Chapter 2

Accession Countries Macroeconomic Outlook and Forecasts

Annex

Cyprus

Macroeconomic Overview and Outlook

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

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

Increased geopolitical tensions, the war in Iraq, and the change of government following the presidential election in February hurt the economy of Cyprus early this year. Tassos Papadopoulos swept the presidential election by winning 51.5% of the votes, while his closest rival, incumbent Clerides, attracted 38.8%. The election results raised further doubts about whether an agreement in unifications talks can be reached as Papadopoulos' victory was achieved on the back of a campaign that criticized the UN-backed peace plan for giving away too much to the Turkish Cypriots. Given Turkish Cypriot leader Rauf Denktash's criticism and opposition to the UN-brokered plan, an immediate solution to the island's decades-long division became even more unlikely and the bilateral talks collapsed in early March. Greek Cypriots have shown a desire to revive the peace talks, but finding a solution to Cyprus' division problem has become less and less likely under the current leadership of the Turkish Cypriot breakaway state. Added pressure from the United States and the UN could once again bring the two sides back to the negotiating table; but finding a solution acceptable to both the current Turkish and Geek Cypriot leadership prior to the country's accession to the EU next spring has become increasingly unlikely.

The economy of Cyprus weakened in 2002, as a result of a slow recovery in the global economy, a decline in consumer confidence, and a drop in tourism revenues. A drop in tourism and export revenues contributed to the country's weaker growth performance last year. Tourism revenues declined by 11.0% in 2002, hurt by a decline of 10.3% in tourist arrivals, and remained weak in the first four months of 2003, decreasing 13.2% compared to the year-earlier period. Nonetheless, the economy still managed to grow by an estimated 2.0% last year. Inflation also remained low, which enabled the central bank to lower interest rates and provide additional economic stimulus through more aggressive monetary easing. The country's economy might have suffered another setback earlier this year as increased geopolitical tensions and the war in Iraq continued to take their toll on tourism, but the quick success of the U.S.-led military campaign in Iraq should boost the country's economic performance later this year and help the economy remain on a growing path.

Cyprus' economic officials expect the country's economic growth to accelerate in 2003 and expand by 4.2%. While lower interest rates and an anticipated surge in tourist arrivals may indeed spur an economic expansion this year, the country's outlook for 2003 remains uncertain. A prolonged slowdown of the tourism sector could spell trouble for the economy of Cyprus and hurt the country's growth prospects. Global Insight therefore expects the economy to fall somewhat short of official projections. Growth in 2003 will be dampened by several factors: the government's fiscal austerity measures aimed at meeting requirements for EU membership; a prolonged overall slowdown in world economic growth (at least in the first half of the year) that is likely to affect tourism and trade; the effects of the ongoing war on terrorism and the aftermath of the war in Iraq on tourism receipts; and downward pressure stemming from the

uncertain stock market. Annual GDP growth should average around 3.3% over the medium term—significantly below the 4.4% level that was recorded in the 1990s.

Progress in Meeting Maastricht Criteria for EMU Accession

In examining the specific Maastricht criteria for accession to the Eurozone, it is safe to assume that Cyprus should be able to meet all the criteria by 2006 without any special assistance from the EU. Cyprus' macroeconomic policy has generally been prudent for much of the last 20 years. Occasionally, fiscal policy has become too loose, but the government has generally been successful in tightening monetary policy to reduce excessive liquidity and inflation. Prior to last year, the government's general fiscal deficit had been on a downward trend—declining to 3.9% of GDP in 1999, 2.7% in 2000, and 2.6% in 2001. The fiscal gap is currently estimated to have increased to 3.6% of GDP in 2002. Total public debt, based on the Maastricht definition, was about 60% of GDP in 2000, compared with 52% in 1995, 53% in 1996, 58% in 1997, 59% in 1998, and 62% in 1999. The debt ratio is estimated to have fallen below the European Union's 60% entry requirement in 2001, but to have increased slightly in 2002, as the fiscal deficit also edged up. Cyprus' public debt currently stands at 62.7% of GDP, slightly above the Eurozone target of 60%.

The country's previous government revealed a new tax reform package in November 2001, aimed at meeting key European Union requirements. The island will drop its preferential tax treatment for offshore companies as it prepares to join the EU. Another provision in the tax package called for a gradual increase in the value-added tax to 15% and an across-the-board corporate tax of 10%. The VAT was increased to 13% in the summer of last year and then to the targeted 15% as of January 1, 2003. Tax issues have been considered one of the most difficult areas in EU membership negotiations. The consolidated budget deficit stood at 215.6 million pounds in 2002. The deficit as a percentage of GDP increased from 2.7% in 2001 to 3.6% in 2002. The state of public finances looks set to worsen further this year, as the 2003 fiscal deficit target was recently revised upward to 5.3% of GDP. The new government, which emerged following the presidential election in February, has accused the previous cabinet of presenting public finances in a better light than their actual state, as well as leaving the new center-left government with shallow pockets and hidden bills. Despite running deficits in the past couple of years, the country expects to improve cost controls and introduce more efficient tax collection methods, which would enable Cyprus to produce a break-even budget by 2006, the year it aspires to join the European Monetary Union. The budget excludes the breakaway northern part of the island.

Inflation in Cyprus may exceed EU levels in 2003 due to increases in certain taxes, which have already pushed average year-on-year CPI inflation to 5.0% through the first five months of this year. **Cyprus, however, should have no problem meeting the Maastricht criterion on inflation for EMU membership by its planned date for joining the monetary union in 2006. The same is true of interest rates.** Interest rate movements in Cyprus are already driven by measures taken by the ECB, and commercial banks have even begun to design plans for introducing the euro as an official currency. While current interest rates are somewhat higher than those in the West, the trend is steadily downward.

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

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	8.9	9.0	9.9	12.8	14.7	16.0	17.1	18.2
Per Capita GDP	*Current Dollars*	11822	11445	12404	15987	18165	19533	20889	21969
GDP, Growth Rate	*Percent*	1.9	4.0	2.0	3.3	3.7	3.3	3.2	3.2
Average Annual Inflation	*Percent*	3.0	2.0	2.8	4.7	3.0	2.2	2.1	2.1
Population, End-Year	*Thousand People*	750	790	800	800	810	820	820	830
Unemployment Rate	*Percent*	NA	NA	NA	NA	NA	NA	NA	NA
Exchange Rate, End-Year	*Cyprus Pound/$*	0.47	0.65	0.55	0.47	0.46	0.43	0.47	0.43
Consolidated Budget Balance	*% of GDP*	-3.4	-2.7	-3.6	-5.3	-3.6	-3.2	-3.0	-1.8
Net Foreign Debt	*Percent of GDP*	NA	NA	NA	NA	NA	NA	NA	NA
Exports	*Million Dollars*	1391	976	843	891	941	991	1043	1093
Imports	*Million Dollars*	3983	3938	4083	4343	4587	4830	5071	5314
Current Account Balance	*Percent of GDP*	-5.3	-4.4	-5.2	-4.8	-4.2	-4.0	-4.0	-4.0

Czech Republic

Macroeconomic Overview and Outlook

The Czech Republic is among the largest and richest of the EU accession countries. With nominal GDP of $56.7 billion in 2001 and a population of 10.2 million, the country ranks second only to Poland, although Hungary is close behind on both counts. On a per capita basis, only Slovenia has a higher level of GDP. In comparison with existing EU member states, however, the Czech economy fares far worse. While the country falls in the middle of EU states in terms of population, with approximately the same number of inhabitants as Belgium, the Czech Republic is less than one-fourth the size of Belgium in terms of GDP. In comparison with larger EU countries such as France, the Czech Republic has just 17% of the population and 4% of GDP. Although Czech GDP per capita is currently far below West European levels, convergence has gone much farther when taking purchasing power into account. At purchasing power parity, Czech GDP reached 57% of the EU average in 2001.

