

# External Economic Environment





# 1. External Economic Environment

## 1.1. Global trends in the development of output and prices

The world economy in 2004 grew faster than in 2003. Global output grew by 5.1%, thanks in particular to faster growth in the United States and Asian economies, particularly the expansion of investment in China. In the euro area and throughout the European Union a general recovery in economic activity was also seen, though its level was both lower and primarily dependent on improved export opportunities, which, however, were somewhat slowed down by the appreciation of the euro. In the expanded European Union, the new Member States of Central and eastern Europe maintained above-average rates of economic growth. Fast growth continued in Russia and throughout the Commonwealth of Independent States. Japan's economy also recorded a clear upturn. The Latin American economies experienced a substantial acceleration in growth.

The fast growth in global output was accompanied by growth in international trade, with exports rising by 8.4% on a year-on-year basis. The rate of economic growth peaked in the first two quarters and slowed down in the second half of the year due to the rapid growth in oil prices. The growth in oil prices was reflected in a moderate acceleration of inflation, however, the trend of low inflation was retained, thanks to the absorption of secondary inflationary effects.

Regional differences persisted in global economic growth, maintaining the long-term state of global imbalances. The main risk factor to sustainability in 2004 continued to be that of America's high current account deficit resulting from an expansionary fiscal policy and a high level of domestic demand.

Commodity market prices under the pressure of the strong global recovery grew significantly. Oil prices grew from the beginning of the year, exhibiting marked volatility. The price of Brent crude peaked at the end of October at a historical maximum of 51 USD/barrel, and on average for the year 2004 reached 38 USD/barrel, which was 33% higher than the average for 2003. Besides high demand in the global recovery phase, the growth in oil prices was also due to uncertainties on the supply side, connected with unclear policies on the part of oil producers, where these caused oil price volatility. At the same time, while there was a substantial overall increase in oil production, emergency reserves were put on hold, which increased oil price sensitivity to the current situation in demand and supply and left very little room for solving potential unexpected problems in oil supply. Prices of non-energy raw materials grew similarly in the first half of the year, later moving on to a moderate decline, due in particular to lower prices of foodstuffs and agricultural raw materials. On the annual average, dollar prices of non-energy raw materials in 2004 were 22% higher than in 2003.

Table 1 **Global output in 2004** (year-on-year growth in %)

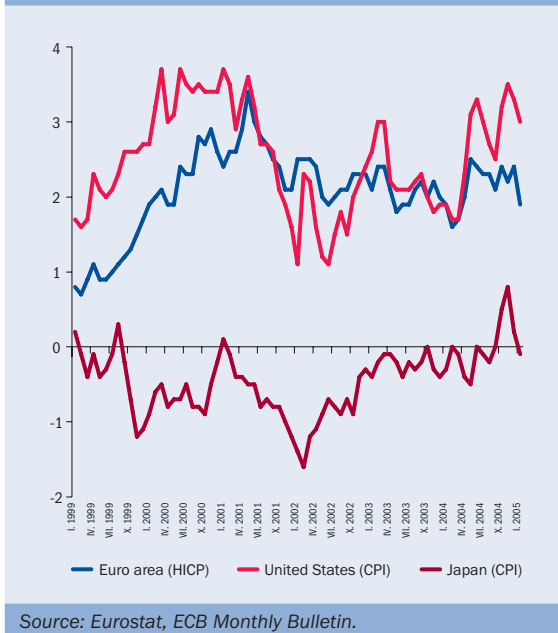
	2003	2004	2005 <sup>1)</sup>
Global output	4.0	5.1	4.3
Developed economies	2.0	3.4	2.6
United States	3.0	4.4	3.6
Japan	1.4	2.6	0.8
Euro area	0.6	2.0	1.6
European Union (EU-25)	1.0	2.4	2.0
Newly industrialized Asian economies	3.1	5.5	4.0
China	9.3	9.5	8.5
Central and eastern Europe	4.6	6.1	4.5
Russia	7.3	7.1	6.0
Brazil	0.5	5.2	3.7

Source: *World Economic Outlook, April 2005; Economic Forecasts Spring 2005, European Economy No. 2, 2005.*

1) Projections.



**Chart 1 Consumer prices in euro area, United States and Japan (year-on-year change in %)**



Source: Eurostat, ECB Monthly Bulletin.

International currency markets in 2004 were dominated by the trends of the euro's strengthening and general weakening of the US dollar. Up until October the euro's strengthening remained moderate, where the markets noted in particular the lagging of economic recovery in the euro area compared to that in the United States and Japan. In mid-October, however, the euro strengthened significantly against the US dollar and also against several Asian currencies pegged formally or informally to the dollar. In the last quarter, the US dollar weakened against all major currencies. The most likely reason for these developments were the growing fears related to the deepening of external and internal imbalances in the US economy. The structure and use of financial flows into the United States changed. A typical tendency was to finance government and private consumption by increased capital inflows to government bonds at the expense of equity capital inflows for financing private investments. The whole process is above all a result of interventions by Asian central banks, tying their currencies to the dollar in this way.

By the end of the year, the nominal effective exchange rate of the euro (towards 23 euro area trading partners) was slightly higher (2.4%) than its level at the beginning of the year. The highest appreciation of the euro was against the US dollar (8.0%, where on 30 December 2004 the euro traded at USD 1.36), the Chinese renminbi and Hong Kong dollar. The euro strengthened by 4.7% against the Japanese yen, implying an appreciation of the yen to the US dollar of more than 3%. The euro maintained a relatively stable exchange rate towards the British pound (strengthening by only 0.5%). The strengthen-

ing of the euro towards these currencies was offset partially by its weakening towards the Swiss franc, Norwegian krone, Korean won and the currencies of some new EU Member States, most significantly the Polish zloty (by 13.5%), Hungarian forint (by 6.2%), the Czech koruna and (by 6.0%), and the Slovak koruna (by 5.8%).

