

EFN REPORT

THE EURO AREA AND THE ACCEDING COUNTRIES



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About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 and co-financed by the European Commission. The objective of the EFN is to provide a critical analysis of the current economic situation in the Euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes two semi-annual reports, in the spring and in the autumn. Further information on the EFN can be obtained from our web site, www.efn.uni-bocconi.it or by e-mail at efn@uni-bocconi.it.

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Executive Summary



The European Union is about to experience its largest increase in population since its creation in the 1950s with the accession of ten new countries

The Acceding Countries are showing continued improvement in their economic outlook despite the muted recovery in the rest of Europe

The European Union is about to experience its largest increase in population since its creation in the 1950s with the accession of 10 new countries. This will increase the population by 20% and GDP by 9%. The institutional implications of this enlargement have already delayed agreement on a new constitution for EU. But there are also important implications for labour and capital markets. It provides a major challenge for inflexible labour markets since free capital movements will accelerate the movements of production to areas of the EU where labour costs are lower.

The question is whether the conditions are in place for the Acceding Countries to move smoothly towards economic and monetary union. The integration of ten new members requires that the internal fiscal and monetary framework is in place to allow convergence under the Maastricht Treaty. Economic and institutional structures need also to be flexible in order to respond best to the opportunities opened up by accession. But it also requires that the existing European Union is flexible and able to respond to the challenges coming from more competition in labour, capital and product markets. This is why the process of labour and product market liberalisation takes on an even greater urgency.

Economic Prospects for the Acceding Countries

On the eve of EU membership, the Acceding Countries are showing continued improvement in their economic outlook despite the muted recovery in the rest of Europe. Following a difficult two years in 2001 and 2002 and the relatively weak performance in the first half of last year, growth gained momentum across the region, fueled by stronger growth in exports, moderate expansion in investment activity and stable growth in consumer spending. The first signs of a global recovery, in particular the reports of a modest growth rebound in the largest EU economies in the second half of 2003, bodes well for short- to medium-term growth in the Acceding Countries. Rising exports are likely to strengthen the gains in industrial production, further improve the financial situation of local companies, and improve the external balances that in some Acceding Countries have deteriorated over the last few years. Growth in the region will be mostly supported by a rebound in investment activity and steady expansion in private consumption. Another factor that will provide a boost to domestic demand will be wider access to EU regional and structural funds for the development of local infrastructure.

Performance on inflation has been more mixed since the summer months of 2003. Grain harvests suffered from drought conditions across the continent, putting pressure on prices of key food products, with prices rising throughout the remainder of last year. Furthermore, two of the Acceding Countries, Slovakia and Hungary, in order to make them compliant with EU requirements, embarked upon a major adjustment to VAT and excise tax rates. While core inflation remained under control, the impact of sharp increases in prices could have a longer-lasting effect on inflationary expectations, providing for a much more challenging environment for the monetary authorities.

Forecasting macroeconomic variables for the Acceding Countries is relevant for policy making, but complicated by the short sample available

Yet some newly developed time series techniques provide reliable results

External balances are sustainable, but FDI flows are crucial to keep the external debt under control

Forecasting Acceding Countries

The forecasts reported above are mostly judgemental, since the implementation of formal methods is difficult, because the transition period to a market based economy only provides short spans of reliable data over time. One way of overcoming this problem is to exploit the data on a wide variety of different aspects of the economy. In this approach, the short time span of the data is augmented by a large number of macroeconomic variables in the longitudinal dimension and factors are extracted from the resulting large data set and used for forecasting. Simple time series models provide a valid alternative forecasting tool, because of their parsimonious specification and good performance in similar contexts.

We compare the usefulness of the two approaches to forecasting by means of simulation experiments and by using data for five of the Acceding Countries, namely the Czech Republic, Hungary, Poland, Slovakia and Slovenia. We also evaluate the role of Euro area information for forecasting, and the usefulness of techniques such as intercept corrections and second differencing which make the forecasts robust to changes in the structure of the economy. We find that factor models work well in general, techniques for making the forecasts robust to structural breaks are useful in a few cases, while Euro area information appears to be virtually irrelevant for forecasting in this context. The latter finding is due to the decreased synchronisation of the Acceding Countries with the Euro area because of the convergence process, as discussed in the EFN Autumn 2003 Report.

Current Account Sustainability in Acceding Countries

Another potential problem for accession countries relates to the sustainability of their current accounts, with the episodes of exchange rate and balance of payment crises during the 90s highlighting the danger of having too large current account deficits.

Most accession countries show large, and in some cases widening, deficits originated both by a surge in investment and by expansionary fiscal policies. Moreover, after the entry into the EU these countries will try to join the monetary union, and the transition to the single currency will have to be designed taking into account current account imbalances.

Higher domestic savings are needed, jointly with steady FDI and flexible exchange rates

Fixed exchange rates limit the flexibility of monetary policy, which can be needed in the road to the Euro

Monetary policy has been effective in the past in controlling inflation and stabilising output

Using standard accounting methods, and given reasonable assumptions on real growth and interest rates, most of the countries under analysis have sustainable external balances, but the contribution of FDI flows is crucial to keep the external debt under control. Projections obtained using a simple econometric model point out to a widening of these imbalances in the medium term.

From a policy perspective, three issues stand out. First, economic authorities will have to design fiscal policies so that a higher domestic savings will offset to a large extent the expected surge in investment. Second, microeconomic policies aimed at guaranteeing steady inflows of FDI and at building a sound financial system capable of managing these high inflows should have a top position in the agenda. Finally, the exchange rate regimes prior to the full adoption of the euro should allow the economy enough flexibility to cope with large external imbalances.

Monetary Transmission in Acceding Countries

The monetary transmission mechanism describes the channels through which monetary policy decisions are transmitted to the economy and affect policy objectives. The analysis of monetary transmission in the Acceding Countries is especially relevant because it is clear that the goal after they are part of the European Union is to join the Monetary Union. In fact, as more central banks in Acceding Countries move towards inflation control, good knowledge of the transmission mechanism in the economy becomes crucial for implementing appropriate policies. Moreover, in the context of the Monetary Union, “country” differences in monetary transmission could be translated on business cycle asymmetries that could have clear effects on convergence.

One aspect that should be taken into account when analysing the transmission of monetary policy in Acceding Countries is their different exchange rate systems (as the degree of monetary independence is clearly linked to the exchange rate system and also to the degree of control of capital flows). Those Acceding Countries that are relying on fixed exchange rates, particularly hard pegs like currency boards, have tied hands in monetary policy. On the other hand, those Acceding Countries which opted for floating exchange rate regimes particularly free floaters with inflation targeting, retain independence in their monetary policies, while those relying on intermediate regimes are somewhere in between.

The empirical analysis leads us to the conclusion that monetary policy has been effective in controlling inflation and stabilising output in nearly all the Acceding Countries we have examined, although the results should be taken with cautious, because of the short time period considered.

It is worth mentioning the cases of the Slovak Republic and Slovenia, where there is clear evidence of an exchange rate transmission channel, but the interest rate channel remains blocked. In this case, given the critical importance of joining the Euro Area as soon as possible, the monetary authorities should shift to a balanced conduct of monetary policy relying on the interest rate channel that would

contribute to prepare the financial sector for the ECB policy-operating environment, where monetary policy is implemented and transmitted primarily through interest rates, and only to a minor extent through the exchange rate.

The Banking System in Acceding Countries

Another aspect we focus on in this Report is the scope for the banking structures in the Acceding Countries to contribute to orderly financial markets and to aid the efficient allocation of capital.

All of the Acceding Countries have already made dramatic strides in improving the stability and efficiency of their banking sectors as well as eliminating restrictions on capital flows. However, these processes are not complete and there is the need for further progress in increasing competition in the banking sector and more substantial flows of short-term capital, even though this may increase the risks of instability in the banking sectors of the individual Acceding Countries.

Extensive restructuring of the banks was required because of the substantial burden of non-performing loans that threatened their viability as financially independent institutions. These banks were therefore financially unviable as independent institutions without significant restructuring of their balance sheets. They lacked not only the financial capital, but also the human and physical capital that would be necessary to compete in a liberalized market for financial services. The privatisation of the banking systems in the transition economies of Central and Eastern Europe was aimed not only at attracting capital injections and increasing efficiency in the financial services sectors, but also at eliminating the inappropriate incentives to bank management that contributed to the burden of non-performing loans inherited from the socialist era. In addition to the processes of restructuring and privatisation that were launched by the economic transition of the 1990s, increased competition in the financial services sectors has generally trimmed the number of banks after initial periods of expansion, through mergers or withdrawal of banking licenses. The growth of domestic credit has increased substantially in the past several years in most of the region as banks became more confident at assessing credit risks. The profitability of the banking system remains low by EU standards and may be further eroded by additional competition.

Recent developments in the banking sectors of Poland and the Czech Republic and Romania who is due to enter the EU in the next wave, indicate significant achievements. There have been improvements in the efficiency and scope of their roles in financial intermediation through restructuring and privatization, the opening of the banking markets to foreign participation and the enhancement of bank regulation and supervision, both in principle and in practice. The Acceding Countries have been aided in this reform process by technical advice and resources from international financial institutions and the European Union. Most usefully, the process of harmonizing the national legislation and practice with the EU's own banking directives has provided a critical road map for domestic

Banking structures in the Acceding Countries contribute to orderly financial markets and aid the efficient allocation of capital

The privatisation of the banking system was aimed at attracting capital injections, increasing efficiency, decreasing non-performing loans

But profitability remains low

Additional progress is required for the banking sector to promote financial stability and help to drive robust economic growth

policymakers and legislators in preparing the bank sectors to cope with the stresses and opportunities of the post-transition and post-accession economic and financial environment. We have also noted areas where additional progress is required if there is to be substantial certainty that these bank sectors will continue to promote financial stability, provide an improved financial intermediation function and help to drive robust economic growth.

It is essential to

- Strengthen the independence of supervisory agencies,
- enforce avoidance of conflict of interest
- and impose exposure limits,
- encourage the principles of good corporate governance,
- and improve standards for auditing.

Economic Prospects in the Euro Area

The recovery of the world economy is now under way...

Full and rapid integration of the ten new member states will be served best by a vibrant and growing Euro Area. However economic performance has been particularly poor over the last three years with a sluggish recovery from the global downturn. Output grew by only 0.4 % in 2003 and we expect this to improve in 2004 to only 1.4%, see Table 1, well short of areas elsewhere in the world economy. The structural changes necessary to achieve the objectives set out in the Lisbon Accord have been very slow to materialise.

After the weak performance of the Euro area economy in the first two quarters of 2003 activity picked up in the second half of the year. This was mainly due to a rebound of exports. Although the Euro appreciated against the Dollar and, to a lesser extent, against other major currencies, exports profited from the revival of the world economy. Consumption nearly stagnated and investment still declined. The modest performance of the domestic economy led to a subdued import growth.

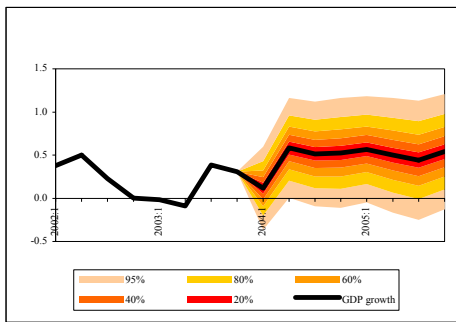
...with the US and Asia as centres of the upswing

The recovery of the world economy is now under way. Geopolitical tensions due to the Iraq war have eased, and the SARS disease no longer appears to threaten economic activity on a global scale. The ICT sector, three years after the end of the new economy bubble, seems finally to find promising new fields, in particular in consumer electronics. Monetary policy is very expansive with real short term interest rates now close to zero in the USA, in Japan and in the Euro area and there is no indication that they will be raised any time in the coming months.

The centres of the recovery are the US and Asia. In the US growth has accelerated throughout the year 2003. The strong stimulus by low prime rates, expanding public expenditure and

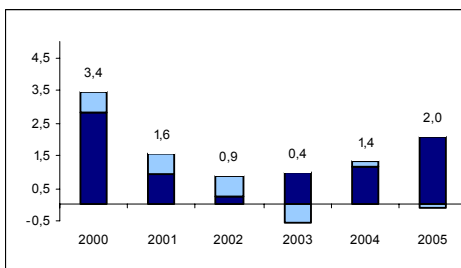
But the Euro area is lagging behind the rest of the world because of slow consumption and investment growth

Figure 1 Quarterly GDP growth rates and confidence bands in the Euro area



Percentage change over the previous quarter

Figure 2 Contributions of domestic components and net exports to GDP growth in the Euro Area



Domestic demand bright, net exports dark area. Percentage points; figures above the columns indicate overall GDP growth

substantial tax reductions has already set a strong upswing in the private sector, which is mainly driven by an increase in business investment. Although the upswing had no significant impact on employment so far, labour markets appear to be flexible enough to be finally able to profit in the near future. Therefore, the risk of an abrupt decline in consumption in the forecasting horizon is low.