The Czech Republic comprises some of the historically wealthiest and most industrialized territories in Europe. Although many local firms lost their competitive edge during 40 years of communism, the country has retained certain advantages in terms of recognizable brand names and manufacturing tradition. Moreover, Prague has been revitalized since 1989, attracting foreign tourists and businessmen alike. Since 1990, the structure of the Czech economy has changed considerably, as industry has declined in importance, losing ground to trade and other services. By 2002, industry accounted for less than one-third of GDP, while domestic trade rose to 17% of the total. Sectors such as transport and communications, banking, and other market services have also grown in significance.

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

Despite such setbacks, the Czech Republic has had no problems attracting foreign direct investment. Given its geographical location next to Germany and Austria, combined with low wages and a strong manufacturing tradition, the country is seen by foreign firms as one of the most attractive in the region. The inflow of FDI has been especially rapid since 1999, as the country nears accession to the EU. By the end of 2002, the Czech Republic had brought in nearly $37 billion worth of FDI, compared with $39 billion for much-larger Poland. That investment will provide the basis for continued rapid increases in industrial production and exports in the future. By November 2002, foreign-controlled firms accounted for nearly one-half of industrial sales and more than two-thirds of total exports. Still, as income levels in the Czech Republic approach those in Western Europe, the country will face the challenge of attracting investments that are not based on the wage differential.

Although the Czechs began the post-communist transition with a very low level of foreign debt and state budgets that were close to balance, fiscal policy has recently become the country's biggest concern. That is partly because of the enormous cost of bank restructuring that resulted from the poor oversight of the banking sector through 1997; however, mandatory spending on areas such as pensions has also been rising rapidly given the aging population. While the Social Democrats have pushed forward with key reforms in the corporate sphere since taking office in 1998, they have shown much less courage in fiscal and social policy. In consequence, although the Czech Republic's foreign debt has remained fairly stable since 1996, domestic debt has been soaring.

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

Progress in Meeting Maastricht Criteria for EMU Accession

With the exception of the fiscal deficit, the Czech Republic will easily be able to meet all of the Maastricht criteria for accession to the Eurozone by 2006. According to ESA methodology, the Finance Ministry is projecting a public finance gap of 6.3% of GDP in 2003. In the absence of fiscal reform, that deficit is set to rise to a high of 7.2% of GDP by 2004 before falling back to 6.6% in 2006, far above the 3.0% limit for entry into the Economic and Monetary Union (EMU). Considerable debate emerged over fiscal reform during coalition negotiations following the June 2002 elections. While the center-right parties wanted to take the needed steps to meet the Maastricht criteria by 2006, the Social Democrats were more reluctant. As a result, the coalition agreement signed by the current ruling parties planned for only limited reform, stating that the public finance deficit may reach 4.9-5.4% of GDP by 2006. The Finance Ministry, however, later came to realize the importance of more responsible fiscal policy, putting forward two alternative proposals in December 2002 aimed at bringing down the consolidated budget deficit. After considerable delay, the government finally approved a blueprint for finance reform on June 23 that would bring the deficit to 4.0% of GDP by 2006. In order to reach that goal, the cabinet is proposing an increase in excise duties and value-added tax and a gradual decline in corporate taxes, with personal income tax remaining constant. Serious tensions are expected to emerge within the ruling coalition when the parliament discusses the reforms later this year, as some Social Democrats have complained that the party is moving away from its roots by disregarding the complaints of trade unions. Meanwhile, many Czech economists as well as the Czech National Bank (CNB) have criticized the government's plan as not moving quickly enough since the country would not be able to join the EMU until 2008 at the earliest. Prime Minister Vladimir Spidla has been quoted as saying that the country will not join until as late as 2011. In its Draft Accession Strategy that was issued in late December, the CNB argued that the Czech Republic should be prepared to adopt the euro by 2007. Even if Prague should choose not to join the EMU in that year, bank officials have stressed that a decline in the public finance deficit is required to support sustained economic growth.

Despite the Czech Republic's growing fiscal deficits in recent years, public debt remains far below the 60% of GDP level required for entry to the EMU. In the first quarter of 2003, government debt reached 429.1 billion koruna, up from 395.9 billion koruna at the end of 2002 and 358.4 billion koruna in March 2002. By December 2003, total government debt is projected to increase further, to over 500 billion koruna. Although the rapid rise is worrying, that figure is still equal to only about 20% of projected GDP. Other criteria are unlikely to pose an obstacle to the country's entry to the Eurozone. Given the very low rates of inflation recorded in 2002 and the first half of 2003, the Czech Republic is not expected to have any problem meeting the Maastricht requirements in that area. The same is true of interest rates, particularly considering that Czech rates have been more or less on par with Eurozone levels since July 2002.

Assuming that the current government stays in power until the next elections, expected in June 2006, we consider it highly unlikely that Prague will meet the Maastricht criteria by that year due to its reluctance to tackle the fiscal deficit. Initially, the Czech Republic was the only accession country that was not planning to meet the requirements for entering the EMU by 2006. More recently, however, Poland and Hungary have also put off their expected entry date. Clearly, if all of the others were ready to adopt the euro by 2006, that would put the Czech Republic in a difficult position. However, given the likelihood that some countries in the region will decide to postpone entry for a few years as they too get their fiscal positions in order, the Czechs may be able to avoid negative consequences of the delay.

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	57.7	57.2	69.5	85.5	95.9	110.1	122.6	129.9
Per Capita GDP	*Current Dollars*	5599	5603	6813	8389	9419	10821	12077	12819
GDP, Growth Rate	*Percent*	4.3	3.1	2.0	2.7	3.9	4.6	4.6	4.0
Average Annual Inflation	*Percent*	8.8	4.7	1.8	0.6	2.9	2.4	2.1	1.9
Population, End-Year	*Thousand People*	10312	10206	10203	10193	10183	10173	10152	10132
Unemployment Rate	*Percent*	3.5	8.5	9.2	10.1	9.6	9.2	8.7	8.4
Exchange Rate, End-Year	*CZK/$*	27.4	36.3	30.1	27.0	25.2	23.9	23.0	22.7
Consolidated Budget Balance	*% of GDP*	-0.3	-5.2	-5.1	-6.3	-5.5	-4.4	-4.0	-3.2
Net Foreign Debt	*Percent of GDP*	8.3	2.3	-4.8	-3.4	-3.6	-2.7	-1.1	0.1
Exports	*Million Dollars*	22482	33397	38402	48678	51439	54523	57874	61323
Imports	*Million Dollars*	27969	36472	40757	51630	54735	58244	62002	65613
Current Account Balance	*Percent of GDP*	-7.4	-5.7	-6.5	-5.6	-5.2	-4.7	-4.3	-3.9

Estonia

Macroeconomic Overview and Outlook

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

Estonia is quickly developing a fairly sophisticated, balanced economy. Manufacturing is the largest sector in Estonia, accounting for 18% of GDP. But services account for about half of the economy. The transport and communications sector represents 16% of GDP, domestic trade, 15%, and real estate and other business services, 12%. The country has successfully installed a business-friendly climate, including zero taxation on companies' reinvested profits. In fact, Estonia is frequently rated one of the most liberal countries in the world. To a large extent, economic stabilization has been achieved in Estonia. Fiscal policies have been relatively tight, although there is room for improvement, and the pension system requires further reform. A currency board, introduced in 1992, has helped bring inflation under control and given credibility to the kroon. The banking system, largely in foreign hands, is healthy. The privatization process can be considered completed for all intents and purposes. One-third of Estonian companies now have some form of foreign equity participation. These companies account for half of exports. Finland and Sweden are the biggest investors in Estonia. As a small, open economy, Estonia will remain vulnerable to external forces, such as the 1998 Russian crisis and the current global economic slowdown, but the sound management of both domestic and external balances leaves the country well placed to quickly adapt to crises.

