40,000
<b>Gross foreign debt (in % of GDP)</b>	36.7	36.4	38.3	38.6	37.4	37.3
<b>Import cover (in months)</b>	4.1	6.0	5.5	4.4	4.0	3.5
<b>Average exchange rate: CZK/EUR</b>	34.07	30.8	31.8	31.9	29.9	29.1
<b>Average exchange rate: CZK/USD</b>	38.0	32.6	28.1	25.6	23.8	23.1

Sources: Bank Austria Creditanstalt Economics Department, CNB

4.2 % and 7.0 % year-on-year, respectively, in the same period. For July, industrial output was reported to expand at an unexpected 11.2 % year-on-year, although the figure could be prone to a downward revision later. However, in light of the robust economic activity, the decline in the number of unemployed by 30,000 year-on-year to 9.6 % of the total labour force (latest data from August) looked unsatisfactory. It appears that problems on the labour market are of structural rather than cyclical origin. The unemployment rate cannot really be significantly reduced without addressing the structural problems. The growth rate of retail sales picked up to 4.7 % year-on-year in the second quarter, contrasting somewhat with the sluggish pace of household consumption. However, the subsequent slowdown in retail sales to 1.6 % year-on-year in July and the fact that the acceleration in second quarter was secured to a large extent by one monthly figure (May) do not point to any boom in consumption.

### Surplus in the state budget

The central state budget remained in surplus after nine months of the year, as robust economic activity generated additional revenue whilst expenditure was behind schedule due to a delay in the preparation of investment projects deemed to be co-financed by EU funds. A better-than-projected balance of the state budget means that the public sector needs to borrow less on the capital markets. The volume of government bond issues for fourth quarter is to be lower than originally planned, which is putting a cap on local bond market yields.

### FDI inflow pressures Czech crown

The completion of two big privatisation transactions – the sale of government majority stakes in Cesky Telecom and Unipetrol – boosted net FDI inflows to 5.6 bn euros in the first half of 2005. Coupled with the low current account deficit, this put upward pressure on the Czech crown. On

one occasion, the CZK/EUR rate reached 29.0, a three-year low. The strength of the Czech crown was mitigated by the central bank purchasing foreign exchange proceeds from privatisation, thereby boosting the level of its reserves by about 3 bn euros. Political uncertainty in the region in September also deprived local currencies of their former gains. As a result, the trade-weighted value of the Czech crown has barely changed since the beginning of 2005 until September. In a year-to-year comparison, however, the Czech currency was still 5.5 % firmer at the end of third quarter.

### Inflation may have bottomed out

The firm crown helped to contain inflation, with the CPI standing at 1.7 % year-on-year in August. A slight upward pressure on prices was discernible only in respect of energy-related items, whilst food prices stagnated and imported consumer goods turned cheaper. However, low margins of motor fuel distributors, untypical for the sea-

son, were also partially responsible for the low inflation rate in the summer. A big jump in margins in September suggested that inflation is likely to have bottomed out already.

### Currency concerns prevent more vigorous policy

The central bank has given little indication of any intention to end its policy of record low interest rates. The key repo rate has stood at 1.75 %, i.e. below the official ECB rate, since April. Meanwhile, low interest rates – both short-term and long-term – are having a visible impact on credit expansion in the economy. The volume of bank loans to households has already been growing annually by one-third for twelve months. Credit growth in the corporate sector has accelerated to 12.8 % year-on-year recently. What is preventing the central bank from tightening its monetary policy is probably above all the concern that this would again trigger a strengthening of the Czech crown. ■

## Outlook

The draft budget remains the most important legislation for the parliament to debate in the rest of 2005. There is a good chance that it may be approved, despite the coalition having the tightest possible majority in the Lower House. However, the stability of the coalition, after the coalition has passed the budget, will remain uncertain. The government is poised to address the severe imbalance in the public health care system. While we are positive a solution will be found to avert the threat of strikes and protests of health care providers, it will not include the changes needed to ensure long-term stability in the system. The issue of pension reform

will not be discussed at all before the election. On the economic front, the inventory rundown may be reversed by fourth quarter. This will boost imports, putting a cap on improvements in the balance of trade. The trade surplus may nonetheless reach Czech crown 30 bn for 2005 compared with last year's deficit of Czech crown 26 bn, and positive contributions of net exports to GDP growth will be maintained in the second half of 2005. Gross fixed capital formation will likely slow further, as the bottom of the inventory cycle may be related to a lower volume of uncompleted investment projects. However, state-financed infrastructure projects will probably continue at their current pace, leaving the full-year growth in gross fixed capital formation still in

place. Private consumption growth will remain sluggish on account of rising oil prices. Economic conditions are unlikely to change dramatically at the beginning of 2006. Barring an unexpected drop in external demand, net exports are projected to continue to contribute to GDP growth, albeit by a lower margin than in 2005. Gross fixed capital formation will be supported by government-financed infrastructure projects. Household consumption is unlikely to be affected by inflation of not quite 3 %, as it will be offset in terms of purchasing power by income tax cuts and higher social income from the state. As a result, private consumption may accelerate slightly in 2006. On balance, GDP is seen maintaining its growth in 2006 just above 4 %.

<b>Area:</b> 93,033 sq. km
<b>Population:</b> 10.1 mn
<b>President:</b> László Sólyom
<b>Prime Minister:</b> Ferenc Gyurcsány
<b>GDP (2004):</b> EUR 80.8 bn
<b>Per capita GDP (2004):</b> EUR 8,000

# Hungary

## Serious problems for euro entry in 2010

### Political situation

Hungary has had a new president since the beginning of August. László Sólyom emerged victorious from the election held in the parliament thanks to the division in the governing coalition with regard to the socialist candidate Szili. The former President of the Constitutional Court followed Ferenc Mádly into the highest office of the State, but one which is predominantly representative in nature. Even the parliament could take on a conservative slant following the elections which are likely to take place on 7 May next year. The Fidesz is out in front in the opinion polls, still well clear of the Socialist party. This

means that Viktor Orbán has a very good opportunity of becoming Prime Minister again after a break of four years. In the meantime, to boost its chances the present government is trying to improve its popularity in the country through its so-called 100-Point Programme, amongst other things by introducing tax changes. However, this does imply the risk of neglecting budgetary discipline, which could impact negatively on fulfilling the fiscal criterion for adopting the euro. The government has recently announced that it is considering postponing the present target date of 2010. Since the opposition sees no reason for haste in this respect either, it has become unlikely that the single

EU currency will be adopted in Hungary during this decade.

### Economic situation

The engine of the Hungarian economy has been purring slightly faster since the second quarter. Economic growth accelerated to 1.2 % in comparison to the previous quarter (first quarter: +0.7 %). Year on year GDP growth totals more than 4 %. Following the weak start to the year the first six months exhibit a growth rate of 3.5 % in comparison to the same period of last year. Private consumption again put in a powerful performance, expanding by more than 3 % over the previous year. Gross fixed capital formation was also responsible for some addi-

tional momentum, which supported by the falling interest rates expanded by more than 9 % year on year. Nevertheless, it was above all the external economy that constituted the driving force behind the acceleration in growth in the second quarter. Exports rose by 11 % yoy, while imports increased by only 3.7 %. However, the import growth figures in the current year are distorted downwards owing to the particularly high imports in the run-up to EU accession in May 2004, so that the contribution made by net exports to growth is exaggerated. So in the coming months the external sector will not provide as much impetus as before, even though the most recent industrial figures demonstrate that export demand still remains fairly high despite the sluggish economies in the EU. Industrial output expanded on average by almost 6 % over the first eight months, thanks principally to the good performance of export-oriented sectors such as vehicle manufacture and the production of electric and optical appliances.

The lower interest rates coupled with corresponding announcements primarily from international companies give reason to expect fairly vibrant investment activity in the remaining months of this year and on into next year. We assume that gross fixed capital formation will rise by roughly 7 % in both years. The sharp increases in real wages will continue to bolster consumption. In the run-up to

### Hungary – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>						<i>Forecast</i>
GDP (real)	3.8	3.5	2.9	4.2	3.7	3.9
Industrial output (real)	3.6	2.8	6.4	8.3	6.0	7.0
Gross fixed capital formation (real)	5.9	9.3	2.5	7.9	7.3	6.5
Consumer prices (yearly average)	9.2	5.3	4.7	6.8	3.7	2.1
Unemployment (yearly average)	5.7	5.8	5.9	6.1	7.1	6.9
Budget balance (ESA 95, in % of GDP)	-3.5	-8.5	-6.5	-5.4	-6.1	-5.0
<i>in EUR mn</i>						
Merchandise exports	31,346	36,821	38,377	44,516	49,150	54,250
Merchandise imports	33,611	39,024	41,275	46,907	50,520	55,950
Current account	-3,613	-4,929	-6,364	-7,123	-6,800	-6,850
Current account (in % of GDP)	-6.2	-7.2	-8.8	-8.8	-7.7	-7.6
FDI (inflow, net)	2,303	2,670	-7	3,392	3,000	3,500
Gross foreign debt (end of period)	37,934	39,021	46,504	56,821	63,000	68,000
Gross foreign debt (in % of GDP)	64.9	56.6	64.0	70.3	71.4	75.0
Import cover (in months)	3.3	2.8	2.8	2.8	2.9	2.8
Average exchange rate: HUF/EUR	256.7	243.0	253.5	251.7	247.5	255.1
Average exchange rate: HUF/USD	286.5	258.0	224.4	202.6	196.9	202.2

Sources: Bank Austria Creditanstalt Economics Department, NBH, KSH

the parliamentary elections in May of next year we expect the growth in private consumption to pick up in 2006 to 3.5 % year-on-year by means of fiscal measures, for example the fall in value added tax, the raising of the minimum wage and changes to family benefits. Nevertheless, the more powerful domestic demand will result in higher demand for imports. Thus the boost given to growth by the external sector will decline over the remainder of the year and despite more favourable conditions on the international scene it will in fact exert an adverse effect on exports in 2006. After posting 3.7 % in the current year, economic growth will increase slightly to 3.9 % next year thanks to the upswing in domestic demand.