The second centre of economic growth is Asia: strong growth in China led to a spectacular expansion of imports of around 40%. Japan, after a decade of stagnation, appears to return to a growth path. This revival is not only driven by exports, but also by private investment. The expanding Asian demand for industrial inputs is a main cause for the quite high oil price and for the rise in many commodity prices since the autumn of 2003.

The US, Japan, and the large countries of the European Union presently all run sizable public deficits. Fiscal consolidation will become a priority when the upswing is clearly under way at the end of 2004. This will contribute to a slightly lower evolution of the world economy in the year to come. World trade will expand around 8.5% in 2004 and 8.1% in 2005, after 4.2% in 2003.

The Euro area lags behind the cyclical upswing of the world economy. The outlook will improve over the forecasting horizon, but the overall performance is expected to remain modest. GDP growth is forecasted at around 1.4% in 2004 and 2.0% in 2005. Although quite low, the expansion of output is higher than the growth rate of potential GDP: as the weak investment activity in the past hampers the current capital stock, potential output growth will decline over the near future. The output gap will narrow over the forecasting horizon, but it will be reduced only gradually. At the end of 2005, still a significant gap of 1.3% of potential GDP is predicted. Thus, no sizable inflationary pressure is expected from the demand side. The relative weak performance of the economy can be seen in the quarter-on-quarter GDP growth rates. From 2004.2 on, they are almost constant at the 0.5% level, see figure 1. Hence, an acceleration can hardly be detected.

Although the global upswing will be reflected in a rebound of exports, the recent appreciation of the Euro will take its toll and will support import growth in 2004. Therefore, net exports will only slightly contribute to economic growth in 2004. Since import growth is expected to be slightly stronger than export growth in 2005, their impact will even turn to be negative, see figure 2.

Both private consumption and investment are expected to pick up gradually over the forecasting horizon. However, the dynamics remain weak, although the financing conditions are favourable: real interest rates are at low levels, and stock prices have been rising since the trough in Spring 2003. The recent slowdown after the terrorist attack of March 11 will be a transitory phenomenon.

One factor explaining the modest path of investment are non-optimistic sales prospects, as reflected by the evolution of the output gap. Since potential growth was above actual in the recent

Labour market prospects will not improve in 2004 and 2005, with unemployment close to 9%

downturn period, stocks are likely to be high. In addition, profit prospects of investors will improve only gradually. Due to a recovery of productivity, real unit labour costs are roughly constant in 2004, and in 2005 a significant decline of roughly 1 percent is expected. However, the previous cumulative increase of this measure was almost about 2 percent over the 2001-2003 period, see table 1. Hence, acceleration in investment is mainly to ensure competitiveness by adopting new technologies. Brighter profit prospects, further improvement of financing conditions, and better financial health of commercial banks will facilitate the development.

Private consumption is expected to profit from the improved confidence of households. HICP price inflation in 2004 will be lower due to the appreciation of the Euro. This, however, will lead to lower wage inflation: wages move in line with prices and productivity, while the labour market situation plays only a minor role. Therefore real incomes will not benefit very much from the appreciation. Moreover, labour market prospects will not conspicuously improve over the forecasting horizon, with unemployment remaining close to 9%. As GDP growth does not exceed productivity growth in 2005, employment will not

Table 1 Economic outlook for the Euro area

	2001	2002	2003	2004: 1st half		2004: annual		2005: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					0.7		0.9		1.4
GDP	1.6	0.9	0.4	1.1	1.4	1.4	1.8	2.0	2.7
Potential Output	2.5	2.4	1.9	1.9	2.4	1.9	2.5	1.7	2.4
Private Consumption	1.8	0.1	1.0	0.8	1.3	1.1	1.5	1.7	2.4
Fixed Capital Formation	-0.1	-2.9	-1.2	0.2	1.7	1.0	2.7	3.5	5.7
Exports	3.3	1.7	0.0	3.9	5.1	4.8	6.3	7.2	9.3
Imports	1.7	0.1	1.5	3.6	5.0	4.7	6.2	7.6	10.0
Unemployment Rate	8.0	8.4	8.8	8.8	9.0	8.9	9.1	8.8	9.2
HICP	2.3	2.2	2.1	1.7	2.2	1.8	2.7	1.9	2.9

Percentage change in the average level compared with the same period a year earlier, except for the unemployment rate which is expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations

Expansionary US style fiscal policy is not feasible in the Euro area...

...and real interest rates are already close to zero or negative

The strong exchange rate of the Euro damages net exports...

...but we do not expect further appreciation because...

...Dollar pessimism does not rest on economic grounds

More flexible exchange rates of Asian currencies are desirable

significantly profit from the upswing. Furthermore, the increase in the labour force participation rate which was observed since 1995 will come to a halt.

Problems of financing the pay-as-you-go pension systems and public sector deficits in major Euro area countries will stay on the political agenda, and are further reasons for cautious consumption behaviour. Also, demand management by fiscal policy which appears to be effective in the US is not an option in the Euro area due to the comparatively weak position of public households in large member countries.

The strong positive stimulus from world trade on exports is jeopardized by the increase in the effective exchange rate of the Euro. The main reason for this development appears to be the sceptical attitude of currency traders towards the sustainability of the large and widening current account deficit in the US. A weaker Dollar, it is argued, will help to reduce the deficit. Because the monetary authorities of important Asian countries have slowed the appreciation of their currencies, a weak Dollar will imply a strong Euro.

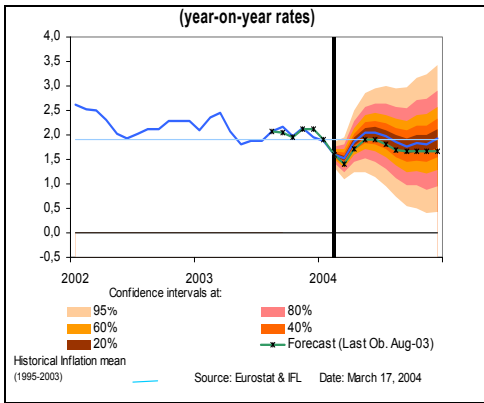
Upon closer inspection, however, the Dollar pessimism does not rest on firm economic grounds. It is not the choice between products of different origins but the intertemporal decisions of US households, firms and the government to spend at present, that lead to large capital imports. The counterpart of these imports is the current account deficit. Therefore, a structural reduction of the deficit would only be caused by changes in intertemporal prices, i.e. interest rates, or by a change in the expectations about future incomes in the US. Such a change might be aided by a weaker Dollar, but that does not mean that the currency has to fall until the deficit has shrunk to some level considered as sustainable. According to the EFN forecast, the Dollar will be roughly stable around 1.20 Euro in 2004. Still, measured by purchasing power parities, the Euro appears to be overvalued relative to the Dollar. Therefore, we expect a depreciation of the Euro down to 1.14 for 2005.

However, exchange rate forecasts are notoriously unreliable. Thus, a further rapid appreciation of the Euro is not to be considered as a totally unlikely event. If it happened, the ECB might very well come under public pressure to counteract by Japanese style intervention. But, since an exchange rate related monetary policy is in danger of being affected by the high degree of instability in the currency markets, the ECB should not depart from its strategic focus on internal stability. The best provision against the pressure from an appreciation would be to convince Asian monetary authorities of the merits of more flexible exchange rates. This would mean that the effects of the Dollar volatility were spread more evenly instead of falling predominantly on Euro area producers.

An analysis of the economic situation of the European economy also needs a short term perspective based on qualitative and

Inflation forecasts for 2004 and 2005 are 1.8% and 1.9%

Figure 3 Annual forecasts for Euro area inflation



quantitative indicators. The general economic sentiment indicator and the index of industrial production can be used for this purpose. This analysis is also useful because for the mentioned indicators observations till February 2004 are available. They show that a moderate recovery is in the way at the beginning of 2004, therefore at this moment no significant revisions of the GDP growth for 2004 and 2005 are expected when data for the first quarter of 2004 arrives.

Finally, in the last six months inflation performed in line with our predictions. The forecast for the average annual rate in 2004 and 2005 are 1.8% and 1.9%, respectively, and reflect slightly higher prices for oil and some industrial goods.

Additional details on all the Chapters are available in a set of Annexes on the webpage www.efn.uni-bocconi.it

Chapter 1

Acceding Countries Macroeconomic Outlook and Forecasts

The economic performance of the Acceding Countries is improving sharply, despite the timid recovery of the rest of Europe

On the eve of their EU membership, the Acceding Countries are showing continued improvement in their economic outlook despite the timid recovery in the rest of Europe. Following a difficult two years in 2001 and 2002 and the relatively weak performance in the first half of last year, growth gained momentum across the region, fueled by stronger growth in exports, moderate expansion in investment activity and stable growth in consumer spending. Poland's growth continued to accelerate in each of the consecutive quarters, reaching an impressive 4.7% year on year (y/y) in the fourth quarter. In the Czech Republic, the second half of last year was also characterized by much stronger expansion, in the 3.4-3.5% range, that should provide basis for further growth in 2004 and beyond (see Table 1.1 and Annex 1 for details). Despite serious problems with gaining traction throughout the year, mostly due to struggling export-oriented sectors, the Hungarian economy is also reporting a visible upturn, with GDP growing by 3.5% y/y in the final quarter of last year, an improvement from the sluggish 2.6% expansion in January-June last year. The Baltic economies continued to break all growth records last year, with GDP growth ranging from 7.4% in Latvia to 8.3% in Lithuania. Growth rates in Estonia moderated to 4.4%, as domestic demand, mostly private consumption was weaker than estimated. The three small economies of Slovenia, Malta and Cyprus, reported moderate growth rates for 2003.

Investment activity and private consumption will play an increasingly important role in determining growth

The first signs of a global recovery, in particular the reports of a modest growth rebound in the largest EU economies in the second half of 2003, bode very well for short- to medium-term growth in the Accession Countries. Rising exports are likely to strengthen the gains in industrial production, further improve the financial situation of local companies, and improve the external balances that suffered in selected countries in the last several years. By no means, however, will the contribution from net exports become the key determinant of growth in the region. Although the negative contribution from net exports is likely to be reduced as exports rebound, growth in domestic demand will continue to play an increasingly dominant role. Even in countries where net exports have recently been strongly contributing to

growth, such as Slovakia, their role will gradually diminish in the next several years. Growth in the region will be mostly supported by a rebound in investment activity and steady expansion in private consumption. Another factor that will provide a boost to domestic demand will be wider access to EU regional and structural funds for the development of local infrastructure.

Conjunctural factors have deteriorated the performance of inflation...

Performance on inflation has been considerably more mixed since the summer months of 2003, with a wide variety of factors affecting price levels. As expected, bumper harvests and the unusual strength of local currencies that had put downward pressure on domestic prices in 2002 have not been repeated last year. As a result of drought conditions across the continent, grain harvests suffered, putting pressure on prices of key food products with increases continuing all throughout the remainder of last year. Although the fast conclusion of the war in Iraq provided some hope that the international prices for oil would drop more rapidly, in reality price levels hardly budged. Furthermore, two of the Acceding Countries, Slovakia and Hungary, embarked upon a major adjustment in VAT and excise tax rates, in order to make them compliant with EU requirements. These one-off adjustments pushed headline inflation up very rapidly, to as much as 10% y/y in Slovakia, and 8.0% y/y in Hungary. While core inflation remained under control, the impact of sharp increases in prices could have longer-lasting effects on inflationary expectations, providing for a much more challenging environment for monetary authorities. Furthermore, in the Hungarian case, inflation levels have continued to be influenced by rapid growth in real wages.

...and the uncertain fiscal situation contributes further

Inflationary expectations across the region are also fuelled by uncertain situation of public finances in four Central European Acceding Countries —Poland, Hungary, the Czech Republic and Slovakia. Moreover, continued fiscal problems are also likely to delay the adoption of the euro by the major Acceding Countries possibly until 2010, five to six years after the EU accession, as the chances of bringing public sector deficit below 3.0% of GDP any time soon are becoming increasingly remote. Despite the proper diagnosis of the underlying problems (structural fiscal rigidities relating to bloated and inefficient social security systems and bureaucratic waste), the local governments show little resolve in tackling the problems they are facing. Partially, this is caused by the election schedules, as ruling parties seeking re-election are unlikely to undertake socially unpopular measures. But the foot-dragging on fiscal reform is also seen as a means of supporting the still weak economic recovery through additional fiscal spending. In our Autumn report, we have indicated that the fiscal situation across the region was not very rosy. Unfortunately, the situation has deteriorated

even further since.

