Annex 1 - Acceding Countries Macroeconomic Outlook and Forecasts

Acceding Countries' economies report accelerating growth into 2004…

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 3.2-3.3% range, that should provide basis for further growth in 2004 and beyond. 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 in 2003, with GDP growth ranging from 7.4% in Latvia to 8.3% in Lithuania. Growth rates in Estonia moderated to 4.9%, as domestic demand, especially private consumption, was weaker than estimated. The three small economies of Slovenia, Malta and Cyprus, reported moderate growth rates for 2003.

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 Acceding Countries. Rising exports are likely to strengthen the gains in industrial production, to further improve the financial situation of local companies and help 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 in particular, as well as steady expansion in private consumption. Another factor that will provide a boost to domestic demand will be a wider access to EU regional and structural funds for the development of local infrastructure.

Based on available numbers and leading indicators, Global Insight projects[1] further acceleration in regional growth this year, with the momentum stemming mostly from better economic performances in the region's largest economies, especially Poland and the Czech Republic: Poland, e.g., reported 8.7% growth in industrial output last year, fueled by increased export sales. While the construction sector is still in decline, investment spending is starting to rebound. Consumers also continue to support growth despite the unstable political situation and the very high unemployment (at 20.6% of the labor force in January). We project 4.6% growth this year, but in light of the recent indicators, we might be erring on the downside. The Czech Republic should also record moderately faster growth this

[1] Please note that Global Insight utilizes discrete general equilibrium models to forecast key indicators for the EU Acceding Countries. These models differ considerably from the econometric model of the Euro area economy that is used throughout this report. A more detailed description of the models used by Global Insight can be found in the EFN's Autumn 2003 report.

year, at 3.5%, up from the estimated 2.9% growth last year. In Slovakia, a further rapid expansion in exports and a moderate improvement in domestic demand will keep growth rates only slightly below the 4.2% y/y mark reached last year. Hungary and Slovenia, the economies most integrated into the EU economy, but also among the least price competitive among the Acceding Countries, have both had a disappointing year in 2003, with expansion of just 2.9% and 2.3%, respectively, and the improvement this year will be modest at best. The Baltic states are in great shape, but they may find it more difficult to repeat their impressive growth rates from 2003.

Inflation is staging a rebound

In our Autumn 2003 Report to the European Forecasting Network, we praised the region's performance on inflation. Both producer and consumer price inflation staged impressive declines during 2002 and early 2003, mainly due to rapid drops in prices of food products, delays in more aggressive increases in administratively controlled prices and strengthening currencies. 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 were not repeated last year. As a result of drought conditions across the continent, grain harvests suffered, putting upward pressure on prices of key food products with increases continuing all throughout the reminder of last year. Although the rapid conclusion of the war in Iraq provided some hope that international prices for oil would drop more quickly, in reality price levels hardly budged. Furthermore, two of the Acceding Countries, Slovakia and Hungary, embarked upon major adjustments 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 7.0% y/y in Hungary. While core inflation remained under control, the impact of sharp increases in prices could have a longer-lasting effect on inflationary expectations, providing 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.

The examples of Slovakia and Hungary clearly show that, under certain circumstances, inflationary pressures have the tendency to re-ignite and that the authorities should pay close attention to any signs of them. On the other hand, the risk of a major resurgence in inflation in the Acceding Countries is rather limited in the short to medium term. The inflationary pressures in the global economy remain subdued. This is not to say, however, that headline inflation will not rise in some countries. Wage pressures could be much greater in this region than in the Euro area, particularly in the medium term as citizens in the Acceding Countries demand purchasing power parity closer to that of their new compatriots. The volatility in exchange rate ahead of entry into ERM II for some of the Central European economies could result in temporary falls in the value of local currencies, as evidenced by the most recent example of the weakness of the Hungarian forint and the Polish zloty. Although this volatility would most likely be short-term in nature, the drops could be steep enough to cause a bump in inflation and force central banks to raise interest rates.

Entry Into the EMU will be delayed by Fiscal Problems

Inflationary expectations across the region are also fueled by the 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 deficits 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 indicated that the fiscal situation across the region was not very rosy. Unfortunately, the situation has deteriorated even further since. In Poland, despite meeting the annual targets in 2003, the consolidated public sector deficit is likely to expand to 5.6% of GDP this year. The detailed plan to reform Polish public finances is currently under consideration by the Polish parliament. So far, the minority government has been successful in finding supporters for the proposed measures. Unfortunately, even when all of the program's savings provisions are implemented according to the 2005-2007 timetable, Poland's total public debt could reach the constitutional limit of 60% of GDP. This, in turn, would automatically initiate a drastic adjustment plan that could destabilize the macroeconomic situation in the country, by then, already an EU member.

In Hungary, in its baseline scenario, the government assumed a reduction in the budget deficit from 9.6% of GDP in 2002 to 4.5% of GDP in 2003 and another scheduled 1.5-percentage-point reduction in 2004. However, it also estimated that, in order to achieve this goal, it would have to cut spending quite dramatically. Such a cut would have resulted in a contraction in aggregate demand by roughly 3.0% of GDP. In fact, in light of the preliminary budget deficit figures for 2002 and the first six months of 2003, the government had to admit early on that a deficit closer to 4.8% of GDP was more likely, but we considered even this increased target as not entirely realistic. In addition, the proposed cuts in the budget deficit would have to take place against the background of strong increases in the gross wage bill of the public sector. The 2003 budget assumed 4.4% growth in GDP last year (revised later on to 3.4%), which was considerably above the market consensus forecast and our own 2.8% forecast. Later on in December, Finance Minister Csaba Laszlo suggested that the deficit might reach 5.2% of GDP. The final budget for the year turned out to be even worse. Hungary's public sector deficit reached 1,054 billion forints last year, or 5.6% of GDP, substantially exceeding expectations. While we expected the deficit to expand considerably in December, when the balances of local governments and health funds were to be consolidated with the state budget, the amount of added deficit in December was exceptionally high. The 2003 results will make it that much more difficult for the government to meet the new 2004 deficit target of 4.6% of GDP and might potentially delay the adoption of the Euro later in the decade. The Finance Ministry and the National Bank of Hungary continue to work under the assumption that Hungary will adopt the Euro as early as in 2008, but the final strategy will not be adopted before May 2004.