Global bond markets in 2004 recorded historically very low yields. A characteristic feature of the yields was their low volatility over the course of the year, confirming in the real development over the past years the trend of a general decline seen in implied volatility (derived from option prices) in individual segments of the financial markets of developed economies. Yields on 10-year US federal funds and on 10-year euro area government bonds followed the same path up until October. Following a decline in the first months of the year (market uncertainty as to the sustainability of the economic upturn in the United States), yields grew until June (the potential inflationary consequences of the growth in oil prices in the context of growing market confidence in the global recovery), and then fell in the third quarter (increased fears of the impact of high oil prices on economic activity). The significant depreciation of the US dollar was the main factor in the divergence in the trends taken by yields in the last quarter. Whereas yields on euro area bonds fell until the end of the year, yields on US bonds grew. On an annual average however the main factor in the movement of yields on long-term federal funds issued by the United States and in the euro area was the growth in oil prices and its potential consequences on inflation and economic growth. Stronger effects were expected in the US economy, where the movement in US bond yields was therefore higher than that in the euro area. Taken as a whole for 2004, long-term government bond yields in the euro area fell on a year-on-year basis by 57 basic points, reaching 3.69% at the year-end. Yields on US long-term federal funds grew by 10 basic points on a year-on-year basis and at the year-end stood at 4.23%.

Stock market prices in the United States and euro area followed a relatively stable, moderately upward course. Only the US dollar's strong depreciation in the last months of the year caused significant growth in the main stock market indices. On a year-on-year basis, the broad Dow Jones EURO STOXX index grew by 10.5%, the US index Standard & Poor's 500 by 11.0%, and the Japanese Nikkei 225 by 7.5%. Growth in equity prices in the euro area was a reflection of the falling yields on long-term government bonds, but also of the strong growth in profits and paid dividends. Over the course of the year, a general factor contributing to the rise in the stock market indices was the very low volatility in equity markets. Similarly as on long-term bond markets, equity markets experienced the effect of low implied volatility in yields as well.

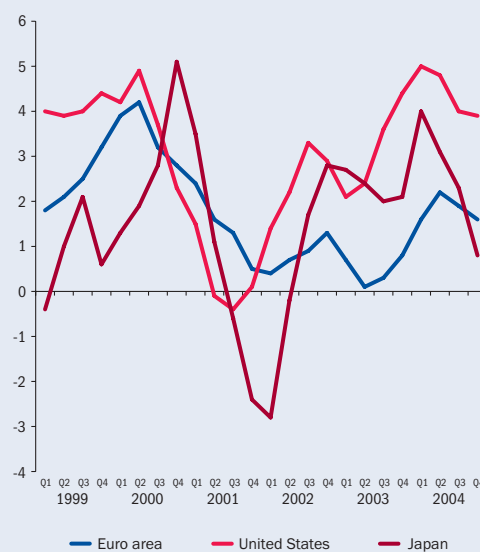
## 1.2. Developments in the main currency areas: the United States, Japan, and the euro area

### Economic development

On a year-on-year basis, real GDP growth in the **United States** accelerated in 2004, reaching 4.4% (in comparison to 3.1% in 2003), which was the highest level seen in the past 5 years. The growth in GDP was due in part to the high level of domestic consumer and capital investment demand, while the contribution of net exports was negative. Household consumption in this year again was supported by accommodative macroeconomic policies, continuing expansion in the housing market, as well as by a significant increase in employment. Growth in the level of employment did not bring about serious pressures for raising nominal wages, a fact which together with the growth in oil prices led to a slowdown in the growth of real disposable income, further decline in the persistently low rate of personal savings and a historically high level of household debt (exceeding 80% of GDP). Favourable external financing conditions and high demand created an advantageous environment for growth in business investment, especially driven by investment in technological equipment and software. The moderate development of labour costs enabled relatively strong productivity growth. The high profitability of the business sector was in no significant way affected by the growth in oil prices. The high level of domestic demand led to a further deepening of the US trade deficit, which in 2004 reached 5.4% of GDP (compared to 5.0% a year earlier), despite the dollar's continual depreciation. Annual inflation measured by the consumer price index in 2004 rose slightly to 2.7% (compared to 2.3% a year earlier). This growth in inflation was however caused almost wholly by the growth in oil prices. Longer-term inflationary expectations remained subdued, since the spread of inflationary pressures was opposed by the rapid growth in productivity and the only very limited effect of the dollar's depreciation on consumer prices.

**Japan's** economy in 2004 continued to recover, while losing momentum over the course of the year. Real GDP grew by 2.7% (compared to 1.4% in 2003), the highest level since 1996. The growth for the whole year was primarily the result of very strong growth in the first quarter, followed by a substantial slowdown in economic activity brought about by dampened exports and a sudden reduction in public investment. Consumer demand over the course of the year remained relatively strong, supported by improved labour market conditions and the income situation of households. The rate of unemployment fell slightly, to reach 4.4%. The structural features of the business sector improved: restructuring of business balance sheets and targeted efforts to reduce costs led to a

Chart 2 GDP in euro area, United States and Japan (year-on-year change in %)



Source: Eurostat, ECB Monthly Bulletin.

growth in corporate profits and a further reduction in bad loans in the banking sector. In the field of price development, deflationary pressures eased a little, and the annual consumer price index reached zero (the first time deflation had not been recorded since 1998), where in the last quarter signals of a growth in prices appeared in some segments of the consumer basket (fresh foodstuffs).