Therefore central banks are reluctant to ease monetary conditions

The resurgence of, still muted, inflationary pressures, and the uncertainty about the fiscal situation, put the monetary authorities across the region on alert. Following rapid declines in policy interest rates in 2001 and 2003, the monetary authorities started 2003 on a considerably more cautious note and the situation has not changed since. Central banks in key countries were reluctant to ease monetary conditions to avoid having to hike rates later in the year.

	Real GDP Growth in %		Avg. CPI Inflation in %		Unemployment rate in % of labor force		Public Sector Deficit in % of GDP	
	2003	2004	2003	2004	2003	2004	2003	2004
Cyprus	2,1	3,7	4,1	2,0	3,3	3,2	-6,0	-3,6
Czech Republic	2,9	3,8	0,1	2,7	9,9	10,1	-12,9	-5,9
Estonia	4,9	5,6	1,3	2,3	9,3	8,8	0,9	0,3
Latvia	7,4	6,1	2,9	3,1	8,2	7,9	-2,8	-2,5
Lithuania	8,3	6,1	-1,2	0,1	10,3	9,8	-1,5	-1,5
Hungary	2,9	3,2	4,7	6,2	6,0	6,0	-5,9	-4,5
Malta	1,3	3,6	0,5	2,2	5,3	5,1	-6,1	-5,5
Poland	3,7	4,6	0,7	2,3	20,0	19,4	-4,9	-5,4
Slovakia	4,2	4,6	8,6	7,5	15,2	14,7	-4,5	-5,7
Slovenia	2,3	3,9	5,6	4,4	6,4	6,4	-1,9	-1,7

Table 1.1 Macroeconomic outlook and forecasts for the Acceding Countries

Chapter 2

Forecasting Methods for Acceding Countries

The availability of a short span of reliable time series suggests the adoption of a simple time series model for forecasting. However...

...the large number of macroeconomic series available for forecasting makes dynamic factor models a powerful alternative forecasting tool

This Chapter is an evaluation of time series methods for forecasting macroeconomic variables such as GDP growth, inflation and interest rates for the ten countries acceding to the European Union. Forecasting of these indicators is an exercise of considerable importance given that key policy decisions will need to take account of the expected future evolution of these variables, as highlighted in the previous Chapter where judgemental forecasts partly based on structural models were discussed.

Because of the period of transition, the difficulties in the forecasting exercise arise from the availability of only short spans (denoted T) of reliable time series and from the existence of structural breaks. This suggests the adoption of simple time series models as forecasting tools, possibly robustified against breaks, because of their parsimonious specification and good performance.

However, despite the constraints on the *time* span of the data, a large number of macroeconomic series of potential use in forecasting (for a given time span) are available for each country. This makes the recently proposed dynamic factor models a viable and alternative forecasting tool, where the limitations on estimation and forecasting implied by the short length of time series are compensated by extending the longitudinal dimensional of the data (denoted N).

Dynamic factor models have been successfully applied in a number of papers to forecasting macroeconomic variables for the US and the Euro area. The primary justification for the use of factor models in large data sets (where N may exceed T) is their usefulness as a particularly efficient means of extracting information from a large number of data series, albeit of a short time span. Forecasts of key macroeconomic variables may be significantly improved, not least because in a rapidly changing economy (subject to irregular shocks), especially in the economies of acceding countries, the

ranking of variables as good leading indicators or forecasting devices for, say, inflation or GDP growth, is not at all clear *a priori*.

Factor models allow to remain “agnostic” about the structure of the economy, but also to incorporate all the available information in the forecasting exercises

Thus, factor models provide a methodology that allows us to remain ‘agnostic’ about the structure of the economy, but to employ as much information as possible in the forecasting exercise. They are also of importance since the methodology offers researchers better tools for the analysis of economic policy, for example by including forecasts from factor models in estimating Taylor-type rules. Moreover, policymakers operate in real time and in their decision-making process commonly use extensive information on economic activity, data from different sources, different frequencies and different vintages. In this respect, factor models permit the incorporation of such heterogeneous information in the empirical analysis, thereby providing a clearly specified and statistically rigorous but economical framework for the use of multiple data sets.

Simulation experiments show evidence that in sample sizes typically available for Acceding Countries AR forecasts perform better for medium horizons...

Annex 2 provides a comparison of the relative performance of the two formal forecasting approaches (time series models and dynamic factor models), first by means of simulation experiments and then using data from five acceding countries: the Czech Republic, Hungary, Poland, Slovakia and Slovenia. The results from the simulation exercise help to interpret the empirical forecasting exercise. In particular, simulation results show that in sample sizes of quarterly data typically available for Acceding Countries, even when a factor model generates the data, AR forecasts can produce higher forecasting precision. In practice, the costs of using a simple AR model are lower than the estimation costs associated with the large scale factor model. This holds unless the factor-based forecasting model is very simple, just one or two factors, and the forecast horizon is short.

In the empirical application we compare various specifications of factor models with simple AR and VAR models. The factor models differ according to the lag structure (inclusion of lagged endogenous variable, lagged factors our without both), model selection method (fixed model structure or selection with BIC criterion) and factor extraction (balanced or unbalanced panel). The main advantage of such an approach is that it considers a large number of different model specifications and thus provides extensive information on general forecasting performance of factor models compared to standard time-series models and serves as a robustness check of our methodological approach. In addition, we consider intercept correction and second differencing as robustifying devices.

...but in empirical exercises factor models generally perform better than AR models in forecasting one-quarter ahead

Overall results support a careful use of factor models for forecasting macroeconomic variables for the Acceding Countries

Our baseline forecast comparison considers only country-specific data. We use quarterly data for the period 1994 – 2002. The number of series range from 38 for Slovenia to 60 for Hungary. The data sets broadly contain output variables (GDP components, industrial production and sales); labour market variables (employment, unemployment, wages); prices (consumer, producer); monetary aggregates; financial variables (interest rates, stock prices, exchange rates), balance-of-payments data and, where available, survey data.

We also investigate how inclusion of Euro area data in forecasting models affects forecasting performance. Euro area information is used in three ways. First, Euro area variables are used as exogenous regressors in the AR forecasts. Second, in the factor models, the forecast for each country is constructed using Euro factors only, in the same way as the country-specific factors. Third, Euro factors are combined with country-specific factors.

The results can be summarised as follows. A factor model yields the best forecasts for GDP growth for the largest countries, namely, the Czech Republic, Hungary and Poland, while a VAR is best for Slovakia and Slovenia. For inflation, an AR model is the best performing for Hungary, while factor models are preferred for the other for countries. For the short term interest rate, factor models work best for the Czech Republic, Poland and Slovakia, an AR model with Euro area information for Hungary and Slovenia.

Five other general results emerge from the analysis. First, in samples as short as ours it may be better to use a fixed model rather than selection using the BIC criterion. Second, adding an AR component to the factor model is usually beneficial. Third, Euro area information has minor predictive content. This finding is due to the declining synchronization of the Acceding countries with the Euro area because of the convergence process, as noted in the previous EFN Report. Fourth, pooled forecasts constructed by taking the average of the individual factor forecasts do not systematically beat the AR benchmark, in line with the simulation results presented in Annex 2. Finally, intercept corrections and second differencing (as forecast-robustifying devices against structural breaks) should be used with care because they yield forecasting gains only in few cases.

To conclude, we argue that the results are supportive of a careful use of factor models for forecasting

macroeconomic variables for the Acceding Countries. The collection of better data sets prove valuable for policy makers, who by being constrained by the time dimension of data at their disposal, could benefit from exploiting as much information as possible from the longitudinal dimension.

Chapter 3

The Sustainability of Current Accounts in Acceding Countries

Current account deficit is a key policy issue for developing countries...

The episodes of exchange rate and balance of payment crises during the 90s highlighted the danger of having too big current account deficits. Policymakers in many developing countries are faced with the problem of how to avoid too wide external imbalances and how to finance the existing ones, minimising the risk of sudden stops or reversals in the flow of foreign investment. Several dimensions of economic policy are concerned. First, demand management: policymakers can exert a (limited) control on the balance between saving and investment by adjusting budget deficits and promoting private saving. Second, the choice of the exchange rate regime plays an important part in how the economy reacts to shocks and how the external imbalances evolve. Third, on the financing side, economic policy must be focused on keeping the countries attractive for foreign investment, especially in the form of long term commitment such as FDI. At the same time structural reforms must be implemented in order to have a sound financial system able to manage international inflows, and to minimise the probability of banking crises.

...and for Acceding Countries too, especially as they will try to join the Monetary Union

The issue of current account sustainability is particularly important for Acceding Countries in several respects. Most of these countries show big and in some cases, widening, deficits, originated by both a surge in investment and expansionary fiscal policies. Moreover, after the entry into the EU these countries will try to join EMU. The transition to the single currency will have to be designed taking into account current account imbalances. In several of these countries external deficits are mostly financed by FDIs, but it is not at all granted that their size will be stable in the near future. The inflow of more risky investment will require developed and sound financial systems.

A first step in analysing current account positions in Acceding Countries is to assess whether they are sustainable, i.e. if the continuation of the current government policy stance and private sector behaviour are going to entail an increase in foreign debt which would require a drastic policy shift (such as a fiscal contraction) or trigger a balance of payment or currency crisis. To this end we use a simple standard accounting methodology, which takes into account the projections of real GDP growth, real interest and exchange rate and the current level of external debt (assumed to be the optimal one) and considers the importance of FDI as a non debt-creating source of financing (see Annex 3 for details). Overall, assuming that in the medium term the FDI flows relative to GDP

According to a standard accounting methodology, most of the Acceding Countries have sustainable current account deficits

will remain constant, all the countries considered, with the exception of Lithuania, have sustainable current account deficits, in the sense that, given the assumptions on growth and interest and exchange rates, debt is stabilised at the current level. However, if FDI are not considered, the sustainable level of imbalances appears much smaller than the observed ones. This underlines the importance of FDI in the financing of the deficit, and highlights the fact that attracting them should be one of the main priorities for economic policies in Acceding Countries.

Fiscal deficits, per capita income growth and trade openness increase the external imbalances

The next step of the analysis is an assessment of what drives the current account imbalances, in order to have a rough idea of their possible developments. We found that the budget deficit is strongly correlated with the external deficit: on average, a percentage point worsening in the budget balance leads to a 0.4 % deterioration in the current account. The increase in per capita income appears to be negatively correlated with the external balance. Higher income reduces individuals' credit constraint and thereby savings, a result in line with previous analyses of developing countries. Financial deepening (measured as ratio of money to GDP) shows a positive correlation: a more sophisticated financial system might incentivate saving. However the overall effects of these variables are ambiguous: for example a more developed credit market may as well boost investment, leading to a deterioration in the current account. Finally, trade openness has a negative correlation with the current account. Higher openness indicates a higher ability to repay external debt, and therefore weaker external borrowing constraints. We use the result of the estimation in order to simulate the paths of current account until 2007. To this end we use a forecast for per capita GDP and the targets for budget deficit these countries spelled out in their Pre Accession Plans. Moreover we assume that for most of the countries trade openness is set to increase. Concerning financial deepening, the possible ambiguous effect it may have leads us to keep it constant for the forecasting period. The simulations indicate that current account deficits are set to widen considerably for all the countries, as the projected reduction in the budget deficit is not enough to compensate for the effects of the forecasted rapid growth in per capita income. On top of that, even assuming that FDI will remain at the same ratio to GDP observed in the last years, this would lead to a quick build up of foreign debt in most of the countries analysed, in contrast with the results obtained previously.

The main implications of this simple simulation exercise are twofold. First of all, widening deficits and some debt build-up are a natural product of the transition process. Secondly, Acceding Countries have committed themselves to a quick reduction of the budget deficit. According to the simulations, these measures (provided that they are really implemented and yield the expected outcome) would not suffice to avoid a deterioration of the external imbalances.

The conclusion for countries willing to join ERM II as soon as

Transition is likely to widen the deficit and increase external debt in Accessing Countries

possible is that, if the government is keen on targeting the current account by means of the fiscal policy only, it will be obliged to take much harsher measures, with possibly negative consequences on growth.

A final note of caution is also imparted in relation to the interpretation of the business cycle evidence in the light of the countries' short post-transition history and their heady development and ongoing structural change.

The results raise two additional issues related to the financing of investment and to the adoption of the Euro.