In the Czech Republic, the fiscal reform also remains the key policy concern. If the government does not take serious reform measures, the budget deficit will continue to rise, endangering long-term growth. After repeated delays, the preliminary blueprint for public finance reform was approved by the cabinet in June 2003, with the aim of bringing the public finance deficit to 4.0% of GDP by 2006. The reforms were approved by the parliament in late 2003, and many of them took effect on January 1 of this year. The fiscal reforms plan for spending cuts worth 200 billion koruna in 2004-06, while collecting 70 billion koruna in extra revenues. Changes in mandatory expenditures are expected to save 120 billion koruna, while cuts in the spending of ministries will reach 80 billion koruna. That deficit target represents an improvement over the 2002 coalition agreement, which stipulated that the public finance deficit would be cut to 4.9–5.4% of GDP by 2006. Nonetheless, the reforms still do not go far enough, as the deficit needs to be reduced to 3.0% of GDP to meet the Maastricht criteria for entry to the Euro area. On February 1, 2004, the three ruling parties agreed on a number of additional fiscal measures as part of the second phase of public finance reforms, boosting revenues by an estimated 17 billion koruna. Nonetheless, a portion of those revenues were expected to go back to Czech firms and citizens, through write-offs for businesses and one-off payments to pensioners and families with children. Even those measures later came under scrutiny, and Finance Minister Bohuslav Sobotka admitted in mid-February that they may be scaled back.

Despite ongoing conflicts within the ruling coalition, the Slovak parliament approved the 2004 state budget on December 12, 2003. The budget deficit is targeted at 5.7% of GDP. That is considerably higher than the level in the Finance Ministry's original draft, which had planned for a state budget deficit of 4.6% of GDP. In comparison with the government's budget proposal, revenues were reduced by 18.07 billion koruna and expenditures were raised by 440 million koruna, thereby increasing the planned deficit by 18.51 billion koruna. The parliament decided that privatization revenues worth 18.4 billion koruna would be used not as budgetary revenues, as previously planned, but would rather go toward reducing debt in the health-care sector. Although the state budget deficit is scheduled to go considerably higher than originally planned, the expenditures to settle health-care debt will not have an impact on the public finance deficit according to ESA 95 methodology, as they are considered a one-off expense. Thus, the public finance deficit is projected to shrink to 3.9% of GDP this year.

The current fiscal ills in the region are not going to disappear in the short-to-medium term unless growth reaches 4-5% annually across the region and budget spending is seriously curtailed. Furthermore, as the candidate countries near the date of EU membership, the flow of pre-accession funds from the EU will require the governments to allocate amounts of matching funds within the budget, putting an additional strain on public finances. In light of the above, it appears that bringing the consolidated fiscal budgets under the 3.0% of GDP ceiling as required by the Maastricht criteria in the largest Acceding Countries by 2005-06 or even 2007 is not necessarily a reasonable assumption.

The direct result of a delayed fiscal stabilization would be a late entry into the EMU and Euro adoption. Based on the developments to date, it seems that the ten Acceding Countries will be adopting the common European currency in two stages. The Baltics, Slovenia, Malta and Cyprus, could potentially adopt the Euro as early as in 2007. The

remaining four countries will be in position to meet all the criteria by 2009-2010 at the earliest.

Authorities Reluctant To Cut Rates Any Further

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 2002, 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.

In Poland, the central bank has left the policy rate unchanged at 5.25% since June 2003 and in the most recent meeting hinted at the possibility of shifting to a tightening bias in its policies. Similarly, the monetary authorities in the Czech Republic decided to cut the policy rate in July 2003, reducing it to 2.0%, and has kept rates unchanged since. In light of the still fragile situation in the external accounts, despite a reduction in both trade and current account deficits so far this year, and the rapid increase in headline consumer price inflation as a result of the introduction of large increases in VAT tax, the Slovak National Bank had opted for keeping the rates unchanged, before cutting the policy rate only moderately to 6.0% in September 2003. Once again, the rates have remained at the same level since that time.

Against the background of consistent policies elsewhere in the region, the Hungarian case clearly stands out. Following the unexpected devaluation of the parity rate of the forint and the ensuing downward pressure on the currency, the NBH unexpectedly raised its key two-week deposit rate by 300 basis points, to 9.50% in two steps between June 11 and June 19. The move was clearly aimed at strengthening the forint and showing that this was the last increase in the cycle in order to reduce market expectations of new increases and attract fixed income portfolio investors back to the market. In line with expectations, the NBH then kept the two-week deposit rate unchanged at its regularly scheduled meetings on June 23, July 7, August 4, August 18, and September 1. The bank set a target range for the forint at between 250-260 forints per Euro that was expected to guarantee both the stabilization of the exchange rate and support the competitiveness of Hungarian producers. The unexpected devaluation of the forint in June created a new environment, under which the bank has to use its interest rate policy to keep the inflation target immune to a further weakening of the forint. This dual targeting mechanism (exchange rate stability and inflation) resulted in another undesirable monetary policy move on November 28. At an emergency meeting that day, the NBH raised interest rates from 9.5% to 12.5%, with immediate effect. The rate was then maintained during the regular scheduled meetings between December and mid-March 2004.