In the past, Estonia's very large current account deficits have been a primary threat to its economy. The country recorded current account deficits of over 12% of GDP in 1997 and nearly 10% in 1998. For the following three years, it did better at controlling the deficit, keeping it around 6% of GDP. In 2002, however, the current account deficit jumped in tandem with the foreign trade deficit, to $801 million, or 12.5% of GDP. Assuming that the government maintains a responsible fiscal policy, we forecast that the deficit should stabilize at around 5% of GDP in the medium term. From the time of Estonia's independence through 2001, more than 70% of the current account deficit was financed by long-term capital flows, primarily direct investments and medium- to long-term bank loans. But with the completion of the privatization process, foreign direct investment has begun to slow, and policymakers will need to be more attuned to control of the current account.

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

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

Progress in Meeting Maastricht Criteria for EMU Accession

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

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

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

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	4.4	5.5	6.4	8.3	9.3	10.5	11.8	13.1
Per Capita GDP	*Current Dollars*	2975	4054	4729	6127	6912	7871	8853	9896
GDP, Growth Rate	*Percent*	3.9	5.0	5.8	5.2	6.2	6.1	6.1	6.0
Average Annual Inflation	*Percent*	23.1	5.8	3.6	1.7	3.3	3.7	4.1	3.9
Population (end-year)	*Thousand People*	1462	1361	1356	1349	1342	1336	1329	1322
Unemployment Rate	*Percent*	10.0	12.6	10.3	9.3	8.8	8.6	8.4	8.2
Exchange Rate, End-Year	*EEK/$*	12.4	17.7	14.9	13.6	13.0	12.8	12.6	12.5
Consolidated Budget Balance	*Percent of GDP*	-1.9	0.3	1.1	0.3	-0.2	-0.2	-0.2	-0.2
Net Foreign Debt	*Percent of GDP*	7.3	22.9	27.4	29.1	31.2	30.7	30.4	30.3
Exports	*Million Dollars*	2050	3305	3439	4250	4763	5257	5741	6249
Imports	*Million Dollars*	3180	4290	4809	5885	6474	7078	7623	8220
Current Account Balance	*Percent of GDP*	-9.2	-6.1	-12.5	-11.7	-8.9	-6.4	-5.9	-5.6

Hungary

Macroeconomic Overview and Outlook

Generally perceived to be one of Central Europe's most advanced economies, Hungary is relatively small in terms of GDP and population when compared with some of the larger EU countries. In 2002, Hungary's GDP was valued at just $60.6 billion at the average market exchange rate, slightly less than that of the Czech Republic, just above one-quarter of the size of the Polish economy, and only 4.5% of France's GDP. In terms of population, Hungary at 9.9 million is similar in size to the Czech Republic and falls roughly in the middle of EU states. Hungarian GDP per capita measured at the purchasing power parity exchange rate amounted to $11,262 in 2001, trailing Slovenia by a substantial margin and comparable to that of the Czech Republic. The economic gap between the EU average and Hungary is still quite sizeable, despite several years of impressive growth in Hungarian GDP, particularly in the late 1990s.

Hungary enjoyed a head start compared to other Central European economies in transition, as the Communist government in the 1980s had already installed some basic features of a market-oriented economy. In the early stages of transition, the Hungarian government offered domestic businesses and foreign investors alike exceptionally attractive conditions for locating their operations in Hungary, including, among other features, tax incentives and special economic zones. Attracted by these offers, the highly qualified work force, aggressive privatization of state property and the proximity to Western Europe, investors poured into Hungary in the early 1990s, making it by far the most popular country in which to invest early in the transition. On average, Hungary has attracted $2 billion in net FDI annually during the last 12 years. Most importantly, Hungary attracted investments into high-valued industries such as electronics and optical equipment, the automotive industry and data processing. Major multinational corporations such as IBM, Phillips and Suzuki build greenfield plants in the country with the aim of exporting most of their production to developed countries utilizing their internal corporate distribution channels. As of 2002, 45 out of the 50 largest multinational corporations were present in Hungary. In the process, Hungary has become the most economically integrated with the EU and the most export-oriented economy in the region. In the course of those developments, the portion of the country's GDP generated by the service sector grew to over 50% in 2001. More than 72% of total industrial sales are generated by companies at least partially owned by foreign investors.

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

The last years of the1990s, under a ruling coalition of the Hungarian Socialist Party (MSzP) and the Alliance of Free Democrats (SzDSz), were characterized by strong export performance and an investment-driven expansion that featured double-digit annual increases in exports and ongoing modernization of the Hungarian industrial base. This government also accelerated the liberalization of the local energy markets. A side effect of those changes and the less restrictive monetary policies was an inflation rate that remained higher than in the majority of the other EU candidate countries. In order for Hungarian exports to remain competitive internationally, the central bank in cooperation with the government employed a crawling-peg exchange rate regime that adjusted the reference rate for the forint downward in line with inflation. This policy was abandoned in May 2001 in favor of an ERM-2 type mechanism featuring a plus/minus 15% fluctuation band around a reference rate against the euro. Since the introduction of the new regime, the forint has appreciated very strongly against both the dollar and the euro. When combined with the slowdown in economic activity in its main export markets in the EU, Hungarian export growth slowed considerably over the last two years, dragging down industrial output as well. The expansionary fiscal policy and exceptionally strong growth in private consumption and construction activity led to a substantial widening of the current account deficit.

Despite continued weak external demand, Hungary's year-on-year economic growth accelerated throughout 2002, and managed full-year GDP growth of 3.3%. This followed 3.8% GDP growth in 2001. While the Hungarian economy is still experiencing problems adjusting to the prolonged slowdown in its major export markets in the European Union, the

worst seemed to be over. Unfortunately, the weaker-than-expected performance the construction sector and lower investment spending reduced the year-on-year GDP growth in the first quarter of 2003 to only 2.7%.

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

Progress in Meeting Maastricht Criteria for EMU Accession

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

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

The relatively loose fiscal policy and high levels of inflation (at 4.8% y/y in December 2002, Hungary's inflation was the second-highest among all EU accession countries) leave little room to maneuver for the central bank's monetary policy. The bank has attempted to target inflation and stabilize the exchange rate of the forint with rather mixed results. The January 2003 interest rate cuts showed vividly that in order to prevent an excessive appreciation of the forint, the central bank had to compromise and permit an overall loosening of monetary conditions. In turn, the questionable decision to devalue the forint's parity rate in June to maintain export competitiveness forced the central bank to hike the interest rates by a cumulative 300 basis points and left the credibility of the central bank in tatters. If the wage growth in the private sector is not curtailed and the forint remains rather weak, inflation will be resilient in 2003. As a result, the convergence of inflation and interest rates to the Maastricht criteria might take longer than originally expected. We expect that following a temporary setback in January-July 2003, the forint will resume appreciating against the euro through the medium term.