### **Budget magic too creative**

The risk factor for the continued high rate of growth exhibited by the Hungarian economy could prove to be fiscal policy. The credibility of the government's budget management has suffered a further setback in recent weeks, after Eurostat revised

the Hungarian budget deficit for 2004 under ESA 95 methodology to 5.4 % of GDP (with the costs of the pension reform already deducted). The reason for the deficit being almost one percent higher than what was originally stated is principally recording the 13th months salary of government employees in the wrong period. Yet what is more serious is that the expenses for motorway construction which the Hungarian government wanted to account for as public-private partnerships must be included in the budget. As the revenue from value added tax is also lower than planned and public expenses are likely to be above budget, Finance Minister Veres has raised the deficit target originally estimated at 3.6 % of GDP for 2005 to 6.1 % of GDP. The deficit for 2006 was accordingly increased from 2.9 % to 4.7 % of GDP.

While the budgeted figure for 2005 now appears relatively plausible as it now comprises the shortfall in revenue caused by the cut in value added tax on fuel brought forward to 1 October 2005, considerable doubts still remain with regard to next year's budget. The government has

proposed a series of tax cuts, some of which are to be introduced as early as January 2006. Besides the reduction of value added tax by 5 percentage points to 20 %, this also includes a reduction in the highest rate of income tax from 38 to 36 %. In addition, the rate of corporate tax for small and medium-sized enterprises has been sliced to 10 % (normal rate: 16 %). The government has yet to present any concrete plans to cut expenditure with a view to countering this loss of revenue. In light of the parliamentary elections it will be very difficult to push through the planned reduction in the number of government employees. Moreover, the draft budget has made no provisions for the agreed purchase of the fighter planes, the impact of which could be in the region of 1/2 a percent of the GDP. As a result, we assume that the budget deficit in 2006 will total at least 5 % of GDP under ESA 95 methodology.

### **Tact and instinct required in monetary policy**

Despite the pick up in growth, inflation has re-

mained low over recent months, amounting to 3.7 % yoy in September. Following an average figure in 2005 of 3.7 %, inflation will decline next year to only 2.1 % thanks in part to the general reduction in value added tax. The central bank has already reacted to the favourable inflation outlook and eased its monetary policy, bringing the base rate down to 6 % at the end of September. Overall, therefore, the key rate has been cut by 325 basis points since the beginning of the year. However, the scope for further rate cuts is limited. In its deliberations on monetary policy for the longer term the national bank must take into account that the low rate of inflation in 2006 will be due to a one-off effect, and inflation will again tend to rise in 2007. Moreover, the right balance must be struck between an interest rate providing an adequate risk for portfolio investors in light of the prevailing budget conditions, one which prevents an outflow of capital destabilising the exchange rate of the forint, and a friendly interest rate for real investments to support growth in the economy. ■

### **Outlook**

After the Hungarian economy lost steam throughout the current year, 2006 will again see a slow acceleration in momentum. This economic growth will probably be supported by domestic demand, since private consumption is picking up again in the run up to the parliamentary elections next year thanks to fiscal measures taken by the government. These measures include the reduction in the rate of value added tax, which will make a contribution to bringing inflation down further to an average of 2 % in 2006. Maintaining price stability also depends to a large extent on the

path pursued by budget policy. Following the latest accounting figures from Eurostat there is a huge need for some consolidation. But in light of the forthcoming parliamentary elections the government is going to find it difficult to achieve any significant reduction in the budget deficit. Fulfilling the fiscal criteria of Maastricht on time (budget deficit no higher than 3 % of GDP) in order to introduce the euro in Hungary as planned in 2010 is now only on the cards if an extremely committed policy of consolidation is adopted after the elections; as things stand at present this looks rather unlikely. The lack of fiscal discipline also implies the risk that the external imbalance will

deteriorate even further. We assume that after the current account deficit narrows in the current year thanks to the development of the trade balance, the gap in 2006 will widen in absolute terms. The more powerful domestic demand will trigger a higher demand for imports, adversely affecting the trade balance. In relation to GDP the current account deficit in 2006 will amount to 7.6 %, roughly the same high level as this year. The development of both the budget and the current account balance will heavily burden the sustained, stable development of the economy for a good time yet.

<b>Area:</b> 312,685 sq. km
<b>Population:</b> 38.2 mn
<b>President:</b> elected on 23 October
<b>Prime Minister:</b> yet to be nominated
<b>GDP (2004):</b> EUR 195.3 bn
<b>Per capita GDP (2004):</b> EUR 5,120

## Electing change

The outcome of the parliamentary elections on 25 September showed that Poles voted against corruption, scandals and unemployment, or simply decided to stay at home. The turnout was as low as 40.6 %. Nevertheless, the next four years will see important decisions.

The ruling Democratic Left Alliance (SLD) won only 11.3 % of the votes and 55 seats in the 460-seat Sejm, compared with 41 % of the votes and 200 seats in the elections held in 2001. Law and Justice (PiS) emerged as the strongest party, with 27.0 % of the votes and 155 seats, followed by the Civic Platform (PO), which won 24.1 % of the votes and 133

seats. The prime minister in a PiS-PO coalition government that will be backed by a strong majority in parliament comes from the PiS. The outcome of the presidential election on 23 October has a significant influence on how the coalition is formed. Among the opposition parties are the SLD and its former coalition partner, the Polish Farmers' Party (PSL), as well as its radical competitor for votes from farmers, Self-defence (SO), which in the meantime also appeals to other groups of voters, and the conservative League of Polish Families (LPR).

## Diverging programmes

The economic-policy programmes of the two parties which will form a coalition

government differ widely from each other. The PO is in favour of introducing the euro in Poland as soon as possible. The party calls for deregulation and less bureaucracy, it wants to reduce the influence of trade unions, and aims to provide more support to small and medium-sized businesses. One of the PO's objectives is to simplify the tax system by introducing a 15 % flat rate for income, corporate and VAT taxes. The PO advocates sharp reductions in public expenditure, especially spending on social welfare.

The PiS, more strongly committed to Catholic and conservative values, demands higher public spending on social services. In some areas including justice and the police, the party calls for a

stronger state, stricter control and higher investments. The PiS is sceptical of early membership of the euro area, claiming that independence in monetary policy offers greater advantages. The party wants to introduce a tax system comprising three different rates of income tax (18 % for the majority of income earners, 28 % and 32 % for those in higher income brackets). Tax benefits are to be abolished, with the exception of child allowances and, possibly, investment allowances. Abolition of the reduced VAT rate (7 %) on various products including food and medicine is not acceptable to the PiS.

## The "anchor"

In 2005, Poland will probably come very close to meeting the target of 35 bn zloty, or 3.7 % of GDP, for the central government deficit, primarily thanks to higher-than-expected revenues from corporate taxes. Although GDP growth is modest, inflation-adjusted public revenues in the first eight months were 15 % higher than in the same period of the previous year, while public expenditure exceeded the previous year's figure by only 6 %.