In light of the above developments, and with the exception of countries with unnecessarily high interest rates, such as Hungary and Slovakia, the period of radical cuts in interest rates in Central Europe is clearly over. Gradualism and moderation are in fashion, as local monetary authorities want to avoid volatility in any form, as they slowly prepare for the accession to the European and Monetary Union. With inflation picking up somewhat later this year in almost all countries in the region, and fiscal deficits staying well above set targets for 2004, central bankers will need to undertake a balancing act

between providing support to investment activity and safeguarding the achievements in fighting inflation. The convergence in interest rates, particularly at the longer end of the curve, should continue without major disruptions.

Country Overviews

…Poland's economy returns to the top of the pack

Among the largest economies, Poland's economy has entered a path of strong growth that should continue to accelerate in the coming quarters. Surprising even the most optimistic forecasters, Poland's GDP grew by a solid 3.9% y/y in the second quarter and 4.0% in the third quarter of 2003, sharply up from the 2.2% gain reported for both the fourth quarter of 2002 and 2.3% growth in the first quarter of 2003. According to the Central Statistical Office (GUS), Poland's GDP grew 3.7% for the full year 2003, considerably faster than the average 3.1% growth in the first half of last year, and moderately above our expectations. This increase implied a 4.6–4.7% year-on-year expansion in the fourth quarter of last year. Growth was driven by further strengthening of the net exports component of national accounts, a 7.7% rise in the value added in industry, 4.3% expansion in value added in market services, and a 3.1% year-on-year increase in private consumption. In contrast, while the rate of growth in capital spending turned positive in the third quarter of last year for the first time since the first quarter of 2001, the cumulative figure for the year remained negative, at -0.9%, below the previous year's level. Value added in construction contracted by 5.1%. The industrial sector, especially its manufacturing branches, is leading the charge, supported by steady domestic demand growth and expanding external demand. The leading business cycle and confidence indicator for industry, published monthly by the Central Statistical Office, also remained strongly in positive territory by the end of 2003 and in early 2004. The indicator has remained close to its highest levels, reported in early 2000.

The Polish recovery is thought to continue, with increased strength in 2004 and beyond. A further rebound in investment spending will accompany private consumption and net exports as key drivers of expansion, broadening the base for growth. Public spending is also expected to expand for yet another year in 2004, a result of a rather lax budget presented by the ruling SLD-UP coalition. Poland will also benefit from a healthy outlook for the global economy. An improvement in consumer and business confidence domestically should create conditions for rapid expansion in both industrial and services sectors. The last two years have proven that Polish manufacturers are able to quickly adjust to adverse economic environments by shedding labor force, restructuring operations, and shifting emphasis towards products more likely to find markets internationally. While business investment is expected to rebound strongly in the coming years, and the importance of net exports will gradually decline, the extent to which growth will continue to accelerate in the short-to-medium term will depend mostly on the sustainability of growth in private consumption. The consumer confidence indicators have been moderating recently after many months of steady growth. However, the retail sales statistics suggest that consumer spending continued unabated in the last few months of 2003, a trend that should continue also this year. The economy should also benefit from the increased confidence in its prospects due to the planned accession to the European Union in May

2004. On the negative side, the need to reduce the budget deficit drastically in 2005–07, to meet the Maastricht criteria for Euro adoption, might put in place austerity measures that could dampen the outlook for consumption.

Despite some improvement earlier in the year, the unemployment rate inched back to 20.6% of the labor force. This persistently high unemployment and the resulting low pressure on wages, combined with moderate increases in the money supply and tight monetary policy have all contributed to keeping inflation in check for most of 2003. The positive impact of these forces was somewhat offset by increases in food prices in the summer months due to drought conditions in most of the country last year. The same factors are expected to determine price levels this year as well. However, the expected economic recovery as well as the effects of weakening of the zloty will start to exert moderate upward pressure on prices. Even with these factors at play, consumer price inflation will comfortably fit within the medium-term target range of 2.5% +/-1% set by the central bank. Headline inflation levels will remain vulnerable to temporary volatility in prices of fuels and food products, while core inflation should follow a more stable but upward sloping trend in the next two years. Authorities should have no problem keeping inflation under control in the medium term, and monetary policy will be careful not to disturb the already-achieved stability by implementing balanced and very gradual adjustments to the monetary policy environment.

The slower economic growth of the last two years has contributed to a substantial reduction in Poland's external deficits. While those imbalances were considered to be major sources of risk in the past, robust growth in exports and weak imports helped trim current account deficits further in 2002 and 2003. The current account deficit did not exceed 3.7% of GDP for the full year in 2002, a very safe level under any circumstance and declined even further to approximately 1.6% of GDP in 2003.

POLAND

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	110.6	204.5	199.2	182.6	192.7	226.9	234.4	247.0
Per Capita GDP	*Current Euro*	2863	5294	5158	4741	5006	5894	6091	6422
GDP, Growth Rate	*Percent*	6.0	1.0	1.4	3.7	4.6	4.9	4.5	4.2
Average Annual Inflation	*Percent*	19.9	5.5	1.9	0.7	2.3	2.8	2.6	2.2
Population, End-Year	*Thousand People*	38639	38632	38610	38514	38500	38492	38478	38463
Unemployment Rate	*Percent*	13.2	17.5	18.1	20	19.4	18.5	17.7	16.5
Exchange Rate, End-Year	*Zloty/EUR*	3.62	3.52	4.03	4.71	4.55	4.42	4.35	4.30
Fiscal Balance	*% of GDP*	-3.3	-4.3	-5.1	-4.9	-5.4	-4.6	-4.1	-3.2
Net Foreign Debt	*Percent of GDP*	20.4	24.8	28.4	29.2	24.7	20.9	20.2	18.9
Exports	*Million Euro*	18810	33827	34789	37224	36472	39962	43862	45755
Imports	*Million Euro*	25101	46872	45720	45405	43476	48503	52992	55279
Current Account Balance	*Percent of GDP*	-1.0	-3.9	-3.6	-1.6	-2.2	-2.7	-2.8	-2.9