In 2004 the **euro area** saw a significant acceleration in economic activity. Annual GDP growth rose by 2.0% (compared to 0.6% in 2003), primarily due to strong growth acceleration in the first half-year. Domestic demand, especially capital investment demand, increased on a year-on-year basis, despite a significant slowdown in the growth of construction investment in Germany and a general decline in government investment. Private consumption throughout the year remained relatively low, suppressed by weak labour market activity and persistent long-term structural shortcomings in the European economy, including uncertainties regarding healthcare and social security reforms underway in several EU Member States. This contributed to stagnation in consumer confidence. The main driving force in the euro area's economic growth, especially in the first half-year, was export. The slowdown in global growth due to rising oil prices and the appreciation of the euro in the second half of the year led to a sudden weakening in the profitability of the external sector, which was manifested in a renewed weakening of economic activity in the euro area.

From the sectoral aspect no significant differences in the creation of added value in the euro area economy were seen in 2004. The growth in added



value recorded in manufacturing as well as in market services essentially followed the same pattern – acceleration in the first half of the year and slowing in the second. This leads to the conclusion that the cyclical development of the euro area economy has recently been influenced by aggregate, i.e. general, and not by specific problems of individual sectors.

Germany, the largest euro area economy, showed in 2004 its extraordinary dependence on outputs of the external sector. The contribution of external demand accounted for three-quarters of the GDP growth achieved (growth of 1.7% against a decline of 0.1% in 2003). The strong growth of exports from Germany was supported by a significant decline in unit wage costs, a favourable export structure with a high share of production related to information technology, as well as having a territorial orientation on China and the United States.

GDP growth accelerated on a year-on-year basis in all euro area countries except Greece, where though it still remains high. The highest GDP growth was recorded in Ireland (5.1%), followed by Luxembourg (4.4%), Greece (4.2%), Finland (3.7%), Belgium and Spain (2.7%), France (2.3%) and Austria, where GDP growth reached the same rate as the average value for the euro area (2.0%). Lower than average GDP growth was experienced in Germany (1.7%), the Netherlands (1.3%), Italy (1.2%) and Portugal (1.0%). The rates of real GDP growth in individual economies thus reached values ranging from 5.1% to 1.0%, and in comparison with 2003, when the difference between the fastest and slowest growing economy was 6 percentage points, thus approximated.

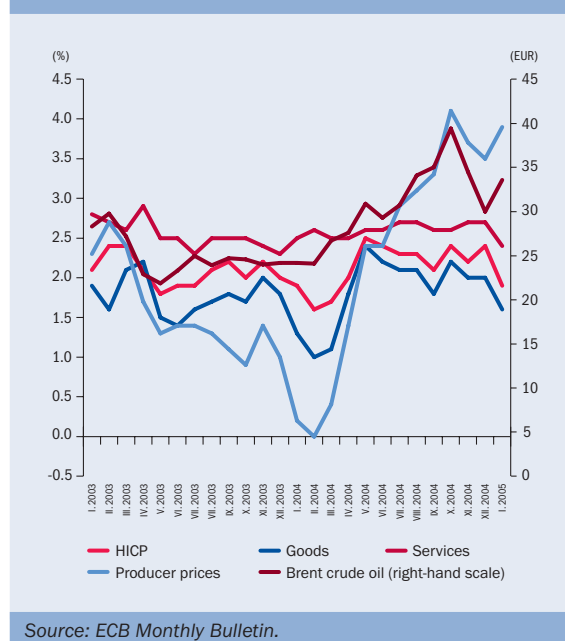
In 2004 annual inflation in the euro area (measured by the HICP) stood at 2.1%, and remained unchanged from a year earlier. The development of inflation over the course of the year was primarily influenced by specific factors. Marked rises in indirect taxes and regulated prices effected a growth in the prices of several items included in the consumer basket, especially in the group of tobacco products and healthcare. Another factor was the growth in global oil prices, which was reflected in higher prices of energy and motor fuels. The higher prices of tobacco, healthcare and energy (which represent approximately 15% of the HICP basket) contributed 1 percentage point to the annual inflation in the euro area in 2004. A factor offsetting the higher input prices particularly in manufacturing was the strong euro and the pressure of competition. Industrial producers' prices, in the conditions with only limited secondary effects of the increase in oil prices, grew by 2.3% on a year-on-year basis (compared to 1.4% a year earlier). Another stabilising factor in euro area inflation in 2004 was the moderate development of wages.

The annual growth of consumer prices (measured by HICP) in the individual countries of the euro area in 2004 ranged from 0.1% (Finland) to 3.5% (Luxembourg). Except Finland, price growth lower than the euro area average was seen also in Belgium (1.9%) and the Netherlands (1.2%). In addition to Luxembourg, inflation above 3% was experienced in Spain (3.3%) and Greece (3.1%). The remaining six countries achieved very similar levels of inflation: Germany and France 2.2%, Ireland and Italy 2.4%, Austria 2.5% and Portugal 2.6%.