The saving rate

Government savings should be increased in order to reduce the external deficit

Investment are going to be high in Accessing Countries for some time, as they still enjoy a much higher return on capital than existing EU member due to a lower capital stock. Therefore a high saving rate is needed in order to prevent dangerously high levels of external deficit. Policymakers in these countries should therefore aim at increasing private savings (which is already at levels comparable to that of EU Countries) or make efforts to strengthen government one. Government saving would also act as a sort of buffer, providing insurance against external shocks affecting negatively the current account. A related question is the feasibility of a large fiscal tightening in these countries, as it may clash with real convergence targets for which a high level of public expenditure is often needed.

Adoption of the Euro

Accessing Countries will experience substantial external imbalances during their transition to the single currency. The choice of the exchange rate regime for the interim period should acknowledge the existence of the deficit and the related risks.

The choice of the exchange rate regime should also consider the external deficit...

Large capital inflows mirroring the current account deficit are largely a real phenomenon, which is independent of the exchange rate regime chosen. However, adopting fixed or flexible exchange rates exposes the countries to different kinds of risk. With a long lasting fixed exchange regime, agents might tend to borrow heavily in the foreign currency, making the costs of adjusting the exchange rate very high. Moreover, given the trend real appreciation due to the Balassa Samuelson effect, too early an adoption of the euro could lock the countries to a "wrong" exchange rate.

On the contrary, a flexible exchange rate would act as a partial disincentive to have big foreign exchange open positions, making

the system as a whole less vulnerable. In this case, however, the mismatching of banks' assets and liabilities can become sizeable, and big swings in the exchange rate can cause relevant problems of non performing loans. In this sense the quality of the financial system in Accessing Countries, has a critical importance, as discussed in the final Chapter of this Report.

**...but
developing
good fiscal,
financial and
monetary
institutions is
as important
as the choice
of the
exchange rate
regime**

It has been argued that in order to have successful macroeconomic policies in developing countries, the development of good fiscal, financial and monetary institutions may be more important than the choice of the exchange rate regime. As shown by almost all the recent examples of exchange rate crisis, weak institutions amplify the effects of external shocks, as in the case of the banking crisis occurred in Asia in 1997, or greatly reduces the possibility of the economic authority to react to external shocks. Recent surveys on the subject and the regular reports produced by the European Commission, show that the adequacy of financial institutions in Accessing Countries is still quite diverse, see also Chapter 5.

A tentative conclusion is that countries still having flexible exchange rates should maintain them as long as convergence has (among other things) reduced the size of the deficit. This must be complemented by strong and credible commitments to keep inflation under control and to improve the financial institutions in order to have monetary policies transmitted to the real sector in the most powerful way, see the next Chapter on the latter point. Adopting a fixed exchange rate agreement and choosing the wrong parity would shift the burden of the adjustment to domestic demand, being devaluation impossible (in the case of euroisation) or extremely difficult or painful, in the case of pegged rate or currency board and given the strong degree of wage and price rigidity. The correction of imbalances would then entail a compression in demand or a marked reduction in nominal wages.

On the other hand, for countries with various forms of fixed exchange rate arrangements, the shift to flexible exchange rates would be too costly in terms of turbulence in the financial system. Their economic authorities will have to put even more attention in checking current account imbalances, using demand policies, and at the same time guaranteeing that deficits are financed in a relatively safe way, and managed by sound financial institutions.

Chapter 4

Monetary Transmission in Acceding Countries

The understanding of the monetary transmission mechanism underlies an effective conduct of monetary policy...

The analysis of the monetary transmission mechanism tries to describe the channels through which monetary policy decisions are transmitted to the economy and affect policy objectives. Knowledge of the monetary transmission mechanism underpins effective conduct of monetary policy: It allows not only selection of an adequate set of policy instruments but also their implementation in a timely way. Two aspects are important in evaluating how monetary policy affects the real economy. First, the transmission from the instruments directly under the central bank's control (i.e., short-term interest rates or reserve requirements) to those variables that most immediately affect conditions in the non-financial sector (loan rates, deposit rates, asset prices and the exchange rate). Second, the link between financial conditions and the spending decisions of households and firms that will affect aggregate demand.

...but the evidence so far is not clear

In this Chapter, we focus on this second aspect of the monetary transmission in eight Acceding Countries: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia. The analysis of the monetary transmission in these countries is especially relevant because after joining the European Union they will try to adopt the euro and enter the single monetary policy area. In fact, as more central banks in Acceding Countries move towards inflation control, a good knowledge of the transmission mechanism in their economies becomes crucial for implementing good policies. Moreover, in the context of the Monetary Union, "country" differences in terms of business cycle positions can also be related with differences in monetary transmission (Kieler and Saarenhimo, 1998). In fact, as Hughes, Hallet and Piscitelli (1999) point out, asymmetries in monetary transmission could destabilise the business cycle, and put countries out of phase with one another in a way that could not be corrected by deficit constrained fiscal policies. The effect would be to delay convergence.

As Ganev *et al* (2002) highlight, the literature on the

An important aspect to consider, when analyzing the monetary transmission mechanism in the Acceding Countries, is the presence of different exchange rate systems

monetary transmission mechanism in Acceding Countries does not contain much clear evidence. Most of the studies dealing with the first step of transmission find some links between market interest rates (the ones influenced or set by central banks) and commercial banks' deposit and lending rates. However, these links are usually very weak. Given this weak first step of transmission, the studies generally do not find evidence of a significant second step of transmission between monetary variables and inflation or GDP.

One aspect that should be taken into account when analysing monetary transmission in Acceding Countries is their different exchange rate systems, as there is a clear link between the exchange rate regime and the way monetary policy affects the real economy. In fact, monetary policy has not been independent from the exchange rate system adopted. Those Acceding Countries that rely on fixed exchange rates, particularly on hard pegs like currency boards, have tied hands in monetary policy. On the other hand, those Acceding Countries that opted for floating exchange rate regimes, particularly free floaters with inflation targeting, retain independence in their monetary policies, with those countries relying on intermediate regimes, such as managed floating, somewhere in between. Moreover, and due to the continuous changes experienced by these economies, the analysis of the role of monetary policy and its transmission is not an easy task. As Gollinelli and Rovelli (2002) highlight, in official policy reports of some central banks during the past decade, one often encountered statements implying that "monetary aggregates behaved unpredictably", "the relation between money and growth was unpredictable" or "changes in interest rates did not significantly affect in a negative way domestic demand". In this context, it is not surprising that at the start of the transition period many Acceding Countries have not chosen to exercise an active, independent monetary policy and instead have adopted a fixed exchange rate policy.

In fact, nowadays, the degree of monetary independence is clearly related with the exchange rate system but also with the level of capital controls in the considered economy. The following figure summarises the interactions between the exchange rate system, capitals controls and monetary independence.

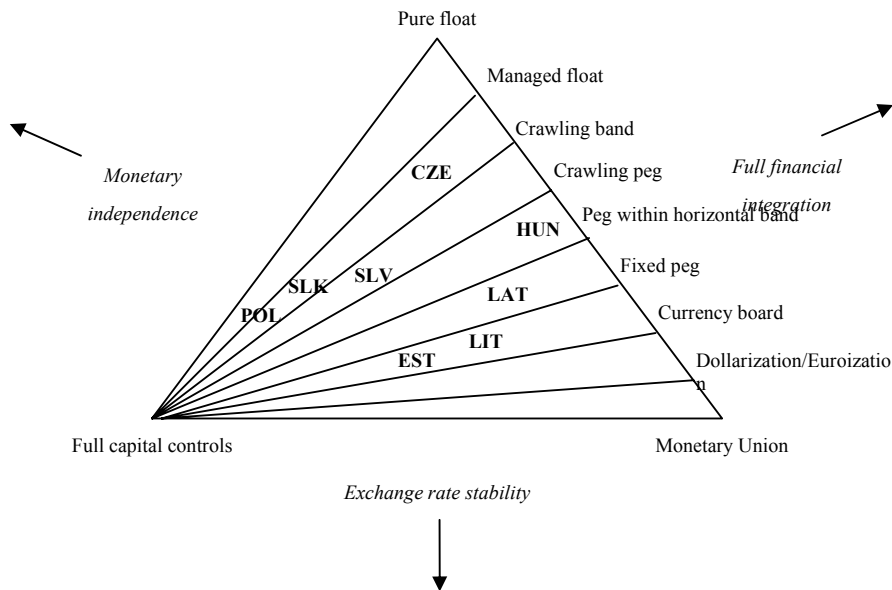


Figure 4.1: Exchange rate systems in the Acceding Countries, adapted from Dean (2003)

The Acceding Countries can be grouped into two main clusters: countries with (free or managed) floating exchange rate systems and countries with fixed pegs

From Figure 4.1, two different groups of countries can be distinguished:

- The first group includes the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia. The first three countries have adopted a direct inflation targeting approach to guide their monetary policy (although in Hungary more than one nominal anchor is considered). Poland has a free floating exchange rate system while the Czech Republic has a managed floating exchange rate system and Hungary has a fixed peg, but with $\pm 15\%$ bands. In these three countries, we should expect a high degree of autonomy for conducting their monetary policy. Regarding the Slovak Republic and Slovenia, both countries use the exchange rate as a nominal anchor for monetary policy and their exchange rate system is a managed floating. It is worth mentioning that, apart from the exchange rate, in Slovenia there is also a monetary aggregate target while in the Slovak Republic various indicators are also monitored in order to conduct the monetary policy. In both cases, the ability to use discretionary monetary policy would be similar, although a bit more limited, than in the previous case.
- The second group corresponds to Estonia, Lithuania and Latvia. The first two countries have currency board arrangements, while Latvia adopted a fixed peg with the SDR. One of the main reasons for introducing the

The empirical analysis supports the effectiveness of monetary policy in the Acceding Countries

currency board was to obtain price stability by eliminating (the money-supply related) domestic sources of inflation. Under a currency board arrangement there is no active monetary policy. This means that exogenous changes in interest rates or money supply do not arise from monetary policy. In fact, once the currency board is in place, fluctuations in the nominal exchange rate become external shocks to which the system adjusts automatically. Something similar happens in Latvia, where the role of monetary policy is very limited.

In order to analyse the role of monetary policy and the relevance of the different monetary transmission channels in these two groups of Acceding Countries, we use different VAR models trying to capture the different dynamics of output, prices, interest rates, money and the exchange rate. We have chosen this methodology because it allows us to place minimal restrictions on how monetary shocks affect the economy. In fact, it explicitly recognizes the simultaneity between monetary policy and macroeconomic developments (reaction function) as well as the dependence of economic variables on monetary policy. Moreover, using different specifications and identification strategies, it is possible to take into account their different exchange rate systems when analysing the monetary transmission process. Of course, other differences between countries such as the financial or the legal structure could play an important role in explaining differences in the transmission of monetary policy are not explicitly considered in this paper. However, it is worth mentioning that although the degree of financial development is surely relevant in the two steps of monetary transmission (from policy variables to market interest rates, loans, etc. and from financial conditions to real activity), some authors have stressed that it would be more relevant for the first step than for the second (see, Cecchetti, 1999). Moreover, other authors such as Carlino and DeFina (1999) have found evidence that the effects of the banking system are clearly interrelated with other variables such as the average size of firms or the predominance of more interest-rate sensitive sectors such as manufacturing or building.

Evidence is also in favour of a strong relevance of the interest rate channel...

The analysis of the impulse response functions of the VAR models (estimated using quarterly and monthly data from 1993 to 2003) permits to conclude that monetary policy has been effective to fight inflation or to stabilize output in nearly all the considered Acceding Countries, although the results should be taken with some caution as the uncertainty around the estimated responses is substantial (probably, due to the short number of available observations).

Following Morsink and Bayoumi (2001), and to evaluate the share of fluctuations in output and prices that are caused by different shocks, we have also calculated their variance decomposition at forecasts horizons of one through four

...though some differences emerge across countries

years, see Figure 4.2. A higher relative influence of each kind of shock could be interpreted as evidence of a higher relevance of the associated transmission channel: the interest rate channel or the exchange rate channel. The results show that the transmission of monetary policy operates through the interest rate channel combined, in some cases, with the exchange rate channel.

Looking at individual countries results (see Annex 4 for details), in the Czech Republic, the response of GDP and prices is very low and, in the case of prices, is only negative eight quarters after the initial shock. The reactions of consumption and investment are very similar to the ones observed for overall GDP, and there is evidence of the relevance of both transmission channels: the interest rate channel and the exchange rate channel.

In Hungary, the reaction of both real GDP and prices is faster than in the Euro area (only three or four quarters after the shock). However, the effects are not as persistent as in the Czech Republic. Contrary to previous results, we find that the most relevant transmission channel is the interest rate.