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	44.9	51.3	60.6	75.8	83.9	95.2	104.8	112.8
Per Capita GDP	*Current Dollars*	4409	5045	5971	7482	8305	9447	10438	11271
GDP, Growth Rate	*Percent*	1.3	3.8	3.3	3.2	3.9	3.7	3.3	3.3
Average Annual Inflation	*Percent*	23.6	9.2	5.3	4.4	4.1	3.6	3.4	2.8
Population, End-Year	*Thousand People*	10174	10175	10154	10134	10104	10074	10044	10012
Unemployment Rate	*Percent*	10.5	9.2	9.0	8.8	8.6	8.4	8.6	8.8
Exchange Rate, End-Year	*HUF/$*	164.9	279.0	225.2	220.2	207.0	198.5	193.6	192.4
Consolidated Budget Balance	*% of GDP*	-2.9	-3.0	-10.1	-6.3	-5.2	-4.5	-4.1	-3.6
Net Foreign Debt	*Percent of GDP*	38.8	44.6	48.3	41.8	37.5	32.5	31.4	30.6
Exports	*Million Dollars*	13145	30497	34336	38628	42414	46485	50111	53869
Imports	*Million Dollars*	16209	33680	37611	42688	46744	50483	53765	57260
Current Account Balance	*Percent of GDP*	-2.7	-3.4	-4.4	-4.9	-4.6	-3.8	-3.1	-2.7

Latvia

Macroeconomic Overview and Outlook

Latvia's economy is tiny compared to most EU and EU accession countries. While Latvia's $7.5 billion GDP in 2001 was similar in size to Iceland's, it was only 0.6% the size of France's economy. Latvia's population is also relatively small, with only 2.3 million residents at the end of 2002. That is 3.9% of France's population: given the much smaller ratio when comparing GDP, it is clear that Latvia's GDP per capita is well below West European levels. Despite recent rapid growth, Latvia remains one of the poorest EU applicant countries. In 2001, according to Eurostat, Latvia's per capita GDP was 7,700 euro in PPS terms. That was the lowest of the 10 countries slated for membership in 2004. The average EU per capita GDP was 23,200 euro. Because of Latvia's small size and the open nature of its economy, it is inordinately vulnerable to external shocks.

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

If the government is to sustain its successes to date, it will need to adopt more restrictive fiscal policies in order to decrease the current account deficit. In the past, Latvia's very large current account deficits have been a primary threat to its economy. In 2000, the current account deficit narrowed to 6.9% of GDP, compared with 9.8% of GDP in 1999 and 10.7% in 1998. But in 2001 it re-expanded, to 9.6% of GDP ($732 million). It narrowed modestly in 2002, but began expanding again in early 2003. Going forward, the Stability and Growth Pact should help ensure that Latvia implements sounder fiscal policy, which in turn will keep current account deficits in check. Latvia is also expected to benefit from large transfers of funds from the EU, higher inflows of foreign direct investment (particularly as corruption becomes less of an issue), and increased trade with Western Europe. However, the narrower current account deficits projected over the next few years are still quite large, and can only be sustained if the authorities are able to conduct policies that encourage continued large inflows of capital.

Net foreign debt is growing, although it is not yet problematic. From $3,181 million in 2001, we project an increase to $6,109 million in 2007, or 44% of forecasted GDP. We project that net foreign debt will continue rising for several years in absolute terms as Latvia completes the privatization process and becomes more dependent on loans to finance its current account deficits. The biggest risk to Latvia's relatively low level of foreign debt would come from continued growth of the country's current account deficit. With the slowing of foreign direct investment, an increase in foreign loans will be necessary to finance future deficits; the larger the deficits, the more foreign debt will be incurred. If foreign debt is seen to be growing too fast, it might affect Latvia's creditworthiness, increasing the cost of borrowing and hence limiting the possibilities for financing. However, we do not foresee a worrisome rise even in the long run.

As the economy picks up, we project that the unemployment rate will trend downward. In the medium term, the baseline forecast calls for increasing levels of output for several years. Since much of Latvia's industry is still relatively labor-intensive, this will require additional labor inputs. With a shrinking labor force, this will translate into a noticeable reduction in unemployment rates. By 2007, we project that the rate of registered unemployed will fall to 6.9% of the labor force. This takes into account the fact that the retirement age is being raised, which will serve to increase the size of the labor force and slow the decline in the unemployment rate. However, the share of unemployed who do not bother to register at all is estimated at 50% of the registered unemployed, since unemployment benefits are fairly low. Also, regional disparities persist: in many of the eastern counties, even the headline unemployment rate is well above 20%, while in Riga it is under 4%.

Progress in Meeting Maastricht Criteria for EMU Accession

Latvia should be able to meet all the Maastricht criteria for accession to the Eurozone by 2007 without any special assistance from the EU, although constant pressure will be required to convince Latvian officials to maintain disciplined fiscal policies. However, this issue has more to do with political will than with structural or financial constraints. For example, the 2002 budget targeted a deficit of 2.5% of GDP, well above the 1% deficit that had been agreed on with the IMF: The IMF expressed concern over the 2002 budget, saying it implied a substantial fiscal loosening and could exacerbate pressure on the current account. The Fund recognizes the need to increase expenditures associated with EU and NATO accession and supports the Latvian authorities' desire to reduce the tax burden, but also deems it necessary to improve expenditure prioritization, enhance tax administration, and implement more public sector reforms. **For a small, open country with a dangerously large current account deficit, a budget deficit of 3% of GDP, as allowed for by the Stability and Growth Pact, is too large.** Yet as expenditures grow in response to EU harmonization requirements and as Latvia strives to catch up with the standard of living in Western Europe, **Latvian authorities may be tempted to continue current fiscal habits, creating budget deficits that are acceptable under the pact's guidelines but that are not conducive to sustained macroeconomic balance.**

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

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

We believe that Latvia will maintain its present peg to the SDR until EMU membership requires a change in exchange-rate regimes. Reserves are sufficient, and the country's central bank has a high degree of stability, credibility, and independence. In January 2003, Prime Minister Repse said that Latvia wanted to enter ERM-2 upon EU accession in 2004, and adopt the euro by 2006. **We believe that Latvia will enter ERM-2 in 2004, and adopt the euro by 2007**.

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	5.1	7.7	8.4	8.8	9.8	11.1	12.5	13.9
Per Capita GDP	*Current Dollars*	2064	3239	3583	3773	4234	4849	5463	6120
GDP, Growth Rate	*Percent*	3.7	7.9	6.1	6.2	6.2	6.1	6.0	5.9
Average Annual Inflation	*Percent*	17.6	2.5	1.9	2.9	3.8	4.2	4.4	4.1
Population (end-year)	*Thousand People*	2443	2346	2331	2315	2298	2282	2266	2251
Unemployment Rate	*Percent*	7.2	7.7	7.6	7.4	7.3	7.2	7.0	6.9
Exchange Rate, End-Year	*Lats/$*	0.556	0.638	0.594	0.643	0.630	0.615	0.606	0.601
Consolidated Budget Balance	*Percent of GDP*	-1.1	-2.1	-2.8	-2.8	-2.5	-2.0	-1.5	-1.5
Net Foreign Debt	*Percent of GDP*	18.9	41.5	45.8	48.8	48.4	46.6	45.3	44.0
Exports	*Million Dollars*	1443	2001	2280	2861	3160	3471	3794	4127
Imports	*Million Dollars*	2320	3506	4041	5231	5739	6253	6756	7290
Current Account Balance	*Percent of GDP*	-5.5	-9.6	-7.8	-8.6	-7.4	-6.5	-5.7	-5.1

Lithuania

Macroeconomic Overview and Outlook

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

After experiencing some of the largest output declines among the former Soviet republics in 1992-93, the Lithuanian economy had grown for four years prior to 1999. Monetary and fiscal policies were tight and improving. Lithuania still lagged Estonia and Latvia in the privatization process, but in most other areas it had made rapid progress. But in 1999-2000, the country's economy suffered significantly more than Estonia's or Latvia's in the aftermath of Russia's financial crisis, as more critical fiscal and external imbalances plus less progress in restructuring limited Vilnius' response. Lithuania's biggest risks are its current account deficits and its dependence on the volatile Russian economy. Sweden is the largest foreign investor, with 17% of the total, followed by Denmark (16%).