The euro area labour market saw no substantial changes in 2004. Employment grew only slightly, connected with the slow reaction of the labour market to the upturn in economic activity. In the development of employment the consequences of the pronounced trend of short-term labour contracts (especially so-called mini-jobs in Germany) were however clearly reflected, which in the previous period of slow growth helped to maintain employment. This is also witnessed by the fact that employment measured by the number of hours worked in 2004 grew faster than the growth of employed persons. From the sectoral aspect a typical declining trend in industry (excluding construction) was seen, accompanied by a growing trend in the services sector. Labour productivity in industry thus increased significantly over the course of the year, helping businesses to raise profitability. Growth in labour productivity across the euro area was relatively high (1.4%), though with marked differences between individual countries (e.g. Germany achieved only 0.1%).

Wage development was moderate. Average wage growth in the euro area was 2.1%, though there were

Chart 3 Price developments in the euro area





marked differences between individual countries (from 0% growth in Germany to approximately 6% in Greece and Ireland). Relatively speaking, wage growth reflected well the development of the labour market in individual countries. Faster wage growth was recorded in those countries where employment growth was faster than the euro area average, while in countries where economic activity was lower, wage growth was substantially slower as well. In 2004 the adverse consequences of fast wage growth accompanied by inadequate productivity growth began to emerge in several countries. Notably, countries where unit labour cost growth exceeded 2% (Italy, Portugal), or as much as 3% (Greece, Spain and Ireland) recorded serious losses in their export performance. Conversely for Germany and the Netherlands, moderate wage development was an important factor in their improved export performance.

The rate of unemployment in the euro area changed only marginally on a year-on-year basis, reaching 8.8%. Nevertheless, significant differences remained among individual countries. The highest rate of unemployment was again experienced in 2004 in Spain (10.8%). Double digit unemployment was registered in Greece, and unemployment rates higher than the euro area average were also seen in Germany and France (9.5%). In Portugal, Italy and Finland unemployment rates ranged between 6.7 and 8.8%. The lowest rates of unemployment, between 4.2 and 4.7%, were recorded in Austria, Ireland, Luxembourg and the Netherlands, where in the case of these last two countries significant year-on-year increases occurred (rising by 0.5 and 0.9 percentage points).

The results of the euro area's external sector for 2004 were characterised by an increase in the current account surplus to EUR 40.2 billion (i.e. approximately 0.5% of GDP), due to the reduction in the income balance deficit and current transfers deficit, and a slight increase in the surplus of services balance. The balance of trade surplus, given the parallel development of export and import values, remained at roughly the same level as in 2003. The balance of trade surplus was the result of very fast export growth in the first half of the year driven by strong growth in foreign demand, more than compensating for the effects of the appreciation of the euro. In the second half of the year, as a result of the decline in exports from the euro area, the high value of imports brought about by the rapid increase in oil prices and partially due to the recovery in domestic demand, the performance of the foreign-trade sector of the euro area weakened substantially.

In 2004 the financial account of the euro area recorded a net inflow of direct and portfolio investment of EUR 18.3 billion, which is less than the figure for 2003. The lower level of financial flows into the euro

area was a consequence of a higher net outflow of direct investment. Portfolio investment recorded a net growth thanks to renewed interest among foreign investors in equity securities in the euro area. Cross-border flows in the framework of debt instruments totalled approximately EUR 200 billion in both assets and liabilities. Euro area investors put around 75% of their funds in foreign bonds and bills, with the remainder going to financial market instruments. Non-residents invested almost exclusively in euro area bonds and bills, they were not attracted to money market instruments given the low level of short-term interest rates in the euro area.

## Monetary policy and public finance

In 2004, following a period of very low interest rates, **the Federal Open Market Committee (FOMC)** reversed the course of its monetary policy, raising the target rate over the course of the year by 125 basic points to 2.25% at the year end. The FOMC's strategy was a clear move away from an accommodative policy (the rate increases were made in five progressive steps of 25 basic points from June 2004), which, while reflecting changes in the US economic outlook, will be supportive in meeting the commitment to maintain price stability. In the fiscal field only a mild correction of the public finance deficit was made, where the deficit reached 4.4% of GDP (compared to 4.6% in the preceding year).

In 2004 **Japan's central bank** continued to base its monetary policy on targeting commercial banks' current account balances held at the central bank. After increasing the target at the beginning of the year, the targeted position remained unchanged over the course of the year. In the fiscal field the government followed the aim of a gradual reduction in the primary deficit by roughly 0.5% per year. The overall public finance deficit fell on a year-on-year basis to 7.0% of GDP (compared to 7.7% in the previous year).

The Governing Council of the **European Central Bank** left its key policy rates unchanged throughout the whole of 2004: the limit rate for main refinancing operations was 2%, the interest rate for deposit facility 1%, and the rate for marginal lending facility 3%. Decisions on setting the ECB monetary policy were relatively complicated, due to the fact that several contrary factors were at work affecting price stability conditions. Besides the changing dynamics of economic recovery in the euro area, which with its gradual attenuation lost the inflationary risk charge, account was taken of the moderate development of wages and the euro's appreciation. On the other hand, the upside risk for inflation stemmed from the growth in oil prices, increase in indirect taxes and regulated prices in the euro area and also from gradual upward



**Chart 4 Public budget balances in the euro area countries (% of GDP)**



pressure on the M3 monetary aggregate, fostered in an environment of low interest rates by high private sector demand for credit, as well as from rapidly growing real-estate prices in several countries.

Fiscal development in the euro area, measured by the reported fiscal balance of the euro area in 2004, recorded a deficit of 2.7% of GDP, the same as in 2003. Despite the unchanged level of the total deficit, the budgetary management of euro area countries was unsatisfactory. Most countries failed to meet the targets set in the updated stability programmes adopted at the end of 2003, or the beginning of 2004, and especially countries with the most severe imbalance were not able to implement their fiscal consolidation plans.