A Rebound in Czech Investment Suggest Better Times in 2004

In the Czech Republic, preliminary data on growth are available only for the first three quarters of last year. GDP jumped 3.4% y/y in the third quarter of 2003, up from a revised 2.4% in the second quarter. Growth was faster than expected, mainly due to stronger household consumption (up 7.3% y/y), but also thanks to a revival of gross fixed investment, which rose 3.9%. The external balance of goods and services continued to

deteriorate in the third quarter, although exports of services did finally improve after declining in the first half of the year. By sector, third-quarter GDP growth was driven by manufacturing (up 5.1% y/y), construction (6.9%), and hotels and restaurants (up 12.2%, mainly due to base effects related to the August 2002 floods). In the first three quarters of 2003, GDP was up 2.7% y/y. Growth was driven almost entirely by household consumption, which was up 6.0% during that period. Government spending rose just 0.4%, while gross fixed investment increased by 2.2%. GDP growth was also held back by net exports, as imports were up 7.0%, compared with a 5.8% rise in exports. By sector, growth was boosted mainly by manufacturing (up 3.6%) and transport and communications (up 3.9%). We had originally projected GDP growth of 3.3% in 2003; however, we later revised that figure down to 2.7% and then to 2.5%. Based on the surprisingly favorable third-quarter figures, and the anticipated 3.2% growth in October-December, we revised our projection for GDP growth back up to 2.8%, assuming a modest deceleration of growth in household consumption in the fourth quarter and a continued growth in investment. After the release of the fourth-quarter sales figures in mid-February, it appeared that we may have underestimated our revised GDP growth rates for last year once again. Although growth in retail sales slowed in the fourth quarter, rising sales in other services helped to compensate, and were expected to keep GDP growth relatively strong. Thus, GDP growth may have reached as high as 3.0% for the year as a whole.

After a moderate increase in economic growth in 2003, we are projecting a further acceleration this year. While GDP was boosted in the past several years by a loosening of monetary and fiscal policy, this year, room for maneuvering will be more limited in those areas. As a result, economic growth will depend more on external demand and business investment, both of which should be positively affected by the Czech Republic's accession to the European Union on May 1. Investment in the Czech Republic should strengthen over the coming years due in part to continued inflows of foreign direct investment (FDI). The Czech Republic remains a very attractive location for foreign firms, given its favorable geographic location, relatively good infrastructure, and skilled labor force. Gross fixed investment should rise rapidly in the coming years, based in part on lower tax rates for firms operating in the Czech Republic. In line with the government's first phase of fiscal reforms, the corporate tax rate was cut from 31% to 28% in January 2004, and is scheduled to decline gradually to 24% by 2006. Personal consumption growth is projected to moderate this year, as higher value-added tax and excise duties send inflation upward. In the medium term, however, household demand should contribute to driving steady economic growth. Meanwhile, government spending will be limited during the next several years, as the cabinet tries to get the country's fiscal situation under control. By sector, industry will play an important role in growth in the medium term, as production is driven by rapid inflows of FDI that have materialized over the past several years.

While EU membership provides an excellent basis for medium- and long-term economic growth, the Czech Republic's prospects are complicated by fiscal challenges, as the public finance deficit is currently well above the 3.0%-of-GDP limit required by the Maastricht criteria for membership in the Economic and Monetary Union (EMU). While several other candidate countries plan to join the Euro area in 2007, Prague has declared that its entry will be delayed until 2009 or 2010. Even that goal will require major fiscal reforms over the coming years. The parliament approved the first phase of reforms in September, but the measures have been criticized as haphazard and insufficient, as the

public finance deficit is expected to remain at 4.0% of GDP in 2006, down from an estimated high of 7.6% in 2003. As it stands now, the deficit is not scheduled to fall to 3.0% of GDP until 2008. The government and the Czech National Bank have agreed that the country will enter the ERM II waiting room only after all the Maastricht criteria have been met. Given the requirement that countries remain in the ERM II for a minimum of two years prior to accession to the Euro area, we believe that the Czech Republic will not join the EMU until 2010. That delay may have serious negative implications for the Czech economy in terms of investment and trade, putting the country at a disadvantage over those countries that join the Euro area earlier.

CZECH REPUBLIC

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	44.4	68.2	77.7	77.4	86.4	99.6	101.5	103.6
Per Capita GDP	*Current Euro*	4306	6686	7614	7589	8484	9794	9991	10203
GDP, Growth Rate	*Percent*	4.3	3.1	2.0	2.9	3.8	4.5	4.0	4.0
Average Annual Inflation	*Percent*	8.8	4.7	1.8	0.1	2.7	2.4	2.3	2.3
Population, End-Year	*Thousand People*	10312	10206	10203	10193	10183	10173	10163	10152
Unemployment Rate	*Percent*	3.5	8.5	9.2	9.9	10.1	9.7	9.2	8.9
Exchange Rate, End-Year	*CZK/EUR*	34.6	32.0	31.6	32.4	32.2	31.2	30.5	29.5
Fiscal Balance	*% of GDP*	-0.3	-5.5	-6.7	-12.9	-5.9	-4.8	-4.0	-3.5
Net Foreign Debt	*Percent of GDP*	8.3	11.8	3.5	2.9	4.3	5.7	7.6	9.2
Exports	*Million Euro*	17294	37315	40642	42596	45540	51443	52169	53415
Imports	*Million Euro*	21514	40751	43016	44839	48281	54972	55730	57011
Current Account Balance	*Percent of GDP*	-7.4	-5.4	-6.1	-6.8	-6.1	-5.4	-5.4	-4.9