The general government deficit – according to the calculation method under the EU's Stability and Growth Pact, the so-called EDP deficit (EDP = excessive deficit procedure) – for 2005 will amount to possibly 3.9 % of GDP, unchanged against 2004. When calculating the

# Poland

## Recovery despite difficult political marriage

Poland – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>					<i>Forecast</i>	
GDP (real)	1.0	1.4	3.8	5.4	3.2	4.4
Industrial output (real)	0.6	1.1	8.4	12.3	3.8	10.2
Gross fixed capital formation (real)	-8.8	-6.8	-0.2	5.3	4.0	9.3
Consumer prices (yearly average)	5.5	1.9	0.8	3.5	2.1	2.2
Unemployment (yearly average)	19.4	20.0	20.0	19.1	18.2	17.3
Budget balance (ESA 95, in % of GDP)	-3.7	-3.3	-4.8	-3.9	-3.9	-3.5
<i>in EUR mn</i>						
Merchandise exports	46,542	49,338	53,836	65,641	74,810	80,780
Merchandise imports	55,100	57,039	58,913	70,151	78,530	86,400
Current account	-5,995	-5,404	-4,109	-2,959	-2,160	-4,360
Current account (in % of GDP)	-2.9	-2.7	-2.2	-1.5	-1.0	-1.8
FDI (inflow, net)	6,373	4,371	3,660	4,892	3,410	5,120
Gross foreign debt (end of period)	81,469	81,046	83,705	93,432	97,620	100,590
Gross foreign debt (in % of GDP)	39.9	40.7	45.1	47.9	43.1	42.7
Import cover (in months)	5.5	5.7	5.3	4.0	4.5	4.1
Average exchange rate: PLN/EUR	3.67	3.85	4.40	4.53	4.01	3.92
Average exchange rate: PLN/USD	4.09	4.08	3.89	3.64	3.19	3.11

Sources: Bank Austria Creditanstalt Economics Department, Statistical Office of Poland, National Bank of Poland

deficit, the costs of pension reform, about 1.9 % of GDP annually, must be recorded as expenditure from 2005 onwards: 20 % in 2005, 40 % in 2006, and another 20 % every following year until 100 % is reached. (The calculation of previous years' budget deficits is still in progress: in compliance with the rules of Eurostat, the European statistical office, the figures for previous years were revised. As a result, the deficit for 2004 was reduced from 4.8 % of GDP to 3.9 % of GDP.)

For the next three years, the PiS proposes a nominal "budget anchor", i. e. the central government deficit should never exceed 30 bn zloty. In this way the deficit should be reduced to 2 % of GDP by 2008, based on the assumption of economic growth of 4 %–5 % annually. For the general government deficit, taking into account the costs of pension reform as outlined above, this would translate into a deficit of just over 3 %. The 30 bn zloty deficit for 2006 should also be acceptable to the PiS's coalition partner PO. However, reaching agreement on how to achieve this will be considerably more difficult.

## Monetary policy in the balance

Since the beginning of 2005, the Polish central bank has lowered its key interest

Election Results				
	2005		2001	
	Votes in %	Seats	Votes in %	Seats
<b>Law and Justice (PiS)</b>	<b>27.0</b>	<b>155</b>	<b>9.5</b>	<b>44</b>
<b>Civic Platform (PO)</b>	<b>24.1</b>	<b>133</b>	<b>12.7</b>	<b>65</b>
Self-defence (SO)	11.4	56	10.2	53
Democratic Left Alliance (SLD)	11.3	55	41.0	200
League of Polish Families (LPR)	8.0	34	7.9	38
Polish Farmers' Party (PSL)	7.0	25	9.0	42
Other parties	11.2	2	9.7	18
<b>Total</b>	<b>100.0</b>	<b>460</b>	<b>100.0</b>	<b>460</b>

Sources: Reuters, Sejm, National Electoral Commission, BA-CA Economics Department

rate, the 7-day reference rate for open-market transactions, by no less than 200 basis points, most recently to a level of 4.50 % at the beginning of September. In the monetary policy guidelines for 2006, which were adopted in late September, the central bank adheres to the inflation target of 2.5 % +/-1%, emphasising that this is a sliding target which does not require immediate reaction to any shocks but has a time horizon of 5 to 7 calendar quarters. However, the document suggests some concern over the high level of oil prices and the resulting second-round effects. Further interest rate reductions are no longer to be taken for granted. Further developments will to a large extent also depend on the future fiscal policy.

## Higher investments

Despite moderately favourable economic indica-

tors for the first half of 2005 – adjusted for inflation, GDP was only 2.5 % higher than in the same period of the previous year – growth prospects for the Polish economy are not bad. The slump in investments in the first quarter may partly be seen as compensating for special effects in 2004, the year of EU accession. In the second quarter, gross fixed capital formation rose 3.8 % yoy, or – according to our estimate – a seasonally adjusted 2.6 % over the previous quarter (these figures compare with an increase of only 1.0 % over the previous year and a decline of 2.1 % qoq in the first quarter). Companies have ample financial resources and demand for corporate loans has started to rise. Profits in the business sector are satisfactory. Since the end of 2004, employment has been rising and this will

gradually support stronger growth of real wages and private consumption (which in 2005 will probably exceed the 2004 figure by less than 2 % in real terms). Given the low figures for the first six months, we forecast GDP growth of 3.2 % for 2005 as a whole. For 2006 we expect growth to accelerate to a level well above 4 %.

A condition of further accelerating growth is that Poland will continue to be able to offset the weaker increase in exports to Germany (10 % yoy on a euro basis in the first seven months according to customs statistics, compared with 19.9 % overall, including 50 % for exports to Russia, 29 % for Hungary and 25 % each for the Czech Republic and the UK) at least partly by growth in other export markets. Growth rates in Russia and in CEE suggest that these increases can be achieved. ■

## Outlook

It remains to be seen how the coalition government can resolve the differences between the parties' programmes. While compromises may be expected, the coalition will not be a pragmatic marriage free of conflict. In the past years, growth in output was achieved mainly through increasing productivity. Now employment is rising, too. Unemployment will

decline somewhat, from 18 % in the current year to 17 % in 2006. But even the rate of 17 % will spark serious controversy in the Polish parliament and government. One of the results of future compromises may be a delay in budget consolidation despite statements to the contrary, and the introduction of the euro may be postponed until 2012. Another result will be Poland's stronger insistence on its national interests in its relations with the EU

(making it not the only country to do so, as everybody knows). In the meantime, however, the Polish economy has become sufficiently robust and sufficiently detached from politics for its recovery to continue even in a difficult political environment. The mainstay of economic growth in 2006 will be investments (+9.3 %) and – thanks to a stronger increase in real incomes – private consumption (+4.1 %).

<b>Area:</b> 238,391 sq. km
<b>Population:</b> 21.7 mn
<b>President:</b> Traian Basescu
<b>Prime Minister:</b> Calin Popescu-Tariceanu
<b>GDP (2004):</b> EUR 58.9 bn
<b>Per capita GDP (2004):</b> EUR 2,720

## Political situation

After the political turmoil over the intended resignation of the prime minister and the possibility of new elections in the autumn had subsided, Prime Minister Tariceanu initiated a government reshuffle at the end of August in response to the declining popularity of the government coalition and the warning criticism from the EU in regard to the intensity with which Romania was implementing reforms. The reshuffle mostly affected key ministries such as the position of the deputy prime minister in charge of economic policy, and the ministries of finance, European integration, health and culture. Moreover, seven secretaries of state were dismissed in

mid-September. The prime minister is hoping that the reshuffle will help to improve his popularity which had taken a severe beating in the confusion over new elections, and to accelerate the reforms required by the EU in order to adhere to the accession date of 1 January 2007. The reshuffle, however, also gave the prime minister the opportunity to rid himself of disagreeable critics within the party and the coalition, thereby temporarily strengthening his own position in the government. A renewed flaring up of the power struggles smouldering within the coalition cannot be ruled out if the Commission's assessment in the progress report due to appear at the end of October is unfavourable.

# Romania

## Being put to the test

## Economic situation

The Romanian economy lost some of its momentum in the second quarter. After still expanding by 5.9 % in the first quarter, the economy slowed to not quite 4 % in the second quarter, putting GDP growth at 4.9 % (2004: 8.3 %) for the first half of 2005. The slowdown is primarily attributable to a sharp decline in agricultural output (-7.1 %) following the unfavourable weather conditions and severe floodings in spring 2005. But production losses as a result of the damage caused by the floodings also affected the momentum of the industrial sector, which slowed to only 3.6 % in the first six months (2004: +6.2 %). The services sector continued to be the

most important engine of growth on the supply side, growing by 6.9 % (2004: 6.1 %). The rapid growth rate of the services sector is on the expenditure side based on the very strong expansion of private consumption, which grew by as much as 11.7 % in the first six months, boosted by the continued robust growth of real wages, rapid expansion of loans and the income effects of the tax reform. This was complemented by robust investment activity (+7.6 %) and strong public consumption (+4.3 %). In the tension between weaker domestic output and buoyant domestic demand, the contribution made by net exports had a considerable dampening effect. While imports expanded by +17.1 %, exports grew by only 5.9 %.

In light of a second wave of severe floodings in July and August, we expect the economy to slow further in the third quarter. Our expectations are based on the anticipated negative consequences for the agricultural sector, and for industrial output which in July again fell significantly, by 7.7 %. At the same time, the substitution of domestic with foreign production is also likely to result in a stronger dampening effect via net exports. We forecast economic growth of 4.7 % for 2005.