For Poland, the observed responses are quite close to those for the Euro area, with the only exception that the response of real GDP is much faster. The only relevant transmission channel is the interest rate channel.

In the Slovak Republic and Slovenia, there is clear evidence of an exchange rate channel, while it seems that the interest rate channel of monetary policy remains blocked. In this context, and given the critical importance of joining the Euro area as soon as possible, the monetary authorities should pursue further de-indexation of the financial contracts and stand ready to use interest rates to defend the currency and fight against inflation. For example, Festi (2001) defends the use of open market policy instruments by the Slovenian central bank. In fact, he highlights that it can enable a permanent flow of money between commercial banks and the central bank that would permit to send signals to the money market. In fact, shifting to a balanced conduct of monetary policy that also relies on the interest rate channel in a de-indexed economy environment would contribute to prepare the financial sector to the ECB policy-operating environment, where monetary policy is implemented and transmitted primarily through interest rates (Suardi, 2001), and only to a minor extent through the exchange rate (Angeloni *et al.*, 2003).

In Estonia, the reaction of GDP and prices to a monetary shock is very fast, although the magnitude of these effects is

small and they are short-lived. There is no clear evidence of the presence of a well-defined interest rate or exchange rate channel.

The results for Latvia show a clear response of prices to a monetary shock but monetary policy does not seem to have clear effects on output. Regarding the transmission channels, it

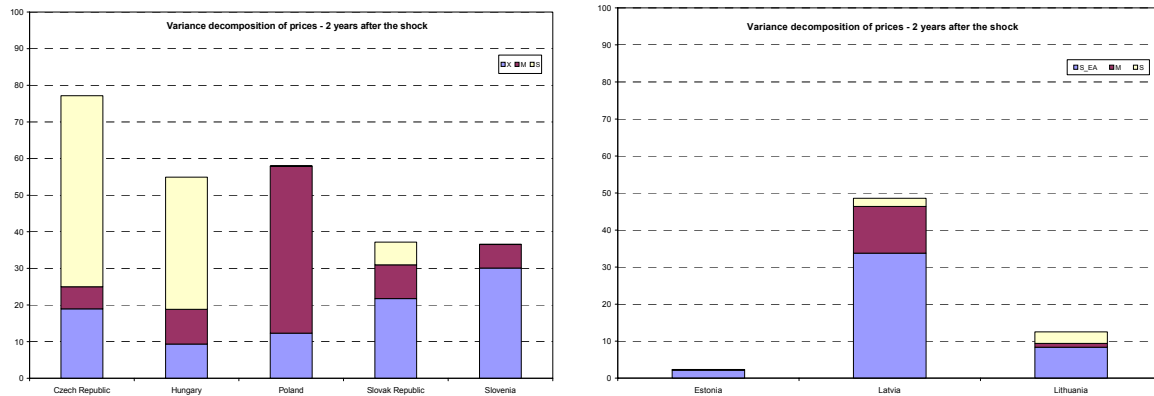


Figure 4.2 Variance decomposition of prices-two years after the shock.

x: exchange rate; m: money; s: interest rate; s_ea: interest rate Euro area

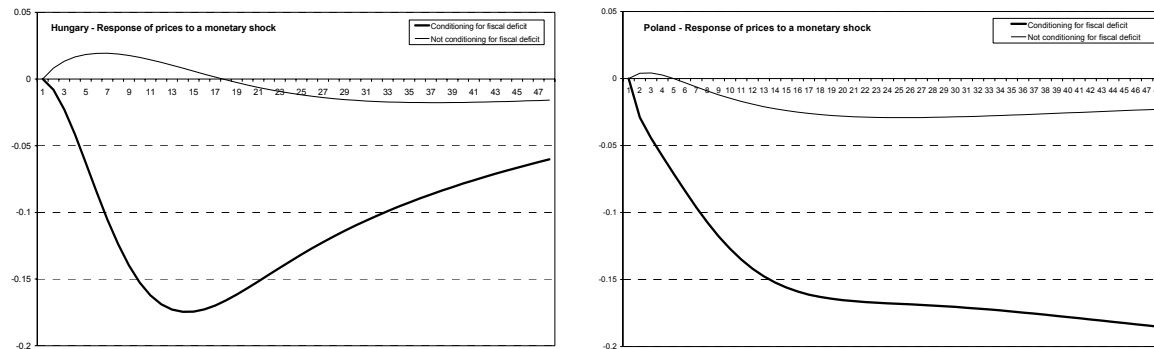


Figure 4.3 Response of prices to a monetary shock in Hungary (left) and Poland (right)

seems that monetary transmission in Latvia works through interest rate and credit channels (but not the exchange rate).

In Lithuania, there are clear effects of monetary policy on output, but not so clear on prices. In fact, the response of prices is the opposite as expected, but probably not significantly different from zero. Regarding the transmission channels, the “direct” interest rate channel seems to have been effective during the considered period.

As highlighted in the EFN 2003 Spring Report, an additional aspect that should be considered when analysing monetary policy in the context of Acceding Countries is the interaction with fiscal policy. As Ganev *et al* (2002) highlight, “during transition, the institutions which are important for the

**In conclusion,
monetary policy
can play an
important role as a
stabilization tool
for the Acceding
Countries...**

**...but, further
research is
needed.**

effectiveness of monetary policy are underdeveloped by definition, while processes hampering monetary transmission (budget deficits, bad loans) may be very strong or even dominant at times. This environment may even force the monetary authority itself into inconsistent actions, decreasing their effectiveness even further.” In order to analyse the role of the interactions between monetary and fiscal policy in monetary transmission, we have re-estimated the models for Hungary and Poland but introducing as an exogenous variable their fiscal deficit. From the analysis of the impulse response functions of prices to a monetary shock in these countries, see Figure 4.3, it seems clear that interactions between fiscal and monetary policy have negatively affected the efficiency of the second to fight inflation. In this sense, it is worth reminding that the independence of the central bank is necessary for conducting an effective monetary policy and, not only, because it is a legal pre-requisite to accede the Monetary Union, but also for economic reasons.

Before concluding, there are some issues that should be taken into account when interpreting the previous results. First, and due in part to the short time period considered because of data availability, confidence bands around the estimates of the responses to the monetary policy shock are very high (probably, in some cases, differences across countries are likely to be not significant). Moreover, one of the problems with cross-country comparisons is that the size of the estimated monetary policy shocks differs across countries. Even if we imposed the same initial disturbance, the problem would not be solved, as we would have to assume that the estimated parameters of the model are invariant to the specification of the policy rule, and then the Lucas critique would apply.

In any case, it seems that monetary policy can play an important role as a stabilization tool for these countries. For this reason, more attention should be paid to the analysis of the transmission channels using micro data on banks and firms. To our knowledge, the only study on this issue is Brada *et al.* (2003) for the Czech Republic. They investigate empirically the role of bank lending in the monetary transmission mechanism in the Czech Republic, using bank level data for 1994-2001. Their results show that changes in monetary policy indicators have counter intuitive results. In fact, in terms of the bank lending hypothesis, monetary policy does not appear to have a significant effect on the supply of bank loans. According to them, these findings suggest that Czech policymakers cannot influence aggregate demand through shifts in loan supply and, as a result, it seems that the bank-lending channel has a limited role in designing monetary policy strategies. This result clearly provides additional information to have a better knowledge of how monetary policy works. This kind of research should be extended to the rest of the Acceding Countries in a near future and the experience for current Euro Area members in the context of the Eurosystem Monetary Transmission Network should provide an excellent guideline (see Angeloni *et al.*,

Chapter 5

Challenges to Banking Sector Stability in Selected Acceding Countries

**The Banking
sectors of
Acceding
Countries have
made dramatic
restructuring...**

Following their accession to the European Union in May 2004, the ten new members will continue to undergo structural and institutional change. The EU has set a target date of 2007 for the accession of two additional countries in the region, Bulgaria and Romania. All of these countries have already made dramatic strides in improving the stability and efficiency of their banking sectors as well as in eliminating restrictions on capital flows. However, these processes are not complete and further progress along these lines, including such phenomena as increased competition in the banking sector and more substantial flows of short-term capital, in and of itself has the potential to increase the risks of instability in the banking sectors of the individual Acceding Countries.

The banking sectors of certain countries have followed rather different paths in the transition of their banking sectors from collections of state undertakings that largely served to intermediate between the government budget and budget-financed enterprises and institutions and collect household savings to groups of predominantly privately held banks functioning in competitive markets for financial services. In each of the cases, extensive restructuring of the banks was required due to the substantial burden of non-performing loans that threatened their viability as financially independent institutions.

**...due to the
burden of non-
performing loans**

The paths chosen in restructuring by Poland, the Czech Republic and Romania have had considerable impact on the roles currently being played by the banking sectors in financial intermediation in the respective economies and provide us with a spectrum of experience to evaluate their readiness to access the European Union.

At the outset of their transition from centrally planned to predominantly market-oriented economies, the Acceding Countries of Central and Eastern Europe shared the common problem that their banking sectors were characterized by a relatively small number of large, state-owned institutions that, due to political pressures and inappropriate incentives to management, had become burdened by large volumes of non-

performing loans. These banks were therefore financially unviable as independent institutions without significant restructuring of their balance sheets.

A large privatisation program was launched...

The Czech and Polish banking sectors, and to a somewhat lesser degree the Romanian banking sector, are now overwhelmingly in private hands. As of mid-2003, 83% of the authorized capital of the Polish banking sector was privately held, up from 51.1% at the end of 1995. In the Czech Republic, the state held a mere 4.1% of equity capital in the banking sector at the end of 2002, down from 31.0% as late as the end of 1996. An initial privatization effort in 1991-1993 as part of the mass voucher privatization program was subsequently followed in 2001-2002 by the privatization of state-owned stakes in the largest banks with the participation of foreign strategic investors. Of Romania's 31 banks (excluding branches of foreign banks), only 3 remained controlled by the state in 2002. The majority privately-owned banks in the country held 59.6% of Romania's total banking assets at the end of 2002, including 7.4% held by branches of foreign banks. As of end-1994, Romania's majority privately-owned banks had held a mere 19.6% of bank assets.

...increasing competition and initiating a concentration process

The impact of increased competition in the financial services sectors has generally been to trim the number of banks after initial periods of expansion, through mergers or withdrawal of banking licenses. This process has tended to preserve a rather highly concentrated character in the banking sectors of the region. In the Czech Republic, there were 37 banks operating at the end of 2002, down from a peak of 55 in 1995-1996. In Poland, the number of banks peaked in 1997-1998 at 83 but fell to 59 by the end of 2002. In Romania, the number of banks grew through 1998, reaching 36, but was trimmed to 31 by the end of 2002. The market shares of the 5 largest banks in each of the countries in recent years testify to the high degree of concentration that has resulted

The role of commercial banks in financial intermediation in Poland and Romania is much weaker than is typical for developed countries, largely thanks to the relatively short period that has intervened since the restructuring of the bank sectors.

Credit to GDP ratio still very low in comparison to EMU members...

While international financial institutions have suggested that the volume of credit to the private sector as a share of GDP in economies at this stage of development should exceed 30%, in Romania in 2002 this ratio stood at only 8.4%. For Poland, the ratio remained in the neighbourhood of 18% through 2001 before falling slightly to 15.2% in 2002, reflecting the impact of tight monetary policy. While the ratio of domestic credit to the private sector to GDP in the Czech republic peaked at 54.3% in 1997, due partly to the recession that was setting in and an extended period required to clean up the troubled portfolios of the banking sector,

it slid to only 24.3% by 2001 and further to 20.0% the following year. In sharp contrast, the comparable indicator for the aggregate of the 12 banking sectors of the EMU members rose from 103% in 1997 to 116% of aggregate GDP in 2002.

As for profitability of banking activity in these economies, in 2000-2001, return on average assets for Czech banks was positive, but fell from 0.69% to 0.45%. Return on average core equity fell from 14.99% to 9.99% in 2001. Polish banks were profitable throughout the 1996-2001 period, but rates of return declined monotonically thanks to increased competition in the market. Prior to restructuring, in Romania, rates of return were very low in 1998 and negative in 1999. Return on average assets reached 3.1% in 2001 and slipped to 2.6% in 2002 while return on average equity hit 21.8% in 2001 but declined to 18.3% in 2002.