Another serious concern facing the Czech Republic in the coming years relates to demographics. Given the rapid aging of the Czech population and the expectations that the workforce will decline in the long term, there exists a real danger that the country will soon exhibit a labor shortage. According to estimates by the Labor and Social Affairs Ministry, the country will need an additional 420,000 skilled workers by 2030. In an effort to prevent a shortfall and to curb the inflow of illegal workers, the cabinet launched a program in summer 2003 in which it is inviting educated foreigners from Eastern Europe to relocate to the Czech Republic. Nonetheless, Czech commentators have speculated that it may be very difficult for the country to attract such people, given that they would also likely have good opportunities to find employment in wealthier countries. In fact, by early November, the program had received only 88 applications, all but one of which came from people who were already living in the Czech Republic.

The worst of the Hungarian growth slowdown is over

Despite a moderate acceleration of economic growth in the second half of last year, the short- to medium-term outlook for the Hungarian economy is unclear at best, with analysts predicting growth rates between as low as 2.7% to 3.6% this year. While some of the preliminary data on industrial performance in the third and fourth quarters of 2003, as well as somewhat improved export figures in November and December provided a silver lining to the otherwise gloomy picture, the short-term outlook is far from optimistic. GDP growth slowed from the revised 3.5% in 2002 to just 2.5% in the first half of 2003, and we have predicted a modest acceleration of growth in the remainder of the year for a full year expansion of 2.9%. Consumer confidence, undeniably the factor that has kept the

Hungarian economy going strong in recent years, has continued to plummet. Exports continue to struggle in the unaccommodating European markets, external deficits are widening dangerously, foreign direct investment inflows are subsiding, and the government is attempting to undertake one of the most radical plans for reducing budget spending since the mid-1990s. In the midst of all these conflicting developments, the economy is trying to get traction and rebound from several quarters of disappointing performance. Under the best of circumstances, the Hungarian economy is likely to muddle through this year or so, registering growth of around 3.2% and hoping for another export-led recovery.

The outlook for this year will be increasingly determined by a combination of developments in private consumption and an ongoing recovery in industrial activity. While wages are still growing in double digits and retail sales continue to expand strongly, we expect growth in those sectors to moderate gradually. In the area of public spending, although the government plans to rein in public spending this year, the "twin deficits" in the budget and on the current account are likely to remain the feature of the Hungarian economy in the short to medium term. The National Bank of Hungary (NBH) will keep a close watch over the fiscal excesses of the government in order to make sure that the ambitious inflation targets are met. Most of the work, however, will have to be undertaken by the government, and the new finance minister will have to prove in the coming months that he is cut out for the job. After bottoming out at 3.6% year on year (y/y), headline consumer price inflation accelerated to 6.6% y/y by January 2004 and will continue to inch upwards during the first half of this year, as administratively controlled prices are hiked, VAT tax rates are normalized with EU requirements and last year's bad harvest pushes up prices for food. Higher-than-expected inflation as well as a still rather unstable forint will both keep the NBH from lowering the rates drastically in coming months. The short-term interest rate differential between the Hungarian and ECB rates at 950 basis points is now by far the highest in the region, but still fails to attract foreign investors, disappointed with the government's unclear policy framework.

Despite the current economic problems, Hungary is on course to record annual GDP growth rates of around 3-4% during 2004-07. Thanks to extensive FDI that has modernized the manufacturing, energy, and financial sectors, Hungary's export competitiveness and performance should continue to improve, although excessive wage growth needs to be curtailed. Pressures from financial markets and the EU to keep fiscal balances in order and foreign debt under control will ensure that Hungary's external imbalances do not reach threatening proportions. Going forward, Hungarian economic policies will be increasingly determined by the upcoming accession to the European Union in 2004 and the need to meet Maastricht criteria for Euro area accession just several years later.

We expect Hungary to grow at rates exceeding those in the Euro area in the long run. On average, GDP is likely to increase 3.9% a year in 2007-25. Hungary is likely to join the EMU by 2009-2010. Deeper integration with the West will help Hungary continue to attract large inflows of foreign direct investment, which, in turn, will stimulate exports, as multinational corporations will be shipping a large portion of their products abroad. One area that can act as a serious constraint to growth in the long term is the tight labor market, as Hungary's population continues to decline. Unemployment is low compared with other countries in the region, and several areas already suffer from labor shortages.

HUNGARY

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	34.5	64.7	72.4	62.1	58.2	66.6	74.3	98.7
Per Capita GDP	*Current Euro*	3391	6360	7130	6159	5805	6681	7508	10033
GDP, Growth Rate	*Percent*	1.3	3.8	3.5	2.9	3.2	3.5	3.3	2.9
Average Annual Inflation	*Percent*	23.6	9.2	5.3	4.7	6.2	3.6	3.3	2.8
Population, End-Year	*Thousand People*	10174	10175	10154	10090	10026	9962	9899	9835
Unemployment Rate	*Percent*	9.9	5.6	6.1	6.0	6.0	5.9	5.9	5.9
Exchange Rate, End-Year	*HUF/EUR*	208.1	247.7	236.1	262.2	252.0	245.0	240.0	240.0
Fiscal Balance	*% of GDP*	-2.9	-2.9	-10.0	-5.9	-4.5	-3.7	-3.5	-3.1
Net Foreign Debt	*Percent of GDP*	38.8	44.1	45.1	37.6	31.3	26.8	26.1	25.2
Exports	*Million Euro*	10111	34075	36258	37094	36675	40038	43443	45108
Imports	*Million Euro*	12468	37631	39716	41495	40657	43332	46257	47583
Current Account Balance	*Percent of GDP*	-2.7	-3.4	-4.1	-6.5	-5.6	-4.1	-3.1	-2.1