## Current account deficit deteriorates

Continued strong private consumption was reflected in a widening of the current ac-

### Romania – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>					<i>Forecast</i>	
<b>GDP (real)</b>	5.7	5.1	5.2	8.3	4.7	6.3
<b>Industrial output (real)</b>	8.4	4.3	3.1	5.3	2.8	6.0
<b>Gross fixed capital formation (real)</b>	10.1	8.2	9.1	10.1	9.0	12.5
<b>Consumer prices (yearly average)</b>	34.5	22.5	15.3	11.9	9.0	7.0
<b>Unemployment (yearly average)</b>	9.0	10.2	7.6	6.8	6.0	6.5
<b>Budget balance (in % of GDP)</b>	-3.2	-2.5	-2.3	-1.1	-1.0	-1.0
<i>in EUR mn</i>						
<b>Merchandise exports</b>	12,722	14,675	15,614	18,935	22,500	25,500
<b>Merchandise imports</b>	16,045	17,427	19,569	24,258	30,000	35,000
<b>Current account</b>	-2,488	-1,623	-3,060	-4,460	-6,750	-8,500
<b>Current account (in % of GDP)</b>	-5.5	-3.4	-6.0	-7.6	-8.9	-9.4
<b>FDI (inflow, net)</b>	1,312	1,194	1,910	4,153	4,000	5,000
<b>Gross foreign debt (end of period)</b>	13,768	15,104	16,753	21,631	30,000	37,000
<b>Gross foreign debt (in % of GDP)</b>	30.7	31.2	33.1	36.8	39.6	40.7
<b>Import cover (in months)</b>	2.9	3.5	3.4	4.8	6.7	8.2
<b>Average exchange rate: RON/EUR<sup>1)</sup></b>	26,027	31,255	37,556	40,532	3.60	3.41
<b>Average exchange rate: RON/USD<sup>1)</sup></b>	29,061	33,055	33,200	32,637	2.86	2.70

Sources: NBR, NIS, Bank Austria Creditanstalt Economics Department

<sup>1)</sup> Redenomination of the leu as of 1 July 2005

count deficit in the first half of 2005 to 2.7 bn euros (3.6 % of the GDP forecast for 2005), after 1.7 bn euros or 2.9 % of GDP in the corresponding period of the previous year. The deterioration in the imbalance of the external position is attributable to the rising trade deficit. Other components of the current account largely offset one another. The marked deterioration in the balance of trade can be explained mainly by the strong domestic economy. But the exchange rate is also to blame for the current developments. In the first six months of 2005, the leu appreciated by about 8 % against the euro in nominal terms, corresponding to almost 12 % in real terms, on account of continued strong inflows of direct and portfolio investment and higher transfers. Imports of goods consequently grew by a robust 24.3 % (in nominal, euro terms) as an average for the first six months. At the same time, the strong import growth compared with an average 16.7 % growth in merchandise exports.

Buoyant consumption and investment activity, together with the appreciation of Romania's currency, will also determine economic developments in the second half of 2005. These factors will continue to adversely affect the current account in the latter

part of this year. The import pull is likely to grow even stronger in light of the greater demand for imports of agricultural products (a result of the floodings) and the increase in energy imports with the onset of the heating season. These developments are expected to result in a record current account deficit of 6.8 bn euros or 8.9 % of GDP in 2005 as a whole.

### Switch to inflation targeting

After a temporary pause in the disinflation process in the second quarter following adjustments of controlled prices and tax harmonisation measures, the upward trend of the consumer price index slowed again due to the moderate rise in food prices and the continued appreciation of the leu against the euro. In the first nine months of 2005 consumer prices averaged 9.2 % against 12.6 % in the same period of the previous year. The continued high oil price, higher food prices as a result of the floodings, and energy price adjustments will, however, probably permit only a slight easing of inflationary pressure in the final months of 2005. Our inflation forecast is an average 9.0 % for 2005 as a whole.

In mid-August the National Bank of Romania (NBR) in

its new inflation report signalled a change of direction in monetary policy with the announcement of its switch to direct inflation targeting. The reorientation involves a gradual shift away from the exchange rate policy of "managed floating" practised thus far to a stronger focus on interest rate policy. With a view to enhancing the transparency of monetary policy and the effectiveness of the interest rate as a monetary policy tool, the NBR has standardised its 12.5 % policy rate and its 8 % sterilisation rate at 8.5 %. This new approach to monetary policy is, however, not pure inflation targeting, as given the continued strong inflow of direct and portfolio investments coupled with the resulting upward pressure on the leu, the NBR has reserved the right to intervene in the foreign exchange market without declaring exchange rate targets. The NBR's inflation targets for 2005 and 2006 at year-end are 7.5 % and 5 %, respectively, with a band width of +/-1 %.

In order to counteract the slowdown in growth seen in the first two quarters and the continuing inflows of foreign capital, the NBR lowered the policy rate from 8.5 % to 7.5 % as of 22 September 2005. With a view to increasing the effectiveness of interest rate policy and promoting leu-denomi-

nated lending, it has now also established a ceiling for the granting of foreign currency loans. In an attempt to curb the sharp rise in foreign currency loans, the NBR required the country's banks as of 26 September 2005 to limit their foreign currency loan portfolio to a maximum 300 % of their own funds.

### Budget surplus

The general government budget closed the first six months of 2005 with a surplus of 1 bn leu or 0.4 % of the GDP forecast for 2005 on account of strong domestic demand and the related above-target revenues from VAT, excise taxes and customs duties. Following the floodings and the subsequent aid and reconstruction measures by the public sector, the surplus will again change to a deficit in the second half of the year, but at a forecast 1 % of GDP in 2005 this will remain roughly at previous year's level. In order to avoid a slowdown of the economy, the government will abstain from increasing the county's VAT from 19 % to 22 % which was scheduled for 2006. It will, however, go ahead with its plan to lower social security contributions by two to three percentage points. The government targets a budget deficit of 0.5 % of GDP for next year. ■

### Outlook

The political turbulence seen in recent months has subsided, but the EU Commission's progress report due to appear shortly could again cause the underlying tension to resurface. The severe floodings have had a significant impact on the economy. In light of their damaging effect on agricultural and industrial output, coupled with the continued imbalance of growth components on the demand

side, an economic slowdown in the second half of 2005 appears likely. The central bank is now seeking to counteract the loss in momentum with a more expansive monetary policy, which will however probably put the current account and consumer prices under further pressure. The budget deficit will remain under 1 % of GDP despite public measures in the areas affected by the floodings. This is also one of the reasons why Standard & Poor's has upgraded Romania's rating by one notch from BB+ to

BBB-, an investment grade rating. The government is now also interested in settling its differences with the IMF over its fiscal policy with a view to resuming discussions concerning the US dollar 400 mn standby agreement suspended in spring. Completion of the privatisation of the remaining two state-owned banks (BCR, CEC) is in sight, giving new impetus to structural reforms, with also positive implications for foreign direct investment needed to finance the current account deficit.

<b>Area:</b> 17 million sq. km
<b>Population:</b> 144 mn
<b>President:</b> Vladimir Putin
<b>Prime Minister:</b> Mikhail Fradkov
<b>GDP (2004):</b> EUR 468.6 bn
<b>Per capita GDP (2004):</b> EUR 3,260

### Putin's succession

Russia's fate depends on the oil price. Given an oil price of more than 40 US dollars per barrel, Russia will remain stable also politically. Whether Putin, contrary to his statements, will agree to amend the constitution and assume the presidency for a third period after the expiry of his term in office in 2008, whether he will bring his influence to bear from another important position or whether there will be a hand-picked successor, will then probably not result in sweeping structural changes. Perhaps the dispute over the distribution of the oil revenue will aggravate. The situation would, however, be different in case a lower oil price

would not permit the implementation of the programmes envisaged in the field of social services and health care and for infrastructure expansion. Then a discontent population might back other parties and candidates. This is, however, not to be expected, judging from the current developments in the international energy markets.

### 2005 satisfactory

With the oil price (Urals brand crude oil) increasing by 44 %, exports of oil, oil products and gas according to the balance of payments soared by 51 % year-on-year to 66.9 bn US dollars in the first half of 2005. Exports of other goods, above all metals, went up by 26 %. Total Russian ex-

ports increased by 40 % to 112.5 bn US dollars, while imports rose by 26 % to 53.6 bn US dollars. The current account surplus amounted seasonally adjusted to 14 % of GDP in the first half of the year, compared to 10 % of GDP in 2004 as a whole. After GDP growth decreased slightly to 5.2 % year-on-year or seasonally adjusted 1.2 % in the first quarter of 2005 compared with the preceding quarter, growth recovered to 6.1 % and 1.9 %, respectively, in the second quarter. In the first 8 months, investments in equipment and buildings made by companies rose by 9.7 %, only a little less than in the previous year. Real income of the population went up by 8.5 % year-on-year. Corporate profits soared as

well. For 2005 as a whole, we expect GDP growth of 6 %, a current account surplus of 14 % of GDP and – thanks to ample revenues from the tax on oil exports – a budget surplus of 5 % of GDP.