In five countries, the deficit ratio was close to the reference limit of 3% (Portugal, Italy), or exceeded it (Greece, France, Germany). Four countries (Greece, France, the Netherlands, Germany) were in a situation of excessive fiscal deficit. France and Germany reported excessive fiscal deficits for the third year in a row. The fundamental revision by Greece of its statistical data according to ESA 95 methodology showed that the country has been in excessive fiscal deficit since 1997, where in 2004 its deficit reached 6.1% of GDP. Budget surpluses were reported in three countries: Belgium (0.1% of GDP), Ireland (1.3% of GDP) and Finland (2.1% of GDP).

Budgetary management results in the euro area – adjusted for interest payments and cyclical effects – showed that the main factor behind the adverse fiscal position was the worsening in the primary bal-

ance. On average for the euro area this means that the measures adopted during the economic boom at the turn of the millennium for slimming down the revenue income sides of budgets (reduction in direct taxes and social security contributions) were in their scope too excessive to be compensated for by an increase in indirect taxes and consolidation on the expenditure side of budgets, particularly in the period of lower economic growth. The short-term effect of consolidation by way of one-off, or temporary, measures was overestimated. Moreover the three most indebted countries (Belgium, Greece and Italy) in the environment of the euro area's low interest rates benefited from savings in interest expenditures, which partially compensated for the worsening in their primary balance. However, Belgium was the only one of these countries to succeed in substantially reducing its level of debt, with regard to the budget surpluses now reported for a longer period of time.

The sharpened development of public finance in the euro area in 2004 led to an open discussion by the Member States and the European institutions concerning requests to re-evaluate, or loosen some of the rules of the functioning of the Growth and Stability Pact and the application of remedial measures in the case of an excessive fiscal deficit.

### 1.3. Development in the non-euro area Member States

#### EU enlargement: basic institutional contexts

On 1 May 2004 the largest-ever enlargement of the EU took place. Ten countries from Central and eastern Europe and the Mediterranean entered the EU: Cyprus, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia. The national central banks of these countries were integrated into the European System of Central Banks and their governors became full members of the Governing Council of the ECB.

With the entry of these 10 new states to the EU the number of EU countries not belonging to the euro area increased from three (Denmark, Sweden and the United Kingdom) to 13. Denmark and the United Kingdom have an opt-out statute as regards their future membership in the euro area and therefore all the implicit obligations ensuing from the Maastricht Treaty (Treaty on the European Union), the Growth and Stability Pact, and the automatic procedural obligations of European institutions do not strictly apply to them.

The EU enlargement of 2004 occurred in the third stage of its integration process, i.e. in the phase



Table 2 **Compatibility of legal regulations and fulfilment of convergence criteria**

	<b>Legal compatibility</b>	<b>Price stability</b>	<b>Government's budgetary position</b>	<b>Exchange rate</b>	<b>Long-term interest rates</b>
Czech Republic	no	yes	no	no	yes
Estonia	no	yes	yes	no	-
Cyprus	no	yes	no	no	yes
Latvia	no	no	yes	no	yes
Lithuania	no	yes	yes	no	yes
Hungary	no	no	no	no	no
Malta	no	no	no	no	yes
Poland	no	no	no	no	no
Slovenia	no	no	yes	no	yes
Slovakia	no	no	no	no	yes
Sweden	no	yes	yes	no	yes

Source: The European Commission: Convergence Report 2004.

of economic and monetary union. All new Member States are therefore automatically fully subject to the legislation of the Maastricht Treaty and the legal documents connected to it, which reject an opt-out statute. On the contrary, they contain an implicit obligation upon every new acceding state to adopt – following the necessary fulfilment of the nominal macroeconomic stability convergence criteria – the single currency and introduce the euro in their country. As EU Member States that have not (as yet) introduced the single currency, derogation is granted. These Member States are then subject to a regular examination procedure by the European institutions. Correspondingly, under Article 122 (2) of the Treaty, the European Commission and ECB are obliged at two-year intervals to draw up convergence reports, by means of which they inform the Council on the progress of convergence, or on whether the individual countries fulfil the conditions necessary for introducing the euro.

The second line of supervision conducted by the European institutions of the progress of the convergence process and in particular its sustainability following the introduction of the euro are the obligations automatically resulting to the new Member States from their accession to the EU based on their participation in the Growth and Stability Pact. For this purpose Member States with derogation are obliged to submit to the ECOFIN Council and to the Commission medium-term convergence programmes, examined each year and regularly updated. New EU Member States submitted their first convergence programmes in May 2004.

The year 2004 was the year in which the Commission and ECB was required to draw up their convergence reports in the framework of the ordinary prescribed two-year interval. The reports were published on

20 October 2004 and, in addition to Sweden, assessed also the 10 new Member States. The convergence reports of both mentioned institutions state that none of the countries examined fulfilled the conditions in 2004 for introducing the euro.

In 2004 four countries had the status of EU candidate country: Bulgaria, Croatia, Romania and Turkey. In December 2004 the European Council agreed that, with regard to the successful completion of accession negotiations with Bulgaria and Romania, the Treaty of Accession may be finalised with a view to its signing in April 2005. The course of accession negotiations with Croatia will depend on the country's cooperation with the International Criminal Tribunal for the former Yugoslavia. Negotiations with Turkey are continuing under the condition of the adoption of certain legislative standards in the country.