Exports propel Slovakia's growth, as FDI flows unabated

Slovak GDP jumped 4.2% year on year in the third quarter of 2003, faster than in the previous two quarters. Thus, Slovakia continued to be one of the Central European leaders in terms of economic growth. GDP was driven entirely by exports, which surged 23.1% y/y, compared with a rate of just 14.3% for imports. As a result, net exports contributed 6.74 percentage points to GDP growth. Household consumption was held back last year by tax and price hikes, which contributed to a drop in real wages. In the third quarter alone, household demand dropped 2.2%. Government consumption was also weak, as the cabinet tried to get the country's fiscal situation in order, rising just 0.2% y/y in the third quarter. Gross fixed investment declined by 0.6% during that period. The data on investment were especially disappointing, as we had assumed that gross fixed capital formation would recover in the second half of the year, as EU accession approached and the government continued to win the confidence of foreign investors. By sector, third-quarter growth was driven primarily by financial mediation, industry, and education. At the same time, value added declined in transport and communications, retail trade, hotels and restaurants, and agriculture.

In the first three quarters of 2003, GDP rose 4.0%, driven entirely by net exports. By sector, growth was especially strong in industry during the first nine months of the year, driven largely by increased production at Volkswagen. VW produced cars and components worth 130 billion koruna in January–September, up 69% y/y. During that period, the firm manufactured 202,754 cars, over 256,000 gearboxes, and 13.4 million components for gearboxes. VW reported a trade surplus of 51.6 billion koruna for the first nine months, with exports and imports of 129.2 billion koruna and 77.6 billion koruna, respectively. The role of net exports in driving GDP growth was widely expected to continue in the fourth quarter, particularly in light of the continued decline in retail sales in October-December. We estimated that gross fixed investment recovered modestly during the fourth quarter, after year-on-year declines in the previous five periods. Based on the better-than-expected third-quarter GDP figures, we raised our estimate of economic growth for the year to 4.0%, up from the previous projection of 3.9%. Full-year published on March 11, confirmed our assumptions, but growth turned in to be even more impressive, at 4.2% last year.

An acceleration in economic growth will take place in 2004 and beyond, reflecting the benefits of Slovakia's tax reforms that were implemented in January 2004, as well as the country's accession to the European Union in May. Although the implementation of a

flat income tax will give many consumers more room for spending this year, personal consumption will rise only moderately, as the final set of major regulated energy price hikes took effect on January 1 and the lower rate of value-added tax (VAT) was raised. Meanwhile, corporate tax cuts should help trigger a jump in investment spending, spurring new hiring. Growth in government spending, in contrast, will be weak during the next several years, based on the current cabinet's fiscal reforms.

Inflows of foreign direct investment (FDI) will be particularly important in spurring growth, especially in manufacturing, financial services and communications, all of which are areas where privatization and restructuring have moved rapidly. The cabinet's fiscal reforms, which have helped to present Slovakia as the most progressive country in Central Europe, should soon assist in attracting higher inflows of FDI. One investment scheduled for completion in 2006 is the PSA Peugeot Citroen plant, which will be the largest greenfield project in Slovak history. The plant should have an annual capacity of 300,000 cars and will employ an estimated 3,500 workers, in addition to indirect employment of 6,000–7,000. The PSA Peugeot investment alone is expected to add as much as 1 percentage point to GDP by 2006. FDI will be boosted further once Slovakia makes further progress on its highway network. In addition, the projected acceleration in growth will also be boosted by the improved performance on the part of Slovak companies, as more domestic entrepreneurs expand their businesses and market forces weed out less competent managers in favor of those who are able to raise sales and improve performance. The healthier economic base should help to trigger new hiring and higher wages, thereby raising household consumption. As a result of those factors, GDP growth should gradually accelerate to a high of nearly 6.0% by 2006, although it may rise even faster if other investments such as that by Hyundai materialize. In subsequent years, GDP growth should slow down to more sustainable rates. Slovakia's current overreliance on a few major firms makes the economy sensitive to fluctuation; however, in the medium term, the country will gradually become more diversified, as the government lays the groundwork for a more business-friendly environment for small- and medium-sized enterprises and the country becomes increasingly integrated with the European Union.

Fiscal reform remains the most pressing economic problem facing the country, but the center-right government that took office following the September 2002 elections seems ready for the challenge and has already made considerable headway in pushing its proposals for tax, pension, and health-care reform through the parliament. We assume that Slovakia will meet the Maastricht criteria for entry into the Euro area by 2007, at the latest, with accession in 2009. Unemployment is another of Slovakia's most difficult medium- and long-term problems, despite a significant decline in 2003. On July 1, new changes in the labor code took effect that should make firms more flexible in hiring new employees. It is also hoped that investments such as the one by PSA Peugeot will eventually help to bring down the unemployment rate.