### Gref's scenarios

Many countries would like to record such figures. Nevertheless, the Russian economy is falling short of its potential, and in particular of the targets it has set itself. German Gref, Minister of Economic Development and Trade, had two scenarios of the development from 2006 to 2008 prepared, one called "inertia" and the other "innovative investment". In the inertia scenario, everything will remain as it was. In the innovative scenario, structural reforms will be speeded up, taxes will be lowered and a public investment fund will be set up. But the two scenarios also assume different oil prices: in the inertia scenario, the oil price averages 33 US dollars per barrel of Urals crude oil, in contrast to 40 US dollars per barrel in the innovative scenario. (In September 2005, the price was 58 US dollars.) The scenarios show that per capita GDP can by no means be doubled without radical reforms and hardly by implementing such reforms. In the inertia scenario, GDP growth will average 4.3 % from 2006 to 2008, fixed capital formation will rise by 7.7 %, and exports will increase by 1.7 % in US dollar terms. In the innovative scenario, the respective

Russia – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>					<i>Forecast</i>	
<b>GDP (real)</b>	5.1	4.7	7.3	7.2	6.0	5.9
<b>Industrial output (real)</b>	4.9	7.0	7.0	7.3	3.8	5.5
<b>Gross fixed capital formation (real)</b>	11.6	3.0	12.8	10.8	9.1	9.5
<b>Consumer prices (yearly average)</b>	21.5	15.8	13.6	10.9	12.8	12.5
<b>Unemployment (yearly average)</b>	9.0	8.0	8.4	8.2	7.4	6.9
<b>Budget balance (in % of GDP)</b>	3.9	1.0	1.4	4.5	5.0	3.0
<i>in EUR mn</i>						
<b>Merchandise exports</b>	113,410	113,413	120,012	147,187	195,880	208,170
<b>Merchandise imports</b>	60,005	64,439	66,603	77,238	97,570	119,920
<b>Current account</b>	39,017	30,775	31,701	48,135	78,590	71,240
<b>Current account (in % of GDP)</b>	11.3	8.4	8.3	10.3	13.7	10.5
<b>FDI (inflow)</b>	3,067	3,658	7,026	9,380	10,060	6,290
<b>Gross foreign debt (end of period)</b>	168,304	161,927	160,777	163,329	173,640	182,330
<b>Gross foreign debt (in % of GDP)</b>	48.7	44.3	42.1	34.9	30.1	26.8
<b>Import cover (in months)</b>	5.4	6.3	9.0	10.7	12.4	11.2
<b>Average exchange rate: RUB/EUR</b>	26.2	29.7	34.8	35.7	35.5	34.8
<b>Average exchange rate: RUB/USD</b>	29.2	31.4	30.7	28.7	28.2	27.6

Sources: Bank Austria Creditanstalt Economics Department, Federal State Statistics Service, CBR

figures are 5.9 %, 10.3 %, and 5.8 %. An average annual GDP growth rate of more than 7 % would be required to fulfil President Putin's desire of doubling per capita GDP by 2010.

### Kudrin's budget

Based on Gref's innovative scenario, Finance Minister Alexei Kudrin submitted a budget for 2006–2008. It anticipates GDP growth of 19 % in real terms between 2006 and 2008 (2006: 5.8 %, 2007: 5.9 %, and 2008: 6.0 %) and an increase in budgetary expenditure by the general government of 20 %. The Duma is expected to agree to further simplifying the tax system, with the additional effect of lowering the tax burden by 0.25 % of GDP annually through 2008.

In 2006 alone, budgetary expenditure (excluding interest payments) is to exceed that in 2005 by 28 % in nominal terms (assuming average annual inflation of 8 %–9 %), with expenses for health care and sports rising by 64 % in nominal terms and those for public investment and subsidies by 70 % (including about 70 bn roubles for the new investment fund), in addition to a substantial increase in the salaries of civil servants. The budget surplus is to decline to 3 % of GDP.

The development of inflation is very important for the public image of the authorities. Kudrin's budget assumes a decline to 4 %–5.5 % by 2008. In addition to a responsible fiscal (and monetary) policy, the limitation of the increase in regulated prices of gas, electricity, train fares, housing and local services to a maximum of 5 %–8 % annually is to contribute to this development. The central bank's target of 8.5 % year-on-year for December 2005 can, however, at best be attained by special measures. The major producers "voluntarily" decided to freeze the price of petrol. The central bank is thinking of permitting a stronger revaluation of the rouble after all, which would, however, further weaken the competitiveness of industries not belonging to the energy and metal sector.

### Gazprom as global player

A reason for German Gref's innovative scenario and Kudrin's budget promoting investments is the desire to reduce the predominance of the commodity sector and manufacture products of higher value added. But the actual development hardly points in this direction. Now as before, the really exciting events take place in the sec-

tors centred on raw materials, primarily in the oil industry.

On September 28th, 2005, Gazprom succeeded in coming closer to its stated goal of becoming one of the leading energy companies worldwide. It signed a contract with Millhouse Capital on the purchase of 72.7 % of Sibneft shares for 13.1 bn US dollars. The financing is ensured by a consortium of international banks. Millhouse represents the interests of Roman Abramovich, the Governor of the province of Chukhotka and owner of the Chelsea soccer club, and of other – unknown – owners. Earlier Gazprom had bought 3.0 % of the shares from Gazprombank and thus potentially holds more than 75 % of Sibneft shares. Should Gazprom really take control of Sibneft, together with its own production it would control about one third of the Russian oil output in addition to most of the natural gas production. But the transactions still have to be approved by the supervisory bodies, i. e. the government. In June 2005, the government had managed to regain a majority stake in Gazprom. The price of Gazprom shares almost doubled from 83 roubles to 150 roubles from June 2005 to September 2005. When – presumably at year-end 2005 – Gazprom shares need not be

traded by foreigners just in the form of American Depository Rights (ADRs) any longer, but can be acquired directly on the Russian stock exchanges, this may result in a further inflow of capital. Another success of Gazprom was the foundation of a joint venture sealed by an agreement on September 7th, in which Gazprom will hold a 51 % interest and E.ON and BASF will have a stake of 24.5 % each. It will lay a 1,200 kilometre pipeline (which will cost 5.7 bn euros) across the Baltic Sea and thus directly connect Germany with the Russian natural gas deposits as of 2010.

In spite of the obvious strategic advantages the Russian government derives from these developments, it is not completely clear whether Gazprom's activities are really initiated by the state. At any rate, the merger with the also state-owned Rosneftgaz, the present owner of the most important Yukos oil field, failed to materialise. Gazprom is possibly becoming too powerful for the Kremlin. Doubtlessly, energy policy is of the greatest importance for Russia both internally and externally, and the government wants to control it to a large extent. One should not bet too high, however, on which roles specific companies will play in the long run. ■

### Outlook

Due to high energy prices, Russia is experiencing a kind of "Golden Age", in which it is increasingly looking for ways to take advantage of the current favourable conditions and make more substantial progress in eliminating the severest poverty and safeguarding or in some areas regaining its position as a large international power. Kudrin's budget does not appear to be unrealistic, except perhaps for the

assumed inflation rate. It is, however, doubtful whether the importance of the industries centred on raw materials will decline. Therefore, it remains to be seen how high the costs of developing the new East Siberian oil and gas fields will actually be, these are to replace the West Siberian oil and gas fields that are becoming depleted. Should they be markedly less profitable than assumed, Russia could be faced with problems in the long run, above all if greater success will not be achieved in such impor-

tant sectors as the car and the electronics industries as well as in agriculture by then. But at present, the Russian economy is growing by 5 %–6 % annually in real terms without major problems. As a result of the real appreciation of the rouble, it will grow by about 20 % this year and possibly by an average 13 %–15 % in the following years in nominal euro terms. This doubtlessly makes a further strengthening of economic relations attractive for European companies and investors.

<b>Area:</b> 49,034 sq. km
<b>Population:</b> 5.4 mn
<b>President:</b> Ivan Gasparovic
<b>Prime Minister:</b> Mikulas Dzurinda
<b>GDP (2004):</b> EUR 33.1 bn
<b>GDP per capita (2004):</b> EUR 6,150

# Slovakia

## Increased risk of early elections

### Political situation

In recent weeks the chance of seeing early elections being held in Slovakia has increased markedly. This was precisely what the opposition parties, the left-populist SMER led by Robert Fico and the KSS (Communist Party), were endeavouring to initiate by blocking sessions of the parliament in the middle of September. The whole situation can be traced back to the collapse of the centre-right governing coalition of Prime Minister Mikulas Dzurinda at the beginning of September. This in turn was triggered by a scandal surrounding the chairman of the smallest coalition party, the ANO (liberal New Citizens' Alliance) and former Economic Minis-

ter Pavol Rusko, in the wake of which the three larger parties, the SDKU (Slovakian Democratic and Christian Union), the KDH (Christian Democrats) and the SMK (Hungarian Minority Party), withdrew from the coalition agreement with the ANO. Although this meant the government formally lost its majority in parliament, following the conclusion of co-operation agreements with ANO MPs critical of Rusko coupled with the support of independent members of parliament who left their parties, the government now again has a small – and shaky – majority (around 76 to 78 of the 150 seats). However, in such a situation the formal requirements of parliamentary stability are conspicuous by their absence.

In the meantime it appears that both the KDH and the SMK have their eyes on early elections, with only the SDKU and its government leader Dzurinda inclined to adhering to the original election date of September 2006. Nevertheless, it is also questionable whether the necessary support of three-fifths of the parliament can be drummed up to call the early election.