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

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

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

The headline unemployment rate fell from 12.9% in the first quarter of 2002 to 12.0% in the first quarter of 2003. In the medium term, unemployment should continue to fall as the economy maintains its strong expansion, and as growth in private-sector employment compensates for continuing layoffs due to the privatization and restructuring of state-owned enterprises. We are projecting a decline in the headline unemployment rate to 8.9% in 2007. The government's European Committee estimates that the migration of workers related to Lithuania's integration with the European Union will cost the domestic economy 1.7 billion litas over 2002-09. Lithuania has some structural characteristics, such as a relatively high minimum wage and restrictions on hiring part-time employees, which will continue to make unemployment rates difficult to reduce. But Lithuania has taken a more liberal approach to this issue than Estonia. In March 2001, its parliament passed a set of amendments to the country's labor laws aimed at liberalizing the labor market. The amendments provide for temporary terms of employment and significantly reduced severance pay.

Progress in Meeting Maastricht Criteria for EMU Accession

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

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

Lithuania's record on price stability is impressive. The currency board has been pivotal to low inflation. Nonetheless, inflation in Lithuania is expected to exceed EU levels for several years due to increases in administratively regulated prices and excise taxes, plus increasing wage pressures. More generally, the extremely low level of current inflation will not be sustainable in the context of a surging economy. By 2006, inflation will be peaking, with average annual inflation just over 3%. **Lithuania should therefore be able to meet the Maastricht criterion on inflation for EMU membership by 2006 or 2007 at worst. The same is true of interest rates.** Interest rates on short-term loans fell from 13.1% in 2000 to 9.0% in 2001, and to 6.8% at the end of 2002. While current interest rates are somewhat higher than in the West, the trend is steadily downward.

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

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	7.9	11.9	13.8	17.9	19.8	22.0	24.4	26.8
Per Capita GDP	*Current Dollars*	2126	3410	3984	5175	5742	6399	7095	7827
GDP, Growth Rate	*Percent*	4.7	6.5	6.7	6.8	5.7	5.5	6.1	5.9
Average Annual Inflation	*Percent*	24.6	1.5	0.3	0.1	2.4	3.0	3.2	3.0
Population (end-year)	*Thousand People*	3707	3482	3463	3456	3449	3442	3435	3428
Unemployment Rate	*Percent*	7.1	12.5	11.3	10.5	9.9	9.4	9.2	8.9
Exchange Rate, End-Year	*Litas/$*	4.0	4.0	3.3	3.0	2.9	2.8	2.8	2.8
Consolidated Budget Balance	*Percent of GDP*	-2.7	-1.7	-1.5	-1.5	-1.5	-1.0	-0.5	-0.2
Net Foreign Debt	*Percent of GDP*	12.3	14.2	11.7	10.6	11.3	12.2	13.2	14.1
Exports	*Million Dollars*	3356	4583	5521	6515	6971	7389	8202	9022
Imports	*Million Dollars*	4559	6353	7682	8989	9797	10777	11747	12687
Current Account Balance	*Percent of GDP*	-9.2	-4.8	-4.8	-5.2	-5.0	-4.9	-4.7	-4.4

Malta

Macroeconomic Overview and Outlook

Malta's economy is among the smallest compared to most EU and EU accession countries. In 2001, Malta's $3.6 billion nominal GDP actually made it the smallest of all West European and EU accession economies—it is only 0.3% the size of France's economy. Malta's population is also tiny, with only about 400,000 citizens at the end of 2002. That is 0.7% of France's population. But on a per capita basis, Malta ranks amongst the richest candidates for EU membership, surpassed only by Slovenia and Cyprus. But the country's small size, its large dependence on tourism revenues, and the increasingly open nature of its economy have made this small Mediterranean island extremely susceptible to external economic and geopolitical shocks. Malta's ability to push through necessary reforms, the country's decision to approve the proposed EU accession in 2004 at a March referendum, and the ruling party's sweeping victory in the April elections on a platform promoting the country's EU membership and reforms, bode well for the country's economic outlook.

Weak external demand, resulting from a still stagnant world economy, as well as a downturn in world tourism in the aftermath of the September 11 tragedy and the ensuing U.S.-led war on terrorism, hurt Malta's economy in 2001 and 2002. Malta's economic performance rebounded weakly in 2002. Real GDP grew 1.0%, compared with a decline of 1.2% a year earlier, but significantly below the 1995-2000 average growth of 4.6%. All sectors of the economy remained sluggish in 2002, with the only signs of a recovery coming from the performance of private and government consumption as well as investment in the construction sector. Gross fixed capital formation growth in construction slowed from its 2001 level, but remained strong at 7.4% last year on the back of strong building activity and development in the tourism sector. Already existing hotel overcapacity on the island, however, should prevent new hotel construction from remaining a major contributor to growth in the future. A rebound in exports, which were down 4.7% in 2002, as well as a pickup in investment in other sectors of the economy besides construction, would be required in order for Malta's economy to have a more pronounced recovery. All sectors of the economy managed to grow, albeit unimpressively, last year, with the exception of the transportation and communications sector, which shrank 4.7%. The drop in the transportation sector comes as a result of reduced airline activity, following a drop in tourist arrivals tied to the United States' ongoing war on terrorism and a slower-than-expected rebound of the world economy. Tourist arrivals continued their decline from 2001, pushing tourism revenues down by 1.2% in 2001 and another 2.8% last year.

Further monetary easing in May and June combined with the world economy's expected better performance later this year and early in 2004 should help Malta's economic performance. This should come despite the setback the economy might have suffered early in 2003 as a consequence of increased geopolitical tensions and the war in Iraq, which pushed oil prices upward and kept the tourism sector depressed. Global Insight expects a more pronounced economic rebound this year, and a more gradual improvement in the medium term. Our baseline forecast projects a GDP growth rate of 3.1% in 2003 and 3.8% in 2004.

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

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

Progress in Meeting Maastricht Criteria for EMU Accession

In examining the specific Maastricht criteria for accession to the Eurozone, it is safe to assume that Malta should be able to meet all the criteria by 2006. While Malta's macroeconomic policy has not always been prudent, the country managed to bring the fiscal balance from a deficit of 9.9% of GDP in 1997 down to a deficit of 6.0% of GDP in 2001 and 5.9% in 2002. The budget deficit actually stood as low as 3.6% of GDP in 1999, but increased in 2001 and 2002 as the government tried to boost economic growth through a more expansionary fiscal policy. Estimates for 2003 suggest that the overall fiscal stance may remain expansionary in the short term until there is enough evidence that a more pronounced economic recovery is on the way. **While the looser fiscal stance in 2001 and 2002 caused an increase in the budget deficit as a percentage of GDP, there is little reason for excessive concern as fiscal consolidation is set to remain a primary objective of budgetary operations in the coming years.** The government's medium-term projections show that greater emphasis is to be placed on expenditure rationalization and a number of measures are to be undertaken to balance the government's accounts.