SLOVAKIA

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	15.7	23.3	25.5	29.7	33.2	38.2	43.0	42.5
Per Capita GDP	*Current Euro*	2933	4338	4748	5514	6155	7076	7959	7872
GDP, Growth Rate	*Percent*	5.8	3.8	4.4	4.2	4.6	5.0	5.8	5.0
Average Annual Inflation	*Percent*	5.8	7.3	3.3	8.6	7.5	3.7	2.4	2.0
Population, End-Year	*Thousand People*	5379	5379	5379	5385	5390	5395	5397	5398
Unemployment Rate	*Percent*	11.3	18.3	17.8	15.2	14.7	14.1	13.4	12.7
Exchange Rate, End-Year	*SKK/EUR*	40.3	42.8	41.7	41.2	40.1	39.4	38.4	38.4
Fiscal Balance	*% of GDP*	-3.7	-4.4	-4.7	-4.5	-5.7	-4.4	-3.8	-3.8
Net Foreign Debt	*Percent of GDP*	7.5	21.4	11.6	7.8	2.1	-0.5	-1.0	-1.4
Exports	*Million Euro*	6837	14195	15288	19482	20422	22778	25354	26385
Imports	*Million Euro*	8528	16412	17559	19878	21596	24051	26668	27655
Current Account Balance	*Percent of GDP*	-10.2	-8.4	-8.0	-0.5	-2.9	-2.8	-2.6	-2.5

Slovenian Consumers Refuse To Spend More

Third-quarter 2003 GDP growth in Slovenia was 2.3%, just somewhat slower than Global Insight anticipated, although still in line with our full-year 2003 growth projection of 2.4%, which is below both the government's latest revised target of 2.6% growth and the general market expectation of 2.8%. Nevertheless, growth did accelerate compared to the first half, indicating the possible beginning of a modest economic recovery. Economic growth is expected to have accelerated in the fourth quarter—to around 2.9% year over year—on the back of improving industrial production, in turn spurred by higher domestic and export demand. In January–September 2003, the economy expanded by 2.2% year over year (y/y), the lowest sustained growth rate since 1993, and 0.9 percentage point slower than in the same period of 2002.

The modest third-quarter recovery was domestic led. Total domestic expenditure growth rose from 4.1% y/y in the second quarter to 4.5% y/y in the third. This acceleration was due entirely to a rapid 9.9% year-on-year expansion of gross capital formation, up from 6.6% y/y in the second quarter. Investment activity in anticipation of Slovenia's entry into the European Union has provided a key boost to the economy, as household and government consumption growth have stagnated and net exports have deteriorated. Household spending has not provided the lift in Slovenia it has in other Central and Eastern European countries. Household consumption growth remained sluggish in the third quarter, at 3.2% y/y, after equaling 2.8% y/y in the first half. Consumer spending has been negatively impacted by a decline in the number of employed and slow real wage growth. Government consumption has also been weak, with growth decelerating throughout 2003 as the government tightens fiscal policy in order to reduce inflation and remain on track to meet Maastricht criteria in 2004.

Leading production data indicate that the mild economic recovery of the third quarter was sustained and likely even accelerated in the final quarter. Industrial production growth recovered in the final third of 2003 after declining through August. In September–December, industrial output grew by 4.5% y/y, after falling by 0.2% y/y in the first eight months. As a whole, however, 2003 marked the third consecutive year of deceleration in industrial growth; industrial production grew 1.4%, down from 2.4% expansion in 2002. Industrial expansion was driven primarily by capital goods demand, which climbed 5.0% last year, as widespread restructuring and civil engineering projects (particularly new road construction) were undertaken. Industrial growth will continue to accelerate into the early part of 2004.

Overall for 2003, Global Insight estimates that GDP growth edged up to around 2.5% y/y in October–December 2003, in line with our full-year 2003 projection of 2.3% economic growth. Although export demand improved in the final quarter, investment activity continued to drive the economy, though it probably slowed somewhat. The lingering effects of a disastrous agricultural season also probably undermined growth in the final quarter. In September, the government estimated that the country's agricultural sector suffered damage totaling 31.7 billion tolars ($150 million) in January–July 2003, due primarily to a severe drought, which reduced estimates of agricultural output by 20–80%. Additionally, hailstorms, a late frost, and a tree disease outbreak inflicted additional agricultural losses in the first half of the year. A shortage in the harvest and, subsequently, fodder has forced the downsizing of the country's livestock as well.

An economic recovery should be more pronounced in 2004, with GDP growth for the year reaching around 4%. The recovery should be led primarily by an improvement in net exports, particularly to Germany. Export demand is already beginning to return, and imports of capital goods should begin to level off this year. Additionally, investment growth should remain vigorous. More than 500 million Euro has been designated for new road construction in 2004 while the first significant spending on the government's first five-year program to subsidize new home ownership.

SLOVENIA

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	14.5	21.8	23.2	24.1	26.5	30.1	30.3	31.4
Per Capita GDP	*Current Euro*	7293	10961	11643	12102	13355	15200	15337	15879
GDP, Growth Rate	*Percent*	3.5	2.9	3.2	2.3	3.9	3.8	3.8	3.5
Average Annual Inflation	*Percent*	9.9	8.4	7.5	5.6	4.4	3.6	3.1	2.8
Population (end-year)	*Thousand People*	1991	1991	1995	1991	1986	1982	1979	1976
Unemployment Rate	*Percent*	7.3	6.4	6.3	6.4	6.4	6.6	7.0	7.1
Exchange Rate, End-Year	*Tolars/EUR*	178.6	221.4	230.3	236.7	235.9	235.3	234.5	234.1
Fiscal Balance	*% of GDP*	0.3	-1.3	-3.0	-1.9	-1.7	-1.7	-1.4	-1.4
Net Foreign Debt	*Percent of GDP*	-0.8	5.0	2.9	5.6	1.8	1.9	6.3	7.6
Exports	*Million Euro*	6425	10439	11059	11684	12494	13762	13518	13735
Imports	*Million Euro*	7060	11131	11315	12246	13196	14592	14333	14477
Current Account Balance	*Percent of GDP*	0.2	0.2	1.7	0.1	-0.5	-0.7	-0.6	-0.3

The Baltics in a League Of Their Own

Estonia

The Estonian economy should be able to maintain a healthy expansion in the medium term. During 2004-07, we project 5.7% annual average GDP growth. The benefits of privatization and restructuring will result in higher productivity and rapid growth (almost 6% per year) in industrial output, and services will also continue to enjoy similar rates of growth. Over the following four years, growth in household consumption should remain at around 5-6% per year, while investment should continue to grow at around 7% per year, which will lead to average annual growth in aggregate demand of 5.1%.