**...as well as
returns on assets**

Improved bank regulation and supervision have been primary factors in shoring up the stability of the financial sectors of the economies in transition to date. Poor corporate governance and expectations of repeated government bailouts did not provide bank managements with appropriate incentives. In many cases, government officials used bureaucratic power to direct lending with soft repayment terms to financially troubled state enterprises. Auditing practices initially fell far short of international standards. Inadequate scrutiny in licensing new banks with insufficient capital to operate in an environment of lax supervision resulted in a rash of bank failures in some of the economies in the early post-transition. Bank supervisory efforts suffered from lack of independence, resources and expertise. The result was the heavy burden on the bank sectors of significant shares of non-performing loans that served as a brake on economic recovery and growth due to inadequate financial intermediation.

**Insufficient bank
regulation and
supervision ...**

In the post-transition period, the Acceding countries benefited from the advice of the international financial institutions in regard to improving the stability of their financial sectors. Joint working groups of the IMF and World Bank, under the Financial Stability Assessment Program, have conducted reviews of bank supervision in individual countries, measuring conformance with the 25 Basel Core Principles for Effective Bank Supervision established under the auspices of the Bank for International Settlements and have made recommendations where such conformance was incomplete. The working groups also conducted simulated stress tests for the individual bank sectors to determine if they would remain stable after suffering particular shocks.

**...being improved
following
recommendations
from IMF and
World Bank**

Accession to the European Union is likely to present the banking systems of Central and Eastern Europe with the potential need to cope with a new set of stresses. The banking systems will face growing capital inflows together with possible change in exchange rate regimes as well as downward adjustment of interest rates in the convergence toward Euro area rates. By the time of accession, all constraints on capital account flows (with the potential exception

of temporary restrictions permitted in extraordinary situations) and barriers to foreign competition in the financial sector will have been lifted.

With Accession the banking systems will face capital inflows...

Substantial capital inflows, initially largely in the form of direct investment, will fuel growth in domestic investment and consumption, in turn widening current account deficits. To the extent that current account deficits would come to be financed to a significant extent with short-term debt, the potential for sudden, sharp reverse flow of capital is created if foreign investors come to change their sentiment about the country.

...and Euro deposits may become very popular

While deposits in foreign currency declined as a share of total deposits as confidence in a fairly stable exchange rate increased, in the run-up to EMU accession, euro deposits may become increasingly popular. Sensitivity to interest rate differentials among local currency and euro deposits in domestic banks and between euro deposits at home and those held abroad could generate destabilizing capital flows. To the extent that banks' balance sheets are asymmetric in terms of their assets and liabilities denominated in foreign currencies, sharp movements in exchange rates can have a substantial impact on their financial situation.

Volatility of exchange rates may have serious consequences for banks...

Additionally, sharp exchange rate movements may also have serious consequences for the financial conditions of the banks' major customers, their ability to repay loans denominated in foreign currency, and hence for the quality of the banks' assets.

...requiring strict monitoring of banks' open foreign currency positions...

It will continue to be necessary for bank supervisors to monitor banks' open foreign currency positions and limit them if they threaten to create serious exchange rate risk to the balance sheets. It will also be necessary to monitor vulnerability to asset quality in the form of foreign currency lending to customers who might be unable to repay in case of unfavorable movements of the exchange rate.

...and further strengthening of supervisory agencies' independence

Acceding to the EU means opening the banking and financial services market wide to foreign competitors. Local banks will see net interest margins narrow and will seek to achieve greater efficiency by reducing the ratio of operating costs to assets, perhaps by growing assets rapidly through risky lending behaviour. Under this scenario, domestic banks may more rapidly approach a threatening proportion of troubled loans in their portfolios to the extent they have engaged in insider lending or implicit government-directed lending. Thus, it will be crucial to strengthen independence of supervisory agencies, enforce avoidance of conflict of interest and impose exposure limits, encourage the principles of good corporate governance, and improve standards for auditing.

Additional details are provided in Annex 5.

Chapter 6

Euro Area Outlook and Forecasts



The recovery of the world economy is now well under way...

...with the US and Asia as centres of the upswing...

Economic outlook for 2004 and 2005

After the weak performance of the Euro area economy in the first two quarters of 2003, activity picked up in the second half of the year. This was mainly due to a rebound of exports. Although the Euro appreciated against the Dollar and, to a lesser extent, against other major currencies, exports profited from the revival of the world economy. Consumption nearly stagnated and investment still declined. The modest performance of the domestic economy led to a subdued import growth.

The recovery of the world economy is now well under way. Geopolitical tensions due to the Iraq war have eased, and the terroristic attacks and the related higher costs for security do not threaten economic activity on a global scale. The ICT sector, three years after the new economy bubble burst, seems finally to have found promising new fields, in particular in consumer electronics. Monetary policy is very expansive with real short term interest rates now close to zero in the USA, in Japan and in the Euro area and there is no indication that they will be raised at any time in the coming months.

The centres of this recovery are the US and Asia. In the US growth has accelerated throughout 2003. The strong stimuli from low prime rates, expanding public expenditure and substantial tax reductions have already set a strong upswing in motion in the private sector. Growth is expected to be around 4.6 percent in 2004. This acceleration is mainly driven by an increase in business investment. According to the February 2004 report of Consensus Economics, forecasts for investment growth are about 10% on average. In contrast, consumption could prove to be the weak point, if households feel that the upswing will continue to side-step the labour market. In this case the saving rate, which is very low by historical as well as international standards, would likely rise. Indeed, up to now there are no clear signs of a significant expansion of employment in spite of the considerable expansion of output; this is due to the strong productivity growth of more than 4%. In our view, labour markets appear to be flexible enough to be finally able to profit from the upswing. Therefore, while the

change to a more cautious spending behaviour of households might very well happen in the not too distant future, the risk of an abrupt decline in consumption in the forecasting horizon is low. In line with the Consensus view, we assume strong US GDP growth rates of 4.6% for 2004 and 3.7% in 2005.

The second centre of economic growth is Asia: In 2003, strong growth in China led to a spectacular expansion of imports of around 40%. Japanese exporters profit from this development. This is one reason why Japan, after a decade of stagnation, appears to be returning to a growth path. The Japanese revival is not only driven by exports, but also by private investment, while the expansion of private consumption remains modest. The expanding Asian demand for industrial inputs is a main cause for the quite high oil prices and for the rise in many commodity prices since the autumn of 2003. The upswing in most Asian countries will continue in the forecasting period. Among these, China is becoming increasingly important for European exporters. By now, combined with Hong Kong, it is easily the third most important foreign destination for EU goods, after the US and Switzerland.

...but the Euro area is lagging behind

The US, Japan, and the large countries of the European Union presently all run sizable public deficits. Therefore, fiscal consolidation will become a priority when the upswing is clearly under way at the end of 2004. This will contribute to a slightly lower evolution of world economy in the year to come. According to our forecasts, world trade will expand around 8.2% in 2004 in 2005, after 4.2% in 2003. Downward risks, however, may stem from a reviving threat of terrorist attacks.

The output gap will narrow only slowly and will still be significant at the end of 2005

The Euro area lags behind the cyclical upswing of world economy. Its economy performed poorly in the first two quarters of 2003, recording a technical recession. Mainly due to a rebound in exports, activity picked up in the second half of 2003. However, private consumption expanded only at a slow rate, while investment continued to decline. Due to the weak performance of the domestic economy, import growth was rather low.

The outlook will improve during the forecasting horizon, but overall performance is expected to remain rather modest. GDP growth is forecast at around 1.4% in 2004 and 2.0% in 2005, see table 6.1. Although quite low, the expansion of output will be higher than the growth rate of potential GDP: the evolution over the past 3 years has slowed down capital accumulation, and the NAIRU has stopped falling. As the weak investment activity in the past hampers current capital stock, potential

Table 6.1 Economic outlook for the Euro area

	2001	2002	2003	2004: 1st half		2004: annual		2005: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					0.7		0.9		1.4
GDP	1.6	0.9	0.4	1.1	1.4	1.4	1.8	2.0	2.7
					1.6		1.5		1.0
Potential Output	2.5	2.4	1.9	1.9	2.4	1.9	2.5	1.7	2.4
					0.3		0.6		1.0
Private Consumption	1.8	0.1	1.0	0.8	1.3	1.1	1.5	1.7	2.4
					1.7		1.6		1.2
Government Consumption	2.4	2.7	1.9	2.0	2.4	2.0	2.4	1.8	2.3
					-1.3		-0.7		1.1
Fixed Capital Formation	-0.1	-2.9	-1.2	0.2	1.7	1.0	2.7	3.5	5.7
					2.6		3.3		4.8
Exports	3.3	1.7	0.0	3.9	5.1	4.8	6.3	7.2	9.3
					2.2		3.2		5.3
Imports	1.7	0.1	1.5	3.6	5.0	4.7	6.2	7.6	10.0
					8.6		8.6		8.3
Unemployment Rate	8.0	8.4	8.8	8.8	9.0	8.9	9.1	8.8	9.2
					8.1		8.2		8.2
NAIRU	8.6	8.3	8.2	8.3	8.5	8.4	8.6	8.6	9.0
					2.4		2.5		2.7
Labour Cost Index	3.3	3.4	2.9	2.6	2.8	2.7	3.0	3.1	3.5
					-0.1		0.1		1.1
Labour Productivity	0.4	0.3	0.5	0.5	1.1	0.8	1.4	2.0	2.9
					1.2		0.9		0.9
HICP	2.3	2.2	2.1	1.7	2.2	1.8	2.7	1.9	2.9
					1.3		0.9		0.9
IPI	0.5	-0.5	0.4	1.5	1.6	1.8	2.9	1.8	2.9

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate and NAIRU that are expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Year	GDP growth	Agriculture	Industrial	Construction	Services	Net taxes
1999	2,82%	0,07%	0,22%	0,12%	2,11%	0,29%
2000	3,49%	-0,01%	0,87%	0,13%	2,60%	-0,10%
2001	1,59%	-0,03%	0,10%	-0,03%	1,72%	-0,17%
2002	0,87%	0,01%	0,05%	-0,05%	0,88%	-0,02%
2003	0,43%	-0,08%	-0,01%	-0,04%	0,55%	0,01%
2004	1,40%	0,02%	0,25%	0,00%	1,15%	-0,02%
2005	2,00%	0,02%	0,37%	-0,01%	1,57%	0,05%

Table 6.2. Contributions of production sectors to GDP growth

output growth still declines over the near future. Consequently, the output gap will narrow over the forecasting horizon: both the reduction in potential growth and the acceleration in actual growth account for this development. Nevertheless, the gap will be reduced only gradually from 2004.1 on. At the end of 2005, still a significant gap of 1.3% of potential GDP is predicted. Thus, no sizable inflationary pressure is expected from the demand side. The relative weak performance of the economy is also documented in the quarter-on-quarter GDP growth rates, see figure 6.1. From 2004 on, they are almost constant at the 0.5% level. Hence, an acceleration can hardly be detected.

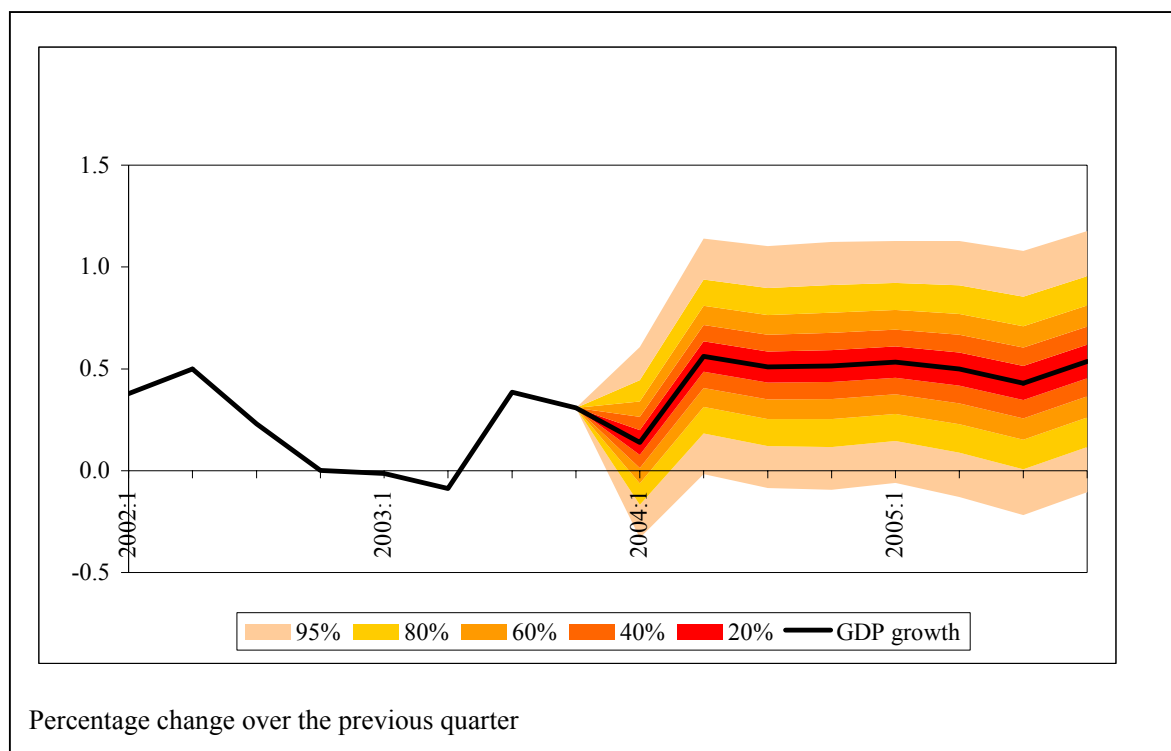


Figure 6.1. Quarterly GDP growth rates and confidence bands

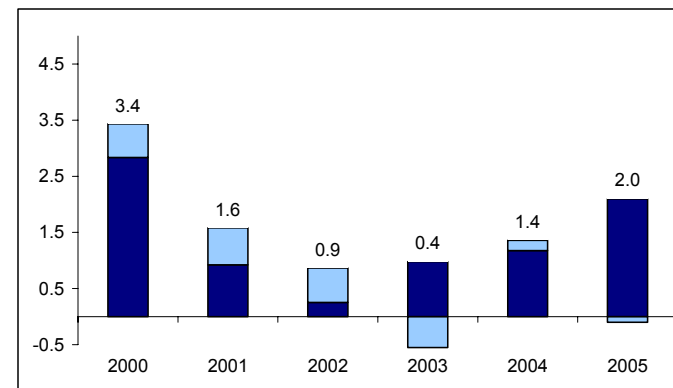
GDP growth will be mainly driven by the services sector