The clear political victor in all of this is the left-populist SMER, which according to the September polls enjoys the support of 34.1 % of the electorate, a record figure, and which would correspond to 58 seats in the parliament. The second strongest party at present would be the SMK (11.8 %) while the SDKU has fallen down the party rank-

ings to fifth place, garnering support of 8.5 %. Aside from the political quarrelling of the government, the recent impetus of the SMER is likely to have come from the increased support of those who have borne the brunt of the disadvantages derived from the economic reforms. The SMER emphasises the unsocial effects of the taxation policy, for example, and like the communists it advocates a withdrawal of the reforms.

### OECD praises reform policy

Yet Slovakia was recently praised by the OECD for its reform policy. In its report published at the end of September particular acknowledgement was expressed regarding the radical restructuring of the taxation system. In 2004 Slovakia became the first country of the OECD to do away with the progressive taxation of income. The flat-tax was introduced with a standard rate of value added tax and a massive reduction in income taxes, all rates fixed at 19 %. According to the OECD the country now has a more transparent, simpler and cheaper system of taxation, which in addition is less distorted and has led to a visible strengthening of production. What is more, to date the reform has more or less had a neutral effect on revenue, since tax receipts have barely changed. Due to the short monitoring period the OECD did not reach a final conclusion with regard to any

### Slovakia – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>FChange from previous year in %</i>						<i>Forecast</i>
GDP (real)	3.3	4.4	4.5	5.5	5.0	5.1
Industrial output (real)	7.6	6.7	5.3	4.2	3.5	6.2
Gross fixed capital formation (real)	13.9	-0.9	-1.2	2.5	6.6	8.2
Consumer prices (yearly average)	7.1	3.8	8.5	7.5	3.0	3.0
Unemployment (yearly average)	18.3	17.8	15.2	14.3	11.5	10.4
Budget balance (ESA 95, in % of GDP)	-6.6	-7.8	-3.8	-3.1	-3.0	-3.0
<i>in EUR mn</i>						
Merchandise exports	14,102	15,184	19,285	22,277	25,640	29,990
Merchandise imports	16,486	17,437	19,848	23,434	26,480	30,890
Current account	-1,960	-2,049	-243	-1,158	-1,480	-1,200
Current account (in % of GDP)	-8.6	-8.2	-0.8	-3.5	-4.0	-3.0
FDI (inflow, net)	1,674	4,069	485	902	1,780	2,440
Gross foreign debt (end of period)	12,612	13,939	16,177	18,190	21,850	23,480
Gross foreign debt (in % of GDP)	55.2	55.7	55.8	55.0	59.4	58.4
Import cover (in months)	2.9	5.6	5.5	5.1	5.3	4.6
Average exchange rate: SKK/EUR	43.2	42.7	41.5	40.1	38.6	37.7
Average exchange rate: SKK/USD	48.3	45.3	36.8	32.2	30.7	29.9

Sources: Bank Austria Creditanstalt Economics Department, National Bank of Slovakia, Statistical Office

adverse effects on distribution. This is because, for a variety of reasons, flat-rate taxes favour households with high incomes, which coupled with a poorer distribution of the tax system could widen the income gap. The negative distribution effects are partly compensated for by the elimination of former tax privileges as well as the relatively high income allowances.

The OECD did level some criticism at, for example, public sector and in particular the insufficient fight against corruption as well as the broad regional differences in employment. While unemployment overall is on the slide, the differences between the boom region in the west of the country – Bratislava is running practically at full employment – and the structurally weak regions of the east – unemployment up to 30 % – are huge.

The action plan adopted by the government last June to introduce the euro by the beginning of 2009 (for details see CEE Report 3-2005) is considered to be realistic by the OECD. It reckons that Slovakia will fulfil all of the Maastricht criteria by 2007 and is encouraging Slovakia

to enter ERM II as quickly as possible. According to the action plan for introducing the euro, entry into ERM II is planned for the second quarter of 2006.

### Investments keep pace with economic growth

With real GDP growth of 5.1 % – just like in the first quarter – overall Slovakia managed to stay on its growth path throughout the second quarter of 2005. Looking at the demand components, growth in private consumption has remained essentially unchanged (first quarter: 5.5 %, second quarter: 5.6 %), while that of public consumption slowed from 1.8 % to 0.7 %. But investments in particular recorded an impressive rate of expansion, with gross fixed capital formation almost doubling from 5.8 % to 10.7 %. In the second quarter, the growth of imports (first quarter: +7.9 %, second quarter: +6.9 %) declined to a somewhat lesser extent than that of exports (first quarter: +7.2 %, second quarter: +5.0 %).

At the beginning of the summer, industry picked up

its rate of growth following moderate rises in May and June, with output expanding in July by roughly 5 %. The automobile sector played a decisive role here. Commanding a share in the output of the processing industry of around 20 %, its cycles and changes in capacity influence the industry and macroeconomic performance of Slovakia. While the output of the automobile sector in May and June was down by around 10 % on the figure the previous year, in July it expanded by an impressive 15 %.

Inflation weakened again during the summer months, posting a figure in both months of only 2 % year-on-year, whereas the beginning of the year was characterised by values of around 3 %. On the whole, during the summer the lower prices of foodstuffs compensated for the hikes in other price categories. The groups of prices sensitive to changes in energy prices – except for prices in the transport sector – have yet to show any major reaction to the increases in the price of oil. In light of the lack of inflationary pressure induced by demand, at the beginning of

October the national bank left its key rates unchanged. For seven months now the 2-week repo rate has been unchanged at 3 %. Nonetheless, it is assuming that inflation will lie just above the target band by the end of the year.

At first glance the current account does not appear to have developed as well this year to date, given that the 1.4 bn euro deficit accumulated in the first seven months was almost three times as high as in the previous year. Yet what must be taken into account is the extremely low figure recorded last year. Instrumental here were developments in the balance of trade, which in terms of imports reflected the robust private consumption and the investment boom, as well as the income balance. The higher dividend payments of foreign investors make a substantial difference in this respect. On the other hand, over the last six months the inflow of FDI has intensified, and posting a figure of approximately 850 mn euros it has compensated for the majority of the current account deficit. ■

### Outlook

Despite the increased risk of early elections it is quite conceivable that the original deadline of autumn 2006 will be kept. The SMER led by Robert Fico has hardly found any potential coalition partners yet, and thus the high level of current support is not synonymous with responsibility for future governance. As a result it is essentially the current parties which are likely to constitute the core of any future coalition, obviously without the ANO and with a different composition. Should this occur then presumably there will be no change of tack in terms of reform policy. We are raising our growth forecast for 2005 up to 5 % following the good results of the second quarter,

and it should remain at around this level in 2006 too. Over the coming months we expect investments above all to determine the rate of economic growth. Household investments will be boosted by the positive development of real wages as well as the low rate of interest, but also corporate investments based on the expansion plans of vehicle manufacturers as well as the continued commitment of foreign investors. Increases in income and the level of interest are also still stimulating robust private consumption. By contrast, economic growth is being subdued by public consumption and for the time being net exports. Because if growth in imports is higher than that of exports, net foreign demand will remain negative. Only in

the course of 2006 and 2007 is this trend likely to be reversed, when the imported assets for the automobile plants will finally result in increased exports. And this will also benefit the trade and current account balances. By 2008 the declining deficit could in fact be transformed into a surplus. Annual average inflation will be somewhat higher than expected this year at 3 % owing to the impact from the autumn of higher energy prices (increase in gas prices from October). Even 2007 should still see an inflation rate of around 3 %. In entering ERM II during the second quarter of 2006, Slovakia after the Baltic States and Slovenia will number among the frontrunners for introducing the euro.

<b>Area:</b> 20,273 sq. km
<b>Population:</b> 2.0 mn
<b>President:</b> Janez Drnovšek
<b>Prime Minister:</b> Janez Janša
<b>GDP (2004):</b> EUR 26.2 bn
<b>Per capita GDP (2004):</b> EUR 13,110

# Slovenia

## Strong 2nd quarter

### Political situation

In June the government launched an initiative to strengthen the international competitiveness of the Slovenian economy. Since then the Reform Committee has drafted proposals, some of which the government is to implement before the end of this year. The implementation shall be facilitated by a separate Ministry for Development. The Ministry of Economy has announced that the privatisation of the telecommunications firm Telco shall commence in 2006. They are looking for a strategic partner who can only obtain a shareholding of 25 %, thus the sluggish privatisation process is continuing. Criticism has been levelled at the govern-

ment because of this and also for a lack of transparency following the sale of shares in the retail chain Mercator, which took place without a tender for Slovenian bidders. In addition, in some areas – for example in the banking sector – the privatisation process has yet to constitute anything more than announcements. Taking a glance at the most recent opinion poll is likely to provide one of the reasons for the restraint shown by the government. The support of the population for the government fell in September to its lowest level since it took office almost a year ago. Nevertheless, there is a clear majority for the coalition, which is led by the Democratic Party (SDS).