### **General economic and monetary development**

Real GDP growth in those EU countries that are not euro area members was in general relatively strong especially in the group of the Baltic and Central European economies, substantially exceeding the average for the euro area and EU-25. The driving force behind growth was mostly domestic demand, especially for capital investment. Growing business confidence, a high degree of capacity utilisation and a favourable outlook in the field of demand, all contributed to the upturn in investment. In several countries, especially in the Baltic states, private consumption spurred by fast wage growth, improved labour market conditions and fast-growing volumes of consumer lending contributed significantly to the growth in domestic demand. In the first half of the year consumption expenditure was also stimulated especially by ex-

Table 3 **Basic macroeconomic indicators of the non-euro area Member States**

(in %)

	GDP			HICP Inflation			Unemployment rate <sup>1)</sup>			Current account (in % of GDP) <sup>2)</sup>		
	2003	2004	2005 <sup>3)</sup>	2003	2004	2005 <sup>3)</sup>	2003	2004	2005 <sup>3)</sup>	2003	2004	2005 <sup>3)</sup>
<b>Former group</b>												
Denmark	0.4	2.0	2.3	2.0	0.9	1.4	5.6	5.4	4.9	3.3	2.3	2.1
Sweden	1.5	3.5	3.0	2.3	1.0	0.4	5.6	6.3	5.9	5.9	7.8	7.5
United Kingdom	2.2	3.1	2.8	1.4	1.3	1.7	4.9	4.7	4.7	-1.8	-1.9	-2.2
<b>Baltic states</b>												
Estonia	5.1	6.2	6.0	1.4	3.0	3.3	10.2	9.2	8.7	-13.2	-12.9	-12.1
Lithuania	9.7	6.7	6.4	-1.1	1.1	2.9	12.7	10.8	10.2	-6.9	-8.3	-8.8
Latvia	7.5	8.5	7.2	2.9	6.2	5.0	10.4	9.8	9.4	-8.2	-12.4	-10.5
<b>Central European states</b>												
Czech Republic	3.7	4.0	4.0	-0.1	2.6	1.9	7.8	8.3	8.3	-6.2	-5.2	-4.7
Hungary	3.0	4.0	3.9	4.7	6.8	3.8	5.8	5.9	6.3	-8.4	-8.9	-8.7
Poland	3.8	5.3	4.4	0.7	3.6	2.1	19.2	18.8	18.3	-2.2	-1.5	-2.4
Slovakia	4.5	5.5	4.9	8.5	7.4	3.7	17.5	18.0	17.6	-0.8	-3.4	-5.0
Slovenia	2.5	4.6	3.7	5.7	3.6	2.1	6.5	6.0	5.9	-0.4	-0.7	-1.0
<b>Mediterranean states</b>												
Cyprus	2.0	3.7	3.9	4.0	1.9	2.3	4.5	5.0	4.8	-3.0	-5.7	-4.9
Malta	-1.8	1.5	1.7	1.9	2.7	2.4	8.0	7.3	7.1	-5.8	-10.1	-9.9
For comparison												
Euro area	0.6	2.0	1.6	2.1	2.1	1.9	8.7	8.8	8.8	0.3	0.6	0.5
EU-25	1.0	2.4	2.0	1.9	2.1	1.9	8.9	9.0	9.0	0.5	0.4	0.2

Source: European Commission Economic Forecasts Spring 2005.  
1) As percentage of workforce.  
2) Data for the euro area and the EU-25 are adjusted.  
3) Projection.

expectations of price increases due to adjustments in indirect taxes and regulated prices, relating to EU accession and, in some countries, to a continuing loose fiscal policy.

Despite the dominant role played by domestic demand in 2004 in the performance of these economies, an important stimulus for growth in several countries (the Czech Republic, Hungary, Poland as well as Sweden) remained foreign demand and foreign trade performance. In general, the dynamics of exports and imports remained relatively strong. In the new Member States, this was supported by the removal of the remaining barriers with the main foreign trading partners following accession to the EU, higher foreign demand and a favourable competitive position due to increases in productivity.

The acceleration in the rate of economic growth created a favourable environment for the expansion of job opportunities and an improvement in conditions in the labour market. Nevertheless, a significant fall in the rate of unemployment occurred only in the Baltic states, while in many other states the converse occurred, with unemployment increasing, related to ongoing structural changes in the business sector. The

highest rates of unemployment remained in Poland and Slovakia.

The development of prices in the monitored countries in 2004 was markedly diverse. The lowest HICP inflation of around 1%, i.e. substantially below the euro area average, was recorded in Denmark, Sweden, the United Kingdom and Lithuania. In most of the new Member States inflation was at levels exceeding the euro area average, and was higher than in the previous year. Inflation fell only in Slovenia, Cyprus and Slovakia, where however it remained at the highest level from among these countries.

The growth in inflation was influenced by various common factors, such as oil price increases and accession to the EU. However, the influence of higher oil prices on national price indices was of various intensity, where this was conditional upon differences in the structure of consumption, market structures and the energy demand of production. The approaching entry to the EU brought about demand-side pressures in the first months of the year, caused by expected price increases following the entry itself in consequence of the harmonisation of indirect and consumption taxes. The majority of countries saw a concurrent increase in