Net exports will contribute only marginally to growth

Considering the different production sectors, table 6.2 shows that acceleration will be more pronounced on services, but without reaching the growth rates of 2001 in 2005. The recovery in industry will be modest and no growth is expected in construction.

Although the global upswing will be reflected in a rebound of exports, the recent appreciation of the Euro will take its toll and will support import growth in 2004. Therefore, net exports will only slightly contribute to economic growth in 2004, see figure 6.3. Since import growth is expected to be weakly stronger than export growth in 2005, their impact will even turn to be negative.

Figure 6.3 Contributions of domestic components and net exports to GDP growth

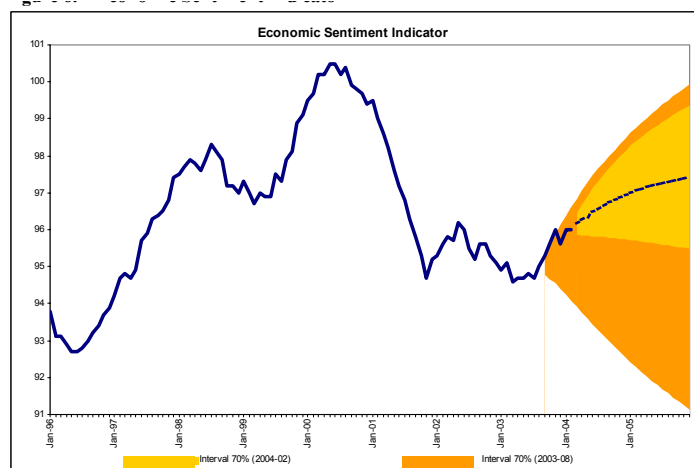


Domestic demand bright, net exports dark area. Percentage points; figures above the columns indicate overall GDP growth

Consumption and investment will pick up gradually, but their growth remains modest

Both private consumption and investment are expected to pick up gradually over the forecasting horizon. Compared to recent upturns like 1998-2000, the dynamics remain weak, although financing conditions are favourable: real interest rates are at low levels, and stock prices have been rising since the trough in Spring 2003. However, expectations of households and firms are not overwhelmingly optimistic, see the indicator of economic sentiment in figure 6.4. While the observations in the period from September to November of 2003 are in the upper band of the forecast interval, the improvement has slowed down since then.

Figure 6.4 Economic sentiment indicator, realized values and forecasts



Date: March 17th, 2004

Investment increases mainly to ensure competitiveness by adopting new technologies

One factor explaining the modest path of investment activity consists of non-optimistic sales prospects, as reflected by the evolution of the output gap. Since potential growth was above actual growth in the recent downturn period, stocks are likely to be high. Moreover, profit prospects of investors improve only gradually. Due to a recovery of productivity, real unit labour costs are roughly constant in 2004, and in 2005 a significant decline of roughly 1 percent is expected. However, the previous cumulative increase of this measure was almost about 2 percent over the 2001-2003 period, see table 6.1. Overall, investment projects will be undertaken not so much in order to meet rising demand, but to ensure competitiveness by adopting new technologies. Brighter profit prospects, the further improvement of financing conditions, and the better financial health of commercial banks will facilitate development. Tendencies for a gradual recovery in investment can be also seen in the survey indicators. The modest investment activity in the Euro area, however, might be accompanied by strong investments by European firms in emerging markets like the accession countries in the globalisation process.

The rise in labour participation will come to a halt and unemployment will remain close to 9%

Private consumption will benefit from the improved confidence of households. Consumer price inflation in 2004 will be lower due to the appreciation of the Euro. This, however, will lead to lower wage inflation: wages move in line with prices and productivity, while the labour market situation plays only a minor role. Therefore real incomes will not benefit very much from appreciation. Moreover, weighty factors prevent a more favourable development of consumption: labour market prospects will not conspicuously improve over the forecasting horizon. As GDP growth does not exceed productivity growth in 2005, employment will not significantly profit from the upswing. As a consequence, the unemployment rate is almost constant. Moreover, the increase in the labour force participation rate which was observed since 1995 will come to a halt. As potential output growth and the NAIRU are interrelated, the latter is expected to rise. Thus the unemployment gap shrinks and chances for a rise of employment without accelerating inflation are reduced.

Social security reforms cause private households to be cautious

Moreover, problems of financing pay-as-you-go pension systems and public sector deficits in major Euro area countries will stay on the political agenda, and are strong reasons for cautious consumer behaviour. Social security reforms were also discussed in the past, but nowadays, the reforms are more fundamental, implying a higher degree of uncertainty of private households.

Likewise, demand management by fiscal policy which appears to be effective in the US is not an option in the Euro area due

to the comparatively weak position of public households in large member countries. This fact is true regardless of the question of whether fiscal policy is slightly contractive or expansive and to what extent the de facto suspension of the Stability and Growth Pact has damaged confidence in the soundness of fiscal policy.

The strong positive stimulus from world trade on exports is jeopardized by the increase in the effective exchange rate of the Euro. Against the US Dollar the Euro has appreciated by about 45% since February 2002, when the rise started. The main reason for this development appears to be the sceptical attitude of currency traders towards the sustainability of the large and widening current account deficit in the US. A weaker Dollar, it is argued, will help to reduce the deficit, at least in the medium term. Because the monetary authorities of important Asian countries like China peg their currencies to the Dollar or, as in the case of Japan, slow down appreciation, a weak Dollar will largely imply a strong Euro.

As the Dollar pessimism does not rest on firm economic grounds...

Upon closer inspection, however, Dollar pessimism does not rest on firm economic grounds. It is not convincing that the large US current account deficit of the last years has its main roots in an overvalued Dollar. In that case, the US economy would have performed poorly because of the lack of competitiveness of American products. The true picture is different: it is not the choice between products of different origins but the intertemporal decisions of US households, firms and the government to spend at present, that lead to large capital imports. The counterpart of these imports is the current account deficit. Therefore, a structural reduction of the deficit would only be caused by changes in intertemporal prices, i.e. interest rates, or by a change in the expectations about future incomes in the US. Such a change might be aided by a weaker Dollar, but that does not mean that the currency has to fall until the deficit has shrunk to some level considered as sustainable. According to the EFN forecast, the Dollar will be roughly stable around 1.20 Euro in 2004. Still, measured by purchasing power parities, the Euro appears to be overvalued relative to the Dollar. Therefore, we expect a depreciation of the Euro down to 1.14 for 2005.

... we do not expect further appreciation of the Euro

More flexible exchange rates are desirable for Asian currencies

However, exchange rate forecasts are notoriously unreliable. Thus, a further rapid appreciation of the Euro is not to be considered as a totally unlikely event. If it happened, the ECB might very well come under public pressure to counteract with Japanese style intervention. But, since an exchange rate related monetary policy is in danger of being affected by the high degree of instability in the currency markets, the ECB should not depart from its strategic focus on internal stability. The best provision against the pressure from appreciation would be to convince Asian monetary authorities of the merits of more flexible exchange rates. This would mean that the effects of Dollar volatility would be spread more evenly instead of falling predominantly on Euro area producers.

Industrial production during the last six months experienced the recovery forecasted in the previous Report

Industrial production

An analysis of the economic situation of the Euro area economy also needs a short term perspective based on a quantitative monthly indicator. The Index of Industrial Production seems to be the best option for this purpose. Six new values have appeared since our last report, for August, September, October, November and December, 2003 and January, 2004. The observed values have confirmed the expected recovery, which has been a little better than forecast. While with data up to July it was expected that there would be a decrease in the average annual rate of growth of Industrial Production in 2003 of 0.1%, now a moderate recovery of 0.4% has been observed. Predictions for 2004 have also been revised up from 1.4 to 1.8%. The forecast for 2005 is also 1.8%.

The recovery comes from sectors producing capital and intermediate goods, and is expected to continue in 2004 and 2005

The average annual rates of growth for the different industrial sectors classified according to the destination of goods are in table 6.3. This table shows there is a recovery in Capital and Intermediate goods but the expectations for 2004 and 2005 for their rates of growth are still below the average levels they registered from 1998 to 2000. A recovery in consumer goods has not taken place during 2003, probably due to the effect of the exchange rate on exports, and this will be slow in 2004 and 2005 with values around 1 and 0% in Durable Consumer goods and around 0 and 1% for Non Durable Consumer goods.

The economic sentiment indicator also point to a mild recovery

The general economic sentiment indicator experienced an important recovery in the last months, but from a historical perspective it remains at rather low levels.

	1998	1999	2000	2001	2002	2003	2004	2005
Capital	6.7	2.4	8.1	1.6	-1.5	0.1	3.8	3.1
Durable	4.2	1.3	6.1	-2.1	-5.7	-4.9	1.1	0.0
Intermediate	3.7	1.9	6.2	-0.5	0.0	0.5	2.5	2.0
Non Durable	2.1	1.2	0.9	0.8	0.5	0.0	0.3	0.8
Energy	1.6	0.8	1.9	1.4	1.0	3.0	-1.0	1.1
Total EMU	3.8	1.8	5.2	0.4	-0.5	0.4	1.8	1.8

Table 6.3 Annual average rates for industrial production in Euro Area

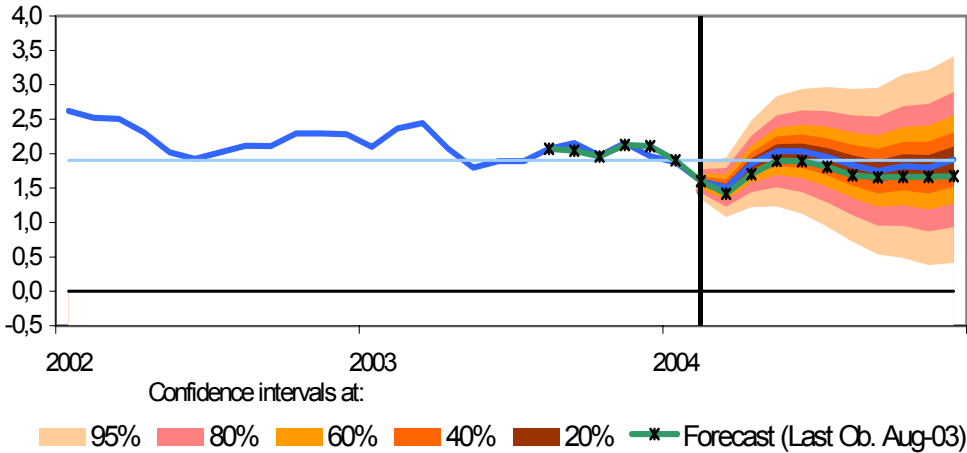
**In the last six months
inflation evolved in line
with our predictions**

Inflation

In last autumn's report the inflation forecasts were constructed using information up to August, showing that inflation in the remaining months of 2003 would be just over 2%, before slowing down during 2004 with an average annual rate of 1.8%. The six additional observations which are now available show that inflation from September to February has been close to our predictions. The forecasts for the average annual rate in 2004 and 2005 are 1.8% and 1.9%, respectively, see figure 6.5. They incorporate higher international Brent prices and slightly higher forecasts for inflation in non-energy industrial goods.