With its rising prosperity Slovenia is likely to lose its status as an objective 1 region of the EU in 2007. In order to continue receiving financial support from the Structural and Cohesion Funds the country is to be divided into two statistical regions. Although the west of the country with the capital Ljubljana will lose its status, after the split the east including Maribor will remain an objective 1 region over the budget period from 2007 to 2013.

### Economic situation

After the relatively subdued start to the year the Slovenian economy flexed its muscles in the second quarter. GDP growth climbed to 5.2 % by annual comparison

(first quarter: +2.6 %) and seasonally adjusted accelerated to 2.6 % over the previous quarter (first quarter: +1.2 %). The driving force behind all this was primarily external demand. In spite of the weak economic conditions in many of the “old” EU Member States, exports surged by more than 10 % in real terms in comparison to the corresponding period of the previous year. The rise in imports lagged well behind at a mere 3.6 %, thus net exports provided a significant boost. They were responsible for almost 90 % of growth in the second quarter. By contrast, domestic demand made a contribution of only 0.5 percent to GDP growth. The main reason for this was above all the major running down of inventories, a consequence of the strong export demand.

In the coming period, net exports will not be able to make as significant a contribution to economic growth as it did in the second quarter. Export growth will start to decline given the continued economic weaknesses in the main export markets of the EU and also in light of the moderate growth seen in many of the Balkan countries with which Slovenia has close economic relations. In contrast to this, imports will increase at a substantially stronger rate than in the initial months of the year, especially with industrial output gaining momentum during the summer, and imports will be necessary both to satisfy consumption needs as well as

### Slovenia – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>						<i>Forecast</i>
<b>GDP (real)</b>	2.7	3.5	2.7	4.2	3.8	4.0
<b>Industrial output (real)</b>	2.9	2.4	1.4	4.8	2.5	4.5
<b>Gross fixed capital formation (real)</b>	-0.4	0.9	7.1	5.9	3.0	3.8
<b>Consumer prices (yearly average)</b>	8.4	7.5	5.6	3.6	2.5	2.5
<b>Unemployment (yearly average)</b>	6.5	6.3	6.7	6.3	6.2	6.2
<b>Budget balance (ESA 95, in % of GDP)</b>	-3.9	-2.7	-2.1	-2.1	-1.9	-1.8
<i>in EUR mn</i>						
<b>Merchandise exports</b>	10,454	11,082	11,417	12,933	14,200	15,300
<b>Merchandise imports</b>	11,139	11,347	11,960	13,942	14,950	15,900
<b>Current account</b>	38	344	-81	-544	-200	30
<b>Current account (in % of GDP)</b>	0.2	1.5	-0.4	-2.1	-0.7	0.1
<b>FDI (inflow, net)</b>	251	1,582	-115	21	200	250
<b>Gross foreign debt (end of period)</b>	10,403	11,482	12,995	15,355	19,000	21,500
<b>Gross foreign debt (in % of GDP)</b>	47.1	48.9	52.8	58.7	68.5	72.8
<b>Import cover (in months)</b>	4.6	6.7	5.9	4.8	4.6	4.5
<b>Average exchange rate: SIT/EUR</b>	217.2	226.2	233.7	238.9	239.5	239.3
<b>Average exchange rate: SIT/USD</b>	243.3	242.7	207.1	192.4	190.6	189.7

Sources: Bank Austria Creditanstalt Economics Department, SNB, SORS

rising demand for imported capital goods.

In the first six months, GDP growth averaged 3.9 %. We have revised our 2005 growth forecast for the year as a whole up to 3.8 % thanks to the strong second quarter. And if bolstered to some extent from abroad, next year GDP growth could be in the region of 4 %. Since the anticipated fall in private consumption will not be too significant and the favourable rate of interest will stimulate investments to a greater degree, growth could be somewhat higher than in 2005. The high price of oil remains a risk factor which could hit the Slovenian economy too.

### Oil price development slows the decline in inflation

Although the government managed to counter the impact of the oil price on inflation by flexibly adjusting the tax on fuel, the price of oil has to date been one of the main factors driving prices this year. However, falls or only moderate rises in the prices of foodstuffs, clothing and public tariffs are subduing inflation. After recording figures under the 2 % mark in the summer, inflation

topped 3 % in September on a year-on-year basis. In the first three quarters average inflation totalled 2.6 % (2004: 3.6 %). The development in the price of oil also implies a potential risk for stronger hikes in inflation, although we reckon the chance of this happening is slim. The somewhat stronger consumption demand noticed over recent months, reflected in growth in retail sales of more than 7 % throughout the first eight months, will again start to lose momentum. Therefore this should result in low inflationary pressure, meaning that over the remaining months of the year the figures should drop below the 3 % mark. This would put average inflation in 2005 at around 2 1/2 %. Taking the average inflation figure of the three countries in the euro area with the most stable prices as a benchmark, Slovenia this year already fulfils the relevant Maastricht criterion for introducing the euro.

### 2006/2007 budget framework in place

Despite the strong economic growth, the budget deficit did not quite develop as originally planned in the second quarter. The consoli-

dated budget deficit (under national methodology) totalled 2.5 % of the half-yearly GDP in the first six months, after amounting to 1.8 % in the same period the previous year. Higher wage and pension expenses played an instrumental role here, along with payments to the EU budget which did not exist until May of last year. Implementing the planned reduction in expenditure growth has thus far been quite inadequate, forcing us to assume that the budget is going to exceed, albeit slightly, the planned deficit of 1.4 % of GDP for 2005 as a whole.

According to the recently announced figures for public finances in 2006 and 2007, the government intends to keep the consolidated budget deficit for 2006 at 1.4 % of GDP and thus at the same level as for this year, bringing it down slightly in 2007 to 1.2 % of GDP. A key issue is the gradual abolition over several years of the municipal payroll tax. According to Finance Minister Bajuk, the loss in revenue that this will cause will be offset by further spending cuts in the public sector (decrease in the number of civil servants). The elimination of the municipal payroll tax will ease wage

costs somewhat which are high by regional comparison, with a view to reinforcing the position of companies in international competition. However, the impact will be mitigated by the slow phasing out of the tax until 2009, while companies active in low-wage, labour-intensive sectors will not obtain as much relief owing to the progressive nature of the tax. Financing the shortfall by means of the planned cut of 1 % in the number of civil servants would appear to be realistic, to the extent that the deficit target could even be met. Based on the figures available for the consolidated budget we anticipate a deficit according to ESA 95 methodology of just under 2 % of GDP for the next two years. The budget deficit will even be around this level in the current year, after amounting to 2.1 % of GDP according to the most recent estimate from Eurostat last year. In our opinion, nothing stands in the way of fulfilling this Maastricht criterion (deficit no more than 3 % of GDP) to introduce the euro in 2007, even if some other challenges will need to be addressed in the medium term, such as the financing of pensions. ■

### Outlook

In the second quarter the Slovenian economy achieved impressive economic growth of 5.2 % by annual comparison. The auspicious development of some early indicators such as retail figures and industrial output indicate that high, albeit slightly more moderate, growth rates are set to remain. We are expecting GDP growth for 2005 and 2006 to be in the region of 4 %. The development of the oil price does constitute a risk for this forecast, which could cast a shadow over the future movements in the inflation rate as well. Otherwise there are no

price-driving factors on the horizon, especially since consumption demand in particular should again develop at a moderate pace. There is some work to be done at least in the medium term with regard to fiscal policy. The budgeted deficit could well be exceeded slightly in 2005 and the budget targets for 2006/2007 also require the implementation of cost-cutting plans. In light of the relatively favourable economic environment it would be advisable now to strive towards finding a solution for the structural deficit (key word: financing pensions). However, the new government has not yet indicated its enthusiasm for pushing through re-

forms. Not even privatisations have been accorded high priority. Consequently, relative restraint can still be used to characterise the activity of foreign investors. The inflow of foreign direct investment totalling 1 % of GDP will be one of the lowest in the region in 2005. Nevertheless, it is sufficient to cover the deficit in the current account. Based on a positive development in the trade balance we expect the current account deficit to total 0.7 % of GDP this year, far lower than the figure posted in the previous year. Thus the Slovenian economy continues to perform well, with relatively high economic growth under fairly stable framework conditions.

<b>Area:</b> 603,700 sq. km
<b>Population:</b> 47.6 mn
<b>President:</b> Viktor Yushchenko
<b>Prime Minister:</b> Yuriy Yekhanurov
<b>GDP (2004):</b> EUR 52.2 bn
<b>GDP per capita (2004):</b> EUR 1,100

## On the way to parliamentarism

Viktor Yushchenko's dismissal of Yulia Tymoshenko's government on 8th September marked the end of the "orange" unity. The government headed by Yuriy Jekhanurov, who on 22nd September succeeded in winning the confidence of the parliament in a second ballot, is a kind of transitional government. It will help to alleviate the conflicts in the country until the parliamentary elections scheduled for March 2006, and prevent a never-ending election campaign. The future of Ukraine requires far-reaching political decisions which can only be taken politically. The prospects that this will be done in a democratic manner are not bad:

there are now political parties which increasingly live up to their definition as parties. Before the Orange Revolution there was a myriad of groups representing special interests of one kind or another. Yuriy Jekhanurov owes his parliamentary victory also to the support provided by the party of former prime minister Viktor Yanukovych. President Yushchenko largely secured this support through his pledge to adhere to the constitutional reform negotiated in December 2004. The reform will shift some of the President's power to parliament, especially the initiative for forming a government. It should take effect on 1st January 2006.