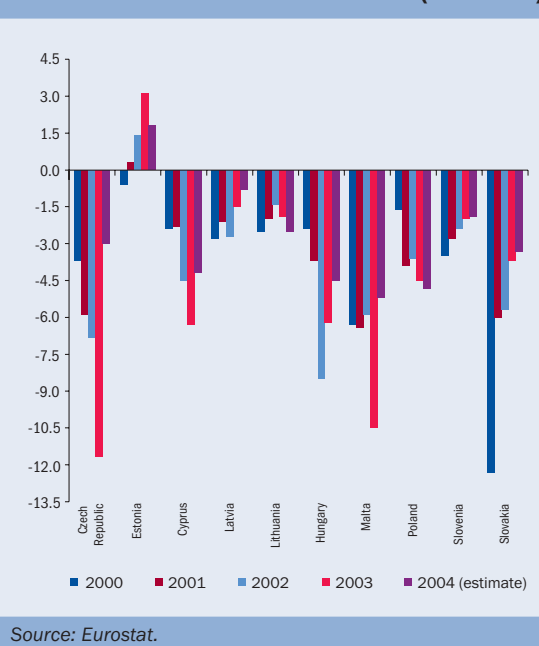
food prices due to their integration into the Common Agricultural Policy and the removal of the remaining trade barriers in this sector. In the second half of the year however the effect of EU entry on price development in the new Member States waned. Of the factors influencing inflation in individual countries in 2004 more specifically, we can identify inflation as having been driven by the rapid economic growth (characteristic for the Baltic states) and increases in regulated prices, while inflation was dampened by a strengthening nominal effective exchange rate (the Czech Republic, Hungary, Slovakia, and in the second half of the year, Poland).

The results of the fiscal sector were essentially in line with the aims of the convergence programmes of May 2004. In most countries they were even better, thanks to a more favourable than expected development of income and mostly also the maintenance of discipline in keeping expenditures at the programme value levels. Hungary's development was worse than its programme value.

Despite the fact that the 2004 budget deficit of general government in ten of the thirteen EU countries that are not members of the euro area improved, development in the fiscal sector is still one of the weakest aspects of the economies of the new Member States. Of them only Latvia in 2004 recorded a fiscal surplus, while a surplus was recorded by Denmark and Sweden. Public finance in the other ten countries ended the year in deficit. Within the standard examination procedures, the ECOFIN Council decided on 5 July 2004 that six countries (the Czech Republic, Cyprus, Hungary, Malta, Poland, Slovakia) were in a situation of excessive deficit. In all cases except Cyprus, the Council permitted a correction of the excessive deficits to be made in the medium term, taking the stated presence of particular circumstances into account. Specifically, the deficit upon entering the EU had been significantly above the reference value, and, in the case of the V4 countries, structural changes accompanying the process of real convergence are underway.

On the external side, outputs measured by the current account deficit were various. Sweden and Denmark, as in preceding years, reported a surplus. Other countries recorded deficits. The highest current account deficits, at a level around 10% of GDP, were recorded in the Baltic states, Hungary and Malta. Relatively speaking, the best results from among the new Member States were seen in Poland, Slovenia and Slovakia. In several countries a year-on-year deepening of the current account deficit was connected with a significant growth in imports in consequence of the recovery in domestic demand and high oil prices. However, in most new Member States the current account deficit also has a significant structural component, in particular a

Chart 5 Public budget balances in the new EU Member States (% of GDP)



Source: Eurostat.

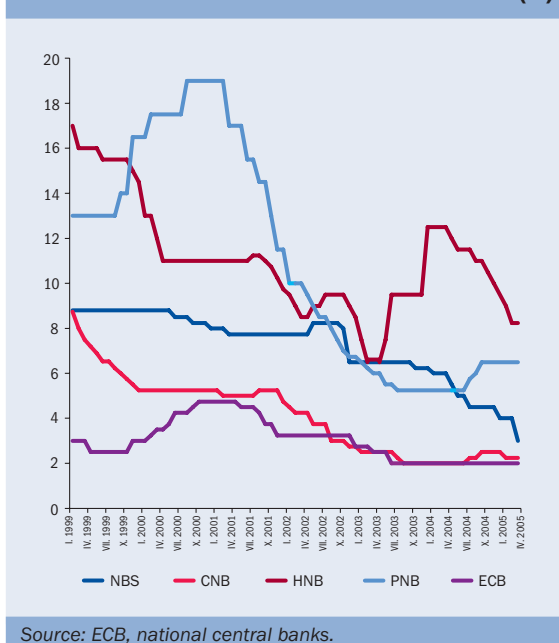
higher demand for investment goods related to the process of real convergence. Moreover, the balance of income deficit began to deepen in several countries, reflecting income connected with the past inflow of foreign direct investment.

The main event in the field of exchange rate policy in 2004 was the joining by Estonia, Lithuania and Slovenia (28 June 2004) Denmark as participant states in the ERM II exchange rate mechanism. All three countries entered the mechanism with a standard fluctuation band of  $\pm 15\%$  around their central parities to the euro, while Latvia and Lithuania kept their currency boards as a unilateral commitment. Participation in ERM II did not bring about any significant tensions on the foreign exchange markets of the participating countries. All four currencies were traded without interruption at the level of their central parities or close to them, while short-term interest rate differentials were also maintained at a low level.

The main monetary policy objective of all non-euro area EU Member States is price stability. The monetary policy and exchange rate regimes of individual currencies essentially remained unchanged in 2004. Six countries applied exchange rate targeting (Denmark, Estonia, Cyprus, Latvia, Lithuania and Malta), four countries inflation targeting (the Czech Republic, Poland, Sweden, the United Kingdom) and three countries combined regimes – inflation targeting taking account of the exchange rate (Hungary), inflation targeting and managed floating (Slovakia), or a two-pillar regime based on currency, real, external, and financial macroeconomic indicators (Slovenia). In various countries however several adjustments were



Chart 6 Key central bank interest rates in V4 countries and the ECB (%)



Source: ECB, national central banks.

made to the monetary policy frameworks, strategically targeted at a gradual preparation of monetary policy for monetary integration. This concerned the circumstances of entry to ERM II, where the Slovenian central bank ended the trend of the tolar's gradual weakening against the euro, and the Latvia's central bank announced a changeover – releasing the lat from the SDR and pegging it to the euro starting from 1 January 2005.