**The forecasts for 2004
and 2005 are 1.8% and
1.9%**

The monthly profile forecast for the year-on-year inflation rate during 2004 and 2005 shows some oscillations, with low values in February and March of 2004 and a subsequent recovery from April on. These low inflation values were also forecast in the previous report and the observed values for January and February can not be considered as a downward innovation on inflation which could even generate changes in monetary policy. A causal explanation of the inflation forecasts is provided in Annex 6.



Historical Inflation mean
(1995-2003)

Source: Eurostat & IFL Date: March 17, 2004

Figure 6.5 Annual forecasts for Euro area inflation (year-on-year rates)

Compared to other forecasts, the EFN is slightly more pessimistic about private consumption...

...while weak acceleration of inflation is seen in 2005

Forecast Comparisons

Table 6.4 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics Inc.

To some extent, the comparison is biased because of the different information sets. For example, the EFN forecast is based on a dataset including the 4th quarter of 2003, which has only been available since March 2004. However, for both years of the forecasting horizon, the EFN outlook is more pessimistic, in particular regarding the development of private consumption. In our view, uncertainties in respect to working prospects and the financing of the social security system will lead to a comparatively weak performance of consumption and cause the saving rate to rise over the forecasting period. While consumption of private households is on a lower path than in other forecasts, our outlook for government consumption is higher. However, these issues are related, as government had behaved anti-cyclically in the past. Hence, if the outlook is more pessimistic, government consumption is likely to be stronger. Also, the restrictions of the Stability and Growth Pact appear to be less binding.

All inflation forecasts show a nearly constant inflation rate in the years of the forecasting horizon. The EU, the ECB and the OECD forecast a slight decline, while our quarterly predictions point to an increase at the end of 2005 because of some decline in the output gap.

Table 6.4 Comparison of EFN forecast with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2004	2005	2004	2005	2004	2005	2004	2005	2004	2005	2004	2005
GDP	1.4	2.0	1.8	2.3	1.9	na	1.6	2.4	1.8	2.5	1.7	2.1
Private Consumption	1.1	1.7	1.6	2.0	1.9	na	1.6	2.2	1.7	2.4	1.4	2.0
Gov. Consumption	2.0	1.8	1.3	1.4	1.4	na	1.1	0.8	1.0	1.0	1.5	1.2
Fixed Capital Form.	1.0	3.5	2.4	3.0	3.1	na	1.7	3.9	2.3	3.9	2.1	3.3
Unemployment rate	8.9	8.8	9.1	8.9	9.2	na	na	na	9.0	8.7	8.8	8.6
HICP	1.8	1.9	1.9	1.7	1.6	na	1.8	1.6	1.5	1.4	1.7	1.6
Industrial Production	1.8	1.8	na	na	na	na	na	na	na	na	2.3	2.5

EU: European Commission, European Economy, No. 5, 2003; IMF: World Economic Outlook, September 2003; ECB: ECB Monthly Bulletin, December 2003, OECD: OECD Economic Outlook, No. 74, December 2003; Consensus: Consensus Economics Inc., Consensus Forecasts, March 2004. IMF forecasts for demand components refer to the European Union. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

BOX 6.1: VARIABLES OF THE WORLD ECONOMY

Important variables indicating the state of the world economy are shown in the table below. For the US and Japan, an economic recovery is expected, in particular for 2004. This is reflected in an increase in GDP growth rates; while inflation will remain moderate. A roughly constant oil price of 30 US dollar per barrel is expected for the forecasting period. The Euro is predicted to depreciate slightly in 2005 against the US dollar and the Yen, in line with the international parity conditions. In particular, purchasing power parity holds as a long run relationship.

Table 6.5 Variables of the world economy

	2004	2005
US GDP Growth Rate	4.6	3.7
US Consumer Price Inflation	1.7	1.9
US Short Term Interest Rate	1.2	1.8
US Long Term Interest Rate	4.1	4.2
Japan GDP Growth Rate	2.8	1.6
Japan Consumer Price Inflation	-0.2	-0.2
Japan Short Term Interest Rate	0.1	0.1
Japan Long Term Interest Rate	1.3	1.3
World Trade	8.2	8.2
Oil Price	30.0	30.0
USD/Euro Exchange Rate	1.20	1.14
100Yen/Euro Exchange Rate	1.21	1.13

Apart from the development of world trade, long term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly taken from Consensus Economics. Oil price in US dollar per barrel, all other variables in percent.

BOX 6.2: THE STABILITY AND GROWTH PACT

Towards the end of 2003 it became clear that the procedures envisaged in the Stability and Growth (SGP) for advising and ultimately, where necessary, sanctioning countries in breach of the 3% deficit ratio rule would not be enforced. Two large countries – France and Germany – were reporting budget deficits in excess of 3% of GDP without the benefit of any of the “escape clauses” written into the SGP that would allow such excesses not to attract the commencement of the procedures, see tables 6.6 and 6.7. The Commission’s advice to commence these procedures was not accepted by the ECOFIN (to test the legality of this, the Commission has launched a case against the ECOFIN’s decision).

No immediate adverse impacts on the bond markets or the foreign exchange market were noticeable (if there were to be any they could easily have been discounted in advance); nor are any such effects incorporated into our forecast. The mechanisms in our model which determine aggregate demand are broadly “Keynesian” and to the extent that the excessive French and German deficits indicate lower government saving than otherwise, they imply a support, welcome in itself, for aggregate demand and output in our forecast period.

This by no means implies, of course, that countries should take their Treaty undertakings lightly when those undertakings conflict with an immediate national interest, nor does it mean that there would be no long-run consequences were the SGP to be completely abandoned. The construction of the Stability and Growth Pact is in certain respects a remarkable thing. There is no other parallel, to our knowledge, to a situation where a group of sovereign nations has come together to agree on a pact which will potentially constrain the freedom of fiscal action of the individual countries. Viewed from this perspective it may not appear too surprising that the first attempt has not ended well. What is important is that the lesson drawn is that a renewed pact will need a better design. A lot has happened in the world since the SGP was first formulated, in terms of the attention that is now paid to the clarity and transparency of policy frameworks. It is true that the trail was blazed by monetary policy makers but there has also been progress in the fiscal sphere as well. (The IMF’s *Code of Good Practices on Fiscal Transparency* is a good example of the principles that should be adopted, whilst the UK Government’s *Code for Fiscal Stability* is a good application of them). The Eurozone is a remarkable entity in combining a unitary monetary actor (the ECB) with a large set (12 at the moment) of independent fiscal authorities. A Pact needs particularly to clarify the aims and scope of fiscal policy to make such a constitution work properly. It also particularly needs to take care of the problem of the solvency of governments. The original pact arguably placed most emphasis on the first of these requirements, providing a “rule-based co-ordination” of fiscal and monetary policy which gave the ECB full rein to assert and use its independence. This aspect of the SGP has been recognized as an optimal arrangement by leading economists such as Alesina et al (2001).

The pact does not contain a debt target other than the one implied by the promise in its preamble that governments will aim, in the medium term, for a position of balance or slight surplus. This target implies long run debt positions of zero or even negative debt. Because the Eurozone countries face in the medium run a problem of pension funding due to demographic developments, it might be sensible to aim for low debt positions now, in order to make room for a build up of debt later on. But this is the kind of thing that needs to be examined and spelt out. Different countries are in different positions regarding their current debt levels and their likely future pensions problems. On this basis it seems that a positive evolution of the provisions of the SGP *might* be one in which a deficit rule feeds back on a debt target as well as the output gap. (John Taylor (2002) has recently drawn attention to a fiscal equivalent of his famous rule for monetary policy). Such a rule would reflect the need to reduce debt levels at the same time as preserving a responsiveness to the cycle. It has been fashionable to say that this responsiveness should be limited to the “built-in stabilizers”, although there are possibilities of a rule-bound discretion being added to them (see Wren-Lewis 2002).

Some people have drawn from monetary policy-makers another lesson, and that is to copy the device of the “monetary policy committee”, which being a committee of experts (not special interests) is able to guide decision-making with freedom from the political imperatives that often produce bad policy initiatives: three such suggestions that we know of are Wyplosz (2002), Fatas et al (2004) and Wren-Lewis(2002) . It may seem unlikely that policy makers will go this far, but the call for the deployment of more disinterested expertise in the process of fiscal policy making is a strong one. One aspect of the SGP that has been undeniably good is the pressure that it has supplied for surveillance and publication of forward plans.

Alesina, A., Blanchard, O., Gali, J., Giavazzi, F. and H. Uhlig (2001) “Defining a Macroeconomic Framework for the Euro Area”, *Monitoring the European Central Bank*, 3, CEPR, London.

Fatas, A., von Hagen, J., Hughes-Hallett, A., Strauch, R. and A. Siebert (2004) “Stability and growth in Europe: towards a better pact”, *Monitoring European Integration*, 13, CEPR, London.

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Taylor, J. (2002) “Reassessing Discretionary Policy”, *mimeo*.

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Table 6.6: General government financial balances

Surplus (+) or deficit (-) as a percentage of nominal GDP								
	1996	1997	1998	1999	2000	2001	2002	2003
Austria	-3.8	-1.9	-2.4	-2.3	-1.5	0.3	-0.2	-1.1
Belgium	-3.7	-2	-0.8	-0.4	0.2	0.6	0.1	-0.2
Denmark	-1	0.4	1.1	3.3	2.6	3.1	2.1	1.8
Finland	-3.2	-1.5	1.3	2.2	7.1	5.2	4.2	3.3
France	-4.1	-3	-2.7	-1.8	-1.4	-1.5	-3.1	-3.7
Germany	-3.4	-2.7	-2.2	-1.5	1.3	-2.8	-3.5	-3.4
Greece	-7.4	-4	-2.4	-1.8	-1.9	-1.5	-1.2	-1.1
Ireland	-0.2	1.2	2.3	2.4	4.4	0.9	-0.2	-0.6
Italy	-7.1	-2.7	-2.8	-1.7	-0.6	-2.6	-2.3	-2.3
Luxembourg	2	3.4	3.4	3.5	6.4	6.1	2.5	-0.2
Netherlands	-1.8	-1.1	-0.8	0.7	2.2	-0.0	-1.6	-1.6
Portugal	-4	-2.7	-2.3	-2.8	-2.8	-4.2	-2.7	-3.5
Spain	-4.9	-3.2	-2.6	-1.2	-0.8	-0.3	0.1	-0.4
Sweden	-3.1	-1.6	2.1	1.5	3.4	4.5	1.3	0.8
United Kingdom	-4.4	-2.2	0.4	1.0	3.8	0.7	-1.5	-2.5
Euro Area	-4.3	-2.6	-2.2	-1.3	0.2	-1.6	-2.2	-2.5

^a Source: Broad Economic Policy Guidelines 2003, Table 77. 2001 -2003 updated from European Commission Forecasts.

Table 6.7: Maastricht definition of general government gross public debt

As a percentage of nominal income								
	1996	1997	1998	1999	2000	2001	2002	2003
Austria	69.2	64.7	63.9	64.9	63.5	67.3	67.3	68.5
Belgium	130.1	124.7	119.3	115	109.3	108.5	105.8	102.7
Denmark	65.1	61.2	55.6	52	46.8	45.4	45.5	42.7
Finland	57.1	54.1	48.8	47.3	44	43.8	42.7	42.3
France	57	59.3	59.5	58.6	57.5	56.8	59.0	61.8
Germany	59.8	61	60.9	61.3	60.3	59.5	60.8	62.7
Greece	111.3	108.2	105	104	102.7	107	104.7	101
Ireland	74.2	65.1	54.8	49.3	38.6	36.8	32.2	33.3
Italy	122.1	120.2	116.4	114.6	110.5	109.5	106.7	106
Luxembourg	6.2	6	6.2	5.9	5.3	5.6	5.7	4.1
Netherlands	75.2	69.9	66.8	63.1	56.1	52.8	52.4	52.4
Portugal	62.8	59.1	55.4	55.1	54.2	55.6	58.1	59.4
Spain	68.1	66.6	64.5	63.1	55.6	56.9	53.8	52.5
Sweden	76	73.1	70.5	65.3	55.6	54.4	52.7	50.9
United Kingdom	52.3	50.8	47.6	45.1	42.1	38.9	38.5	39

^a Source: Broad Economic Policy Guidelines 2003, Table 77. 2001 -2003 updated from European Commission Forecasts.