The main parties which will in future determine Ukraine's political landscape

# Ukraine

## Decision in March

are: "The People's Union Our Ukraine" (with Viktor Yushchenko as its Honorary President and Roman Bessmertniy its Chairman), the "Yulia Tymoshenko Bloc", the "Party of the Regions" led by former prime minister Viktor Yanukovych, the Socialists headed by Oleksandr Moroz (coalition partner in the Tymoshenko government and the Jekhanurov government) and the "Social Democratic Party of Ukraine (United)" led by Viktor Medvedchuk, formerly Kuchma's Chief of Staff.

The following are the key issues of debate:

1) How rigorously should the fight against the economic clans, corruption and irregularities of the past be conducted, so that on the one hand

business life is not excessively disrupted, and on the other hand renewed violations of the law are not encouraged and the hopes of the participants in the Orange Revolution are not too disappointed. ("The People's Union Our Ukraine" advocates a more moderate approach, while the "Yulia Tymoshenko Bloc" takes a more radical view).

2) To what extent should Ukraine open its economy to foreign companies, and how much protection and support should one give domestic producers and investors ("The People's Union Our Ukraine" is more in favour of opening the economy, while the Socialists under Oleksandr Moroz are more willing to protect the market, especially the agricultural sector, even if this makes membership of the WTO more difficult).

3) How balanced should the country's relations with the EU and Russia be? While virtually all parties favour Ukraine's membership of the EU, only few appear to be willing to pay the price of full emancipation from Russia: energy at world market prices.

4) What should be done to counteract the decline in economic growth and the possible deterioration in the Terms of Trade on account of higher energy and falling metal prices? The "Party of the Regions", the "Social Democratic Party of Ukraine(United)" and the Communists advocate a significant increase in social spending, while "The People's Union Our Ukraine" believes

### Ukraine – Selected Indicators

	2001	2002	2003	2004	2005	2006
<i>Change from previous year in %</i>						<i>Forecast</i>
<b>GDP (real)</b>	9.2	5.2	9.4	12.1	3.0	4.5
<b>Industrial output (real)</b>	14.2	7.0	15.7	12.5	3.3	7.0
<b>Gross fixed capital formation (real)</b>	13.2	6.0	15.8	11.4	4.0	7.0
<b>Consumer prices (yearly average)</b>	12.3	0.8	5.2	9.0	14.0	11.0
<b>Unemployment (yearly average)</b>	11.8	10.1	9.1	7.8	7.5	9.0
<b>Budget balance (in % of GDP)</b>	-1.5	0.2	0.1	-3.1	-3.0	-3.0
<i>in EUR mn</i>						
<b>Merchandise exports</b>	19,075	19,732	20,959	26,868	27,400	31,110
<b>Merchandise imports</b>	18,854	18,982	21,197	23,862	27,870	31,100
<b>Current account</b>	1,565	3,354	2,552	5,468	1,960	2,440
<b>Current account (in % of GDP)</b>	3.7	7.7	5.9	10.4	3.1	3.3
<b>FDI (inflow, net)</b>	858	732	1,257	1,378	1,350	1,980
<b>Gross foreign debt (end of period)</b>	22,799	22,922	21,023	24,585	29,730	34,990
<b>Gross foreign debt (in % of GDP)</b>	53.7	52.4	48.2	47.0	46.8	46.9
<b>Import cover (in months)</b>	1.7	2.4	3.0	3.2	4.3	4.1
<b>Average exchange rate: UAH/EUR</b>	4.8	5.0	6.0	6.6	6.4	6.3
<b>Average exchange rate: UAH/USD</b>	5.4	5.3	5.3	5.3	5.1	5.0

Sources: Bank Austria Creditanstalt Economics Department, National Bank of Ukraine

that greater liberalisation and significant tax cuts would be a more appropriate solution. But this party also supports stronger public investment.

5) In combating inflation, the "Yulia Tymoshenko Bloc" has already shown that it is sometimes not afraid of resorting to administrative methods – much to the annoyance of some of its government allies and foreign commentators. Viktor Yushchenko, on the other hand, wanted to see a greater liberalisation of the hryvnia (and its appreciation), which is however opposed by large sections of the population whose savings are held in US dollars.

The elections in March will play a very significant role in answering these questions. But whatever the answer may be, it is important that it is increasingly obtained by means of a transparent, parliamentary process. This could permit corrections to be made without revolutions or other processes involving very high social costs.

### Sharp decline in growth

Ukraine's real GDP growth slowed markedly in the first eight months of 2005, from 12.1 % in 2004 to 2.8 % year-on-year. Gross fixed capital formation also lost significant momentum. Industrial output growth slowed from

12.5 % in 2004 to 3.5 % in the first eight months of 2005, year-on-year, including the output of the metal industry from 12.0 % to minus 3.2 %. In 2004, exports grew at a rate of 41.6 % on a US dollar basis, largely as a result of strong international demand for metals. In the first 8 months of 2005 this growth rate declined to 7.6 %. This compared with a decline in import growth from 26.0 % to only 24.3 %. In light of the weaker prospects for the global metals industry and the uncertain political situation in Ukraine, which is adversely affecting the investment climate, we now expect economic growth to reach only 3 % this year. The current account surplus is likely to shrink from about 10 % of GDP in 2004 to about 3 % of GDP. Inflation, on the other hand, will climb from 9 % to an average 14 % in 2005, driven by an acceleration in food prices compared with (the election year) 2004, higher public transport fares and a more rapid rise in rents.

### Budget 2006: moderate stimulus

On 15th September the provisional government headed by Jekhanurov presented its draft budget for 2006 in parliament. The budget's purpose is to promote

growth by further raising minimum wages and by CPI-index-linking the minimum subsistence level, as well as to guarantee the necessary transfers to the pension fund and healthcare services. The main stimulus is to come from increased public investment, however, especially in road construction.

The consolidated budget of the central and local government calls for revenues of 149.5 bn hryvnia (29.2 % of GDP compared with a planned 30.2 % of GDP in 2005), a nominal 13.6 % more than the amount budgeted for 2005, (about 4 % in real terms). A reduction in the rates of some levies, including various pension contributions and accident insurance contributions, is intended to provide tax relief of an overall 1 % of GDP. Expenditure is to increase by 14.1 % (an estimated 4.6 % in real terms) to 161.0 bn hryvnia (31.4 % of GDP, compared with a budgeted 32.4 % of GDP in 2005).

The election promises in December 2004 have pushed spending in 2005 well above the level of the previous year. But so far, especially due to the efforts of the tax authorities, revenue has increased to an even greater extent. Nevertheless, it remains to be seen whether this will apply to the entire year.

The draft budget for 2006 assumes real GDP growth of 7 %, inflation of 8.7 % as of year-end and an exchange rate of 5.0–5.2 hryvnia for 1 US dollar. While the other assumptions may be realised, we believe that the assumption on economic growth is too optimistic. The assumed budget revenue growth is set at a cautious level, but is presumably based on an excessively high estimate of the base level in 2005. The (consolidated) budget deficit will therefore hardly fall below 3 % of GDP. Looking just at the effects of the deficit, fiscal policy in 2006 will by and large be growth neutral. The combination of a reduction in levies (and a simplification of procedures), plus the multiplier effect of investment spending, will, however, probably cause the budget to slightly stimulate economic growth. Investment spending is planned to increase by no less than 20 % (a real 10 %).

Higher-than-planned budget deficits require the government to speed up the privatisation process. The initial measure taken in this regard is the auction of the "Kryvorizhstal" steel works on 24th October. The privatisation proceeds will however probably not be sufficient to cover the deficits either in 2005 or 2006, and Ukraine's government will have to issue more securities. ■

### Outlook: recovery in growth from mid-2006

Both privatisation and the issue of securities will help promote inflows of foreign capital, and Ukraine can also expect to receive loans from international financial institutions such as the World Bank, IMF, EBRD and the EIB. The country will therefore probably be in a position to meet its payment

obligations even in the event of a gas dispute with Russia. It will be difficult for Ukraine to achieve its target of WTO membership in the current year, notwithstanding parliament's approval of some more of the legislation required in this respect; it is uncertain whether the necessary majority will be obtained for the opening of the agricultural sector. This in turn casts uncertainty over the prospect of a free trade zone with the EU following membership

of the WTO. Trade relations with the EU will however be further strengthened. GDP growth in 2005 will fall far short of the 2004 level, but should pick up again from the second half of 2006. Much will depend on the parliamentary elections in March. Thereafter, Ukraine's future course will be much easier to predict. This should trigger investment activity by domestic and foreign investors.