The debt ratio remained below the Maastricht criterion of 60% until last year, when an expansionary fiscal policy and growing deficit took their toll on total public debt. Total public debt, based on the Maastricht definition, was about 62% of GDP in 2002 and currently stands at 65.5% of GDP, slightly above the Eurozone target of 60%, having grown steadily from 52% in 1997. Given the strengthening of the Maltese lira in recent months and the expected strengthening of the global economy following the second quarter of this year, **Malta should not be hard pressed to keep its outstanding public debt close to the 60% requirement.**

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

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	3.3	3.6	3.9	4.9	5.7	6.2	6.7	7.2
Per Capita GDP	*Current Dollars*	8781	9304	9971	12202	14279	15571	16811	18058
GDP, Growth Rate	*Percent*	4.0	-0.4	1.0	3.1	3.8	4.2	4.0	4.0
Average Annual Inflation	*Percent*	2.5	2.9	2.1	1.3	2.0	2.1	2.1	1.8
Population, End-Year	*Thousand People*	380	390	390	400	400	400	400	400
Unemployment Rate	*Percent*	NA	NA	NA	NA	NA	NA	NA	NA
Exchange Rate, End-Year	*Maltese Lira/$*	0.36	0.45	0.40	0.34	0.33	0.32	0.32	0.31
Consolidated Budget Balance	*% of GDP*	-7.7	-6.0	-5.9	-6.1	-5.5	-4.5	-3.5	-3.2
Net Foreign Debt	*Percent of GDP*	NA	NA	NA	NA	NA	NA	NA	NA
Exports	*Million Dollars*	1731	1917	2077	2210	2318	2428	2541	2677
Imports	*Million Dollars*	2795	2592	2891	3076	3225	3374	3526	3741
Current Account Balance	*Percent of GDP*	-12.1	-4.8	-1.7	-3.1	-3.8	-3.9	-3.8	-4.2

Poland

Macroeconomic Overview and Outlook

Poland is by far the largest of the EU accession countries, both in terms of its economy and population. GDP at current market prices amounted to $183.4 billion in 2001. This was more than three times that of the Czech Republic, the second largest economy among the EU accession countries. When compared with the economies of current EU members, Poland's GDP would rank 11th, roughly 14% that of France calculated using market exchange rates. Poland's population of 38.6 million will be the sixth largest in the enlarged EU, and almost four times that of the Czech Republic, the second largest EU accession country in terms of population. Despite the size of its economy, Poland ranks only sixth among the Central European accession economies in terms of GDP per capita. With GDP per capita at purchasing power parity of only $8,122 in 2001, Poland is well behind Slovenia, the Czech Republic, Hungary, Estonia and Slovakia. Poland's GDP per capita is also substantially below the EU average, despite economic growth at rates far exceeding those of the EU during the most of the 1990s.

Partially because of its size, Poland features the least open economy among the EU accession countries, with total external trade in goods (export plus imports) equal to only 41% of GDP at current prices. The shares of exports, valued at $30,275 in payments-based terms in 2001, directed to developed economies and to the EU were 75% and 69%, respectively, marking a dramatic shift in the direction of exports since the transition began in 1990. Exports are concentrated to the largest EU economies, with Germany alone accounting for 33% and 24% of Polish exports and imports in 2002, respectively. Although the Polish economy features the largest agricultural sector among the accession countries, with approximately 17% of the economically active population still employed in this sector in 2000, agriculture's contribution to GDP was capped at 5% that year. Value added in the manufacturing sector, which in 1990 accounted for 58% of GDP, now accounts for only 37%. The majority of Poland's GDP is now generated in the booming services sector.

During most of the 1990s, Poland was considered to be the undisputed leader among the European transition economies. Thanks in large part to administering radical "shock therapy" to its economy in 1990, Poland was the first country in the region to come out of the transition recession, reporting positive growth in GDP already in 1992 (2.5% y/y). It was also the first country to regain the pre-transition level of GDP, in 1997. Poland's booming economy and its vibrant private sector (over 2 million new businesses were registered during the first five years of transition) has attracted large inflows of foreign direct investment. Overall since the beginning of transition, Poland has attracted over $60 billion in net FDI, by far the most among the transition economies including Russia. However, on a per capita basis, Poland's FDI still lags behind that reported by the Baltic states, Hungary, the Czech Republic and Slovakia. Although a large portion of the FDI was directed toward manufacturing, in particular the automotive industry, the size of the Polish market has also attracted substantial investment aimed at satisfying domestic demand rather than export-oriented production. This meant that despite the large amount of FDI in Poland over this period, FDI contributed less to increasing the export competitiveness of the manufacturing sector than in the case of any of the other countries in the region.

Poland's average annual GDP growth substantially exceeded that in the EU during 1992-2000, as the economy benefited from opening export markets in the West and dramatic increases in productivity brought about by FDI and industrial restructuring. Domestic demand, both in the form of capital investment and private consumption, boomed as private and corporate consumers reaped the first benefits of lower inflation and more affordable credit. This expansion, which exceeded growth in real GDP by a wide margin during 1994-97, led to substantial external imbalances (at its height, the current account deficit reached 8.3% of GDP) and relatively high inflation. Growth in domestic demand was also supported by rather lax fiscal policy on the part of the social-democratic government. As a result, in an effort to cool the economy, the National Bank of Poland considerably tightened monetary conditions. Unfortunately for Poland, this policy adjustment coincided with the ruble crisis in Russia in 1998 and the slowdown in growth in Poland's main export markets in the EU. Poland's economic growth slowed to a crawl in 2001-02 as evidenced by GDP growth rates of 1.0% in 2001 and 1.4% in 2002. Poland avoided a post-transition recession, and the signs of a gradual economic recovery became visible in late 2002 and early 2003.

While inflation was clearly the weakest point of Poland's economy in the early stages of transition (Poland consistently featured the second highest consumer price inflation levels in Central Europe after Hungary), growth in prices has been slowing consistently and fell below 1.0% year on year in the last months of 2002. According to our forecast, Poland's monetary and fiscal authorities should have no problem keeping inflation under control in the next several years. On the

other hand, following two years of sub-par economic growth, unemployment (at 17.9% of the labor force in May 2003) is now by far the most important medium-term problem facing the Polish economy.

According to our most recent forecast, Poland's economic growth should accelerate over the next several years. Following two years of mediocre growth, GDP is expected to expand 2.8% in 2003 and 3.9% in 2004. The acceleration in growth will be achieved with low levels of inflation (2.5% plus/minus 1%) and only moderate increases in deficits on trade and on the current account. As the economy picks up, we also project that the unemployment rate will trend downward. However, much more substantial changes to the labor market structure and employment taxation and regulations will be necessary to reduce the unemployment problem more decisively. Poland's economic integration with the EU will continue to proceed smoothly. The country is to become a full member of the EU as of May 1, 2004, and its economy and infrastructure should benefit from large transfers of structural and cohesion funds. In 2004-06 alone, Poland is slated to receive 11.4 billion euros in structural support, an amount that will be then increased by close to 25% in matching funds from Poland's national budget.

Progress in Meeting Maastricht Criteria for EMU Accession

Among the large EU accession countries, Poland is the most likely candidate to meet all Maastricht criteria for accession to the Eurozone as soon as 2007. Consumer price inflation was below Eurozone levels throughout most of 2002 and interest rates have been gradually converging with the EU levels. The monetary authorities should have no problems keeping inflation under control, especially since Poland is among the relatively most advanced countries in the region in terms of adjustment of administratively-controlled prices to cost-recovery levels. In light of the above, a reduction in fiscal deficits and a further stabilization of the Polish zloty constitute the biggest challenges for the Polish authorities in the EMU convergence process.