## Development in the V4 countries

In 2004 the fast growth of the **Czech Republic's** economy benefited from the favourable results of the net exports and investment. Despite the strong appreciation of the Czech koruna, and thanks to the removal of the remaining trade barriers upon entry to the EU, the balance of trade improved substantially, where its deficit at 0.8% of GDP was the lowest since 1993. Conversely, in comparison with the preceding year, in consequence of the slower growth in real wages, the growth in private consumption slowed and government consumption on a year-on-year basis fell. Concerning price development, the deflation recorded in 2003 changed to only a moderate inflation, since the growth in prices of raw materials and oil was essentially eliminated by the strengthening of the domestic currency. Approximately half the price growth was due to administrative measures (in particular increase in indirect taxes). Development in the labour market in the conditions of the ongoing restructuring of the business sector and the fast growth in productivity lagged behind the acceleration in economic activity: employment fell and the rate of unemployment remained at

approximately the same level as in the previous year. Favourable results were recorded in developments in public finance. Thanks to the growth in the economy, as well as in consequence of changes in budgetary rules adopted in mid-2004, enabling the carry-over of unused funds into the future year, the general government achieved a budget deficit of 3% of GDP, which is substantially less than the forecasted figure in the convergence programme (5.2% of GDP). After assessing the development of prices and uncertainties in the fiscal sector, the Czech central bank raised its key interest rate in June 2004 (the first time since July 2001) by 25 basic points to 2.50%.

The relatively high rate of economic growth achieved by **Hungary** in 2004 was the result of a significant acceleration of economic activity in the second half of the year. Compared to the previous year, growth took on a more balanced nature. Whereas growth in private consumption slowed by almost half, growth in investment, and especially in exports, accelerated. Hence the external sector contributed positively to GDP growth. The main factor in this shift was an attenuation of the disproportionately fast growth in real wages in the public sector (which on an annual average for the three preceding years had exceeded 10%). The development of prices in the first half of the year recorded a growing trend, caused largely by administrative adjustments to prices and taxes, and in the second half of the year, inflation declined, thanks in particular to the strong appreciation of the forint. Development in the labour market recorded a slight fall in employment. The rate of unemployment on a year-on-year basis remained essentially unchanged, at 5.9%. Public finance ended the year in a deficit of 4.5% of GDP, which is 1.7% less than in 2003. Over the course of 2004 the Hungarian central bank, taking the improving inflation outlooks into account, reduced its key interest rates in total by 300 basic points to 9.5%.

Real GDP growth in **Poland** reached 5.3% in 2004. As in the previous year, economic growth was driven by exports, whose performance was not weakened despite the significant appreciation of the Polish zloty over the course of the year. In domestic demand, after a three-year fall, a reversal in the form of a strong recovery in investment was recorded, while household consumption grew only slightly, with regard to the weak growth in real income and persistent high unemployment. However, the situation in the labour market began to improve slightly: employment stopped falling and the rate of unemployment decreased slightly. In price development, a significant acceleration in inflation was recorded, brought about in particular by growth in food and oil prices, as well as by an increase in indirect taxes, connected with commitments related to entry to the EU. In 2004, the fiscal deficit represented 4.8% of GDP, which is sub-



stantially less than the budget forecast. The improved public finance management was primarily the result of a substantially better than expected performance in the field of social security. In June, consumer price inflation exceeded the upper boundary of the central bank's target interval ( $2.5 \pm 1\%$ ), and remained above this boundary for the rest of the year. In the short period from June to August, in order to eliminate the secondary effects of the acceleration in inflation, the Polish central bank raised its key reference rate by 125 basic points to 6.5%.

**Slovakia** again in 2004 recorded the fastest growth rate among the V4 countries, with real GDP growing by 5.5%. Here, the driving force behind the growth changed completely, where the only source for this growth became domestic demand, while the contribution of the external sector was negative. Exports recorded double-digit growth, though imports grew faster, driven by high investment as well as private consumption demand. The fast growth in private consumption was influenced by the favourable growth in real wages and lower income taxes. The growth in consumption also benefited, in relation to the tax reform and the permitted transfer of the payment of several components of employee remuneration from 2003 into 2004. The current account deficit

deepened slightly on a year-on-year basis as a result of higher imports, but also due to the substantial growth in the level of repatriated profits. The labour market was characterised by a significant slowdown in the growth of employment, which was connected with, among others, the continuation of cost-saving measures in the public sector. The rate of unemployment following a strong fall in 2003, thanks to reform measures, again grew slightly on a year-on-year basis. In price development the trend of falling inflation continued, where its persistently high rate is connected with the administrative adjustments, primarily the deregulation of prices and the increase in indirect taxes. Public finance in 2004 absorbed a large package of the government's reform agenda, which was reflected on both the side of budget income and budget expenditure. Tax reform introduced a uniform tax rate of 19% for personal and corporate income tax as well as value-added tax. At the same time several reforms in the social sphere entered into force. The recorded budget deficit of 3.3% of GDP was lower than planned, however, the result was considerably influenced by delaying expenditures linked to co-financing from EU funds. The National Bank of Slovakia, with regard to the continuing appreciation pressures on the Slovak koruna, reduced its key interest rates over the course of the year in total by 200 basic points.