Average annual increases in consumer prices should fluctuate around 3-4% in the next four years. Inflation will not fall much lower, as remaining administered prices are adjusted to global market levels; but Estonia should have no problem eventually meeting the Maastricht criteria on inflation. We believe the country will maintain its currency board

until EU membership requires a change in the exchange-rate regime. With EU membership scheduled for May 2004, EMU membership and the adoption of the Euro could take place as early as 2006.

With growth in Western Europe and Scandinavia, Estonia's two primary markets, expected to recover over the next few years, after the current slowdown, the pace of growth in exports is projected to marginally exceed imports. The trade deficit is projected to fall from 24.3% of GDP in 2003 to 17.6% in 2008. In absolute terms, however, the trade deficit will rise from $1,972 million in 2002 to a projected $2,598 million in 2008, as both exports and imports continue to grow at healthy levels. Similarly, the current account deficit will begin to fall relative to GDP, but will grow some years in absolute terms due to increasing trade deficits. Assuming that the government maintains a responsible fiscal policy, the current account deficit should stabilize at around 6% of GDP in the medium term. With the current account deficit under control, Estonia will become an even more attractive investment site, and the country should have no trouble drawing enough long-term investment to finance its current account deficit.

Our long-term forecast for Estonia assumes a continuation of solid growth during the entire forecast period. Annual GDP growth rates are expected to average 4.9% in 2008-25, as the economy benefits from continued development after accession to the EU. Annual growth rates are expected to moderate to around 5% from 2011 and below 5% from 2015 onward. With little or no population growth over that period, per capita GDP at purchasing power parity rises from $11,549 (in 1995 dollars) in 2002 to $40,697 in 2025. According to the Estonian government's Pre-accession Economic Program, adopted in August, economic growth should ensure that the country's GDP per capita is equal to 50% of the EU average by 2010. Consumer price inflation is projected to stay slightly above the average EU level for an extended period, as nominal increases in wages push up inflation in the environment of a fixed exchange-rate regime. Regardless of the future of the Stability and Growth Pact, a tradition of sensible fiscal policies in Estonia will ensure that the country maintains a healthy fiscal policy, which, in turn, should keep current account deficits in check. Estonia is expected to benefit from large net transfers of funds from the EU, continued inflows of foreign direct investment, and increased trade with Western Europe.

ESTONIA

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	3.4	6.3	6.8	7.2	8.0	9.3	9.6	10.2
Per Capita GDP	*Current Euro*	2288	4592	4994	5306	5964	6948	7215	7704
GDP, Growth Rate	*Percent*	3.9	6.5	6.0	4.9	5.6	5.9	5.7	5.6
Average Annual Inflation	*Percent*	23.1	5.8	3.6	1.3	2.3	3.4	3.8	3.6
Population (end-year)	*Thousand People*	1476	1367	1361	1356	1349	1342	1336	1329
Unemployment Rate	*Percent*	10.0	12.6	10.3	9.3	8.8	8.6	8.4	8.2
Exchange Rate, End-Year	*EEK/EUR*	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6
Fiscal Balance	*% of GDP*	-1.9	0.3	1.1	0.9	0.3	-0.2	-0.2	-0.2
Net Foreign Debt	*Percent of GDP*	7.3	22.6	27.8	29.1	30.0	30.3	33.9	35.3
Exports	*Million Euro*	1576	3694	3620	3951	4460	5058	5128	5359
Imports	*Million Euro*	2446	4794	5053	5678	6291	7069	7067	7282
Current Account Balance	*Percent of GDP*	-9.2	-6.1	-12.5	-15.0	-10.9	-7.8	-7.6	-7.1

Latvia

After a brief slowdown in 2003, GDP growth resumed to relatively high levels, and for 2003 as a whole, GDP expansion is likely to have reached 7.4%, as final data have not yet been released. GDP should grow at an annual average rate of 5.8% in 2004–07. Value added from manufacturing should register average growth of around 6% per year. The transport sector will maintain healthy growth of near 7% annually in those four years and continue as an engine of the economy. Latvian transport firms will be forced to adjust to the new Russian tariffs that favor Russian ports—modernization of infrastructure, adjustment in charges, and higher-quality services will keep Latvia competitive as a trade route for goods to and from Russia.

A still-healthy economy will be mitigated by the need to keep external balances under control, with average annual consumption growth just over 3% in 2004-07. Public investment and consumption will be kept in check, but the government has to provide for additional efforts to tighten fiscal policy, as the target for the central budget's balance in 2004 still posts a deficit of 2.2% of GDP, which could be lowered considerably, given the favorable macroeconomic environment. The private sector, however, should keep investment humming at 6.7% per year through 2007, as EU accession nears. Assuming the government maintains its current policies, average annual growth in aggregate demand in 2004-07 is projected to stay around 5.8%.

Further out, annual GDP growth rates should average 4.8% in 2008–25, as the economy benefits from continued development after accession to the European Union. Annual growth rates are expected to moderate from around 5.5% in 2008 to around 4.5% from 2014 on. With the population expected to continue to shrink for several more years, this means a substantial increase in per capita GDP in purchasing power parity terms, from $8,386 (in 1995 dollars) in 2002 to $29,711 in 2025. However, given the low starting point, this still leaves Latvians much poorer than most West Europeans.

Inflation in Latvia will follow the pattern of inflation in Estonia, with wage pressures and increases in regulated prices putting upward pressure on prices, but not to an excessive level. Remaining administered prices still need to be adjusted to cost-recovery levels, an important step for Latvia in the medium term to ensure that its economy is competitive. Additionally, wage pressures will intensify as EU accession nears. After