Although Poland's consolidated budget deficits in the last two years were considerably lower than those in the Czech Republic and Hungary, they were still well above the levels required by the Maastricht criteria. Poland's public finance deficit exceeded 5.3% of GDP in 2002 and is expected to fall to just 4.9% of GDP this year. Moreover, further reductions in the deficit, although made much easier by the expected recovery in GDP growth, will require a substantial restructuring of the expenditure side of the budget. In 2002, close to 68% of total budget expenses was essentially fixed and determined by schemes that linked payments under several state-sponsored social programs indexed to inflation. A reduction in social expenses will not be popular, and therefore reform of public finances was postponed to the second half of 2003, following the popular approval of EU accession in a nationwide referendum held in June 2003. It is also expected that the current Polish government for political reasons (ahead of the next parliamentary elections in 2005) is likely to risk expanding the budget deficit in 2004 and 2005 in order to support economic growth and reduce unemployment. Such actions would be counterproductive in the medium term, shifting the burden of budgetary tensions into the later post-accession years and putting Poland at odds with the current regulations of the Stability and Growth Pact. In light of the planned large deficits in 2003, Poland's public debt will be dangerously nearing 60% of GDP.

We believe that Poland will maintain its free float regime for the zloty until the entry into the ERM-2, now most likely in 2005-2006. Assuming that Poland meets all of the Maastricht convergence criteria by 2007 (with a number of risks still possibly delaying this target date), the earliest possible date for an entry into the Eurozone is 2008-09. We assume such a timetable for Eurozone entry in our baseline scenario.

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	143.8	183.4	189.3	214.0	238.2	266.8	290.8	309.4
Per Capita GDP	*Current Dollars*	3722	4747	4903	5541	6159	6886	7505	7981
GDP, Growth Rate	*Percent*	6.0	1.0	1.4	2.8	3.9	4.3	4.0	3.0
Average Annual Inflation	*Percent*	19.9	5.5	1.9	0.9	2.0	2.8	2.6	2.2
Population, End-Year	*Thousand People*	38639	38632	38610	38614	38685	38736	38750	38764
Unemployment Rate	*Percent*	13.2	17.5	18.1	17.4	16.8	16.0	15.5	14.5
Exchange Rate, End-Year	*PLN/$*	2.87	3.99	3.84	3.65	3.46	3.36	3.31	3.29
Central Gov. Budget Balance	*% of GDP*	-3.3	-4.3	-5.1	-4.9	-5.2	-4.7	-4.2	-3.5
Net Foreign Debt	*Percent of GDP*	20.4	24.7	27.5	23.2	20.6	18.1	16.2	15.4
Exports	*Million Dollars*	24453	30275	32945	39223	43145	47460	51257	55357
Imports	*Million Dollars*	32632	41950	43297	49611	53828	60287	65713	69656
Current Account Balance	*Percent of GDP*	-1.0	-3.9	-3.5	-2.8	-3.0	-3.6	-3.9	-3.6

Slovakia

Macroeconomic Overview and Outlook

Slovakia ranks fourth among the ten EU accession countries in terms of both population and GDP, putting it behind the other Visegrad countries. With a nominal GDP of $23.7 billion in 2002, Slovakia is near the bottom of the bunch in terms of per-capita income. However, the country fares much better in purchasing power parity terms, where per capita GDP is above that of Poland and the Baltic states. In relation to the existing EU member states, the Slovak economy is comparatively poor. At 5.4 million, the country has approximately the same number of inhabitants as Denmark; however, Slovakia is only about one-eighth its size in terms of nominal GDP. Compared with France, Slovakia has just 9% of the population and less than 2% of the GDP. Slovakia's convergence with EU member states has gone further when taking purchasing power into account, however, reaching 47% of the EU average in 2001.

Historically, Slovakia was much more rural than the neighboring Czech Republic, although the differences were to some extent evened out during the communist era, when the former was developed in line with the demands of the socialist state. Many of the firms built in Slovakia during that period were dedicated to the production of heavy industry and weapons that were intended for export to the Soviet Union. Once trade with the USSR collapsed after 1989, Slovakia was in a tough position, and unemployment quickly surged. Observers were skeptical about whether the Slovaks could make it economically after they split from the Czechs in 1993. However, after a period of political posturing and considerable wavering over the need for economic reform, Slovakia has emerged as a positive surprise. That is particularly true after the September 2002 parliamentary elections produced one of the most cohesive reformist governments that has been voted to power anywhere in the region during the last 13 years. Since 1990, the structure of the Slovak economy has changed considerably, as industry declined in importance, losing ground to trade and other services. By 2002, industry accounted for just over one-fourth of GDP, while domestic trade reached nearly 15% of the total. Sectors such as communications, banking, and other market services have also grown in significance.

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

Considered as something of a pariah state until 1998, Slovakia has attracted far less foreign investment than many other countries in the region, despite lower wages and relatively good infrastructure. By the end of 2002, Slovakia had brought in less than $9 billion worth of FDI, compared with $37 billion for the Czech Republic, which is somewhat less than twice its size. Nonetheless, that situation is now changing, as demonstrated most markedly by the decision of PSA Peugeot Citroen in January 2003 to build a 700 million euro assembly plant in the western Slovak town of Trnava, which won out over competing locations in Poland, Hungary, and the Czech Republic. The plant, which will produce small vehicles starting in 2006, should have an annual capacity of 300,000 cars, and will employ 3,500 workers. Such investments will provide the basis for continued rapid increases in industrial production and exports in the future.

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

Progress in Meeting Maastricht Criteria for EMU Accession

Slovakia's current government is aiming to meet the Maastricht criteria for accession to the Economic and Monetary Union (EMU) by 2006. As in the case of several other countries in the region, the most difficult challenge for the Slovaks will be the fiscal criteria, as the cost of bailing out the banking sector has put undo strain on the country's finances. Slovakia's 2003 state budget is the first to adopt the EU's ESA 95 standards. Although the budget includes both spending cuts and increases in indirect taxes, the deficit remains large, at close to 5% of GDP. The current government is also starting to use ESA standards to calculate the public finance deficit. According to its revised medium-term financial outlook that was published in November, the Finance Ministry estimates that the public finance deficit totaled 7.8% of GDP in 2002. The ministry plans to bring that deficit down to 3.3% of GDP by 2005 and 3.0% in 2006. The continued cuts will be hard for the population to swallow, and the cabinet may be tempted to loosen spending toward the end of its term as the next parliamentary elections approach in the fall of 2006. The ability to reach the 3% goal by 2006 will depend largely on the success of the government's fiscal reforms, scheduled for implementation in January of next year. Those include a flat income tax for individuals and corporations and a unified VAT rate, all at 19%. The Finance Ministry assumes that the effects of the tax reform will be fiscally neutral, as the tax burden shifts from direct to indirect taxes and the simplification of the tax administration helps to prevent cheating. The cabinet is also planning an ambitious overhaul of the pension and social welfare systems, and it is using a portion of privatization revenues to help finance those reforms. Assuming that the current cabinet remains in power for a full four years, we believe that the government will succeed in meeting its goals.

Slovakia is not expected to have any major problems meeting the other Maastricht criteria. Following a surge in 2001, central government debt reached 386 billion koruna in 2002, or 36.0% of GDP. That represents only a 5.6% increase over the 2001 level in absolute terms, as a portion of privatization revenues was used to pay down public debt last year. Public debt is scheduled to rise in absolute terms over the coming years but will remain fairly constant as a percentage of GDP, well below the 60% level required by the Maastricht criteria. In regard to inflation, Slovak consumer prices are surging this year due to hikes in regulated prices and indirect taxes. However, core inflation remains low, signaling that inflation should subside considerably during the next several years. In regard to interest rates, Slovak rates are currently above Eurozone levels, but they are set to fall considerably this year and next given the low core inflation and improvement in the trade deficit.

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

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	20.5	20.5	23.7	33.1	38.5	44.2	50.3	54.7
Per Capita GDP	*Current Dollars*	3813	3804	4403	6147	7140	8189	9311	10123
GDP, Growth Rate	*Percent*	5.8	3.3	4.4	3.9	4.6	5.3	6.2	5.5
Average Annual Inflation	*Percent*	5.8	7.3	3.3	8.3	6.5	4.3	3.3	2.0
Population, End-Year	*Thousand People*	5379	5379	5379	5387	5394	5402	5404	5406
Unemployment Rate	*Percent*	11.3	18.3	17.8	15.5	15.2	14.9	14.7	14.0
Exchange Rate, End-Year	*SKK/$*	31.9	48.5	40.0	36.3	34.0	32.9	31.5	31.6
Central Budget Balance	*% of GDP*	-3.7	-4.5	-4.8	-4.6	-3.6	-3.1	-2.8	-2.7
Net Foreign Debt	*Percent of GDP*	7.5	21.9	11.9	5.7	1.4	-1.3	-1.4	-1.1
Exports	*Million Dollars*	8889	12704	14459	20104	22659	24239	26505	28720
Imports	*Million Dollars*	11087	14689	16626	21882	24506	26262	28696	30956
Current Account Balance	*Percent of GDP*	-10.2	-8.6	-8.2	-5.0	-4.5	-4.1	-3.7	-3.5

Slovenia

Macroeconomic Overview and Outlook

Slovenia's economy is characterized by both its small size—although it is larger than the smallest of the EU and EU accession countries—and its relative per capita wealth compared to the other EU candidate countries. In 2002, Slovenia's GDP totaled $22.0 billion, only 1.5% the size of the French economy. Slovenia's population at that time was only 2.0 million people, 3.4% of the number of French inhabitants. GDP per capita at the end of 2002, then, totaled $11,026. Although only about 46.1% of the French level and 44.9% of the EU average, Slovenia's per capita GDP ranked as the highest among the EU accession countries save Cyprus, and was close to Portugal's level (93.3%) and comparable to Greece (89.3%). Among EU candidate countries from Emerging Europe, only the Czech Republic and Hungary's GDP per capita in 2002 equaled even half of Slovenia's level. Furthermore, the economic gap between Slovenia and the EU is closing. Since 1995, economic growth in Slovenia has outstripped that of the European Union's in every year, averaging 4.0% per annum in those eight years compared to the EU's average of 2.3%.

Slovenia's small size and relative ethnic homogeneity have provided for a dearth of political problems, allowing the government to concentrate on supporting economic growth and reform. Emerging from the former Yugoslavia in 1991, the country's historical ties to Western Europe laid the groundwork for rapid economic development. More than half of GDP in 2001 came from services, with real estate (11% of total GDP), retail trade (10%), and transport and communications (7%) the largest service sectors. Tourism is a key industry in the country, a vital element of most of the service sectors. The largest single sector, however, remains manufacturing, which accounted for 24% of GDP in 2001. While initially suffering from low productivity and relatively poor international competitiveness, widespread restructuring, government-sponsored employment retraining, and administrative limits on wage growth since the late 1990s have substantially boosted the prospects for the country's manufacturing sector. Overall, macroeconomic stability has been achieved in Slovenia, and the economy is well poised to maintain at least moderate economic growth, meeting the challenges of membership in the European Union.

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

Slovenia's external accounts are healthy, with the current account either nearly balanced or in surplus in every year except 1999 and 2000. In 2001, the current account recovered and was nearly balanced, thanks to strong export growth despite a slowdown of demand from the European Union, Slovenia's largest export market. The current account pushed into surplus in 2002—to 1.7% of GDP—thanks to a further substantial reduction in the foreign trade deficit. The continuation of strong export growth—augmented by improved market access to both Western and developing Europe—will likely keep the current account in surplus in 2003 as well. With low inflows of FDI until 2001, Slovenia had to increase its long-term borrowing in order to finance its current account deficits in 1999-2000. The country's foreign debt level, therefore, rose by more than a quarter in that period. Slovenia's foreign debt level poses little threat to economic stability, however, as it remains quite low. The country has long enjoyed the highest credit rating in the region.

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

Progress in Meeting Maastricht Criteria for EMU Accession

Despite some potential difficulty, Slovenia will most likely meet all of the Maastricht criteria by 2006 or 2007. **Fiscal policy has kept budgetary deficits at or below the 3% of GDP level since 1997**, with the exception of 2000 when the deficit rose to 3.2% of GDP. A recently approved supplemental budget allows the primary budget deficit to reach only 1.3% of GDP in 2003 and 1.0% of GDP in 2004. In general, economic growth and revenue targets in the two-year budget may be overly optimistic, but any deficit above the target would not likely be more than double the level currently anticipated by the government. Despite progress, the government may need to more aggressively reduce its <non-discretionary expenditures in order to limit its budgetary deficits. In particular, the expansion of government spending on public sector wages will need to be curtailed from current levels if budgetary targets are to be better met. Increased spending on defense as Slovenia joins NATO and the continuing expense of economic reform (including planned pension reform in the medium term) will place additional upward pressures on the budget deficit. As the government works toward limiting expenditure growth, the IMF has suggested that Slovenia allow its deficits to grow somewhat in the short term rather than raising taxes, arguing that the country's medium-term strategy of EU integration would not be harmed by a short-term rise of the budget deficit. **Relatively tight fiscal policies kept Slovenia's public debt at 16.5% of GDP in 2002, well below the criteria of 60% of GDP, a limit that we do not see the country reaching in the foreseeable future.**

Inflation has remained stubbornly high in Slovenia, at 7.5% in 2002. This is well above the current Maastricht limit and remains the largest question mark regarding the country's preparations for EMU membership. In late 2002, Bank of Slovenia Governor Mitja Gaspari publicly announced that reducing inflation would become the central bank's top priority, though he admitted that inflation would not be substantially reduced until the second part of 2003. **Gaspari pledged that the country would be able to attain 4% inflation by the first half of 2004, and be able to meet the Maastricht criteria by 2006.** Although the initial inflationary target might be a bit optimistic, consumer price growth will likely slow to needed targets by 2006. The Bank of Slovenia's primary tool to combat inflation has been the reduction of interest rates in hopes of bolstering the value of the local currency. Assuming that the Bank of Slovenia will continue to work to boost the real strength of the tolar in order to reduce inflation, and thanks to a shift of interest rate targets away from past practices to European norms over the past year, **interest rates should begin to fall below the criteria limits in the near future.**

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

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Dollars*	18.9	19.5	22.0	28.2	31.2	34.4	37.6	40.6
Per Capita GDP	*Current Dollars*	9481	9810	11026	14180	15683	17381	19025	20534
GDP, Growth Rate	*Percent*	3.5	2.9	3.2	2.7	3.9	4.1	4.2	4.0
Average Annual Inflation	*Percent*	9.9	8.4	7.5	6.2	5.8	4.5	3.4	2.5
Population (end-year)	*Thousand People*	1991	1991	1995	1991	1986	1982	1979	1976
Unemployment Rate	*Percent*	7.3	6.4	6.3	6.5	6.4	6.5	6.9	6.9
Exchange Rate, End-Year	*Tolars/$*	141.5	250.9	221.1	202.2	199.9	196.5	193.8	192.3
Consolidated Budget Balance	*Percent of GDP*	0.3	-1.3	-3.0	-2.1	-2.4	-2.6	-2.4	-2.3
Net Foreign Debt	*Percent of GDP*	-4.9	-0.1	-2.6	-5.8	-9.6	-12.4	-14.2	-16.4
Exports	*Million Dollars*	8353	9343	10473	13412	14246	15255	16160	17163
Imports	*Million Dollars*	9178	9962	10716	13923	14995	16165	17173	18054
Current Account Balance	*Percent of GDP*	0.2	0.2	1.7	0.5	-0.2	-0.5	-0.6	-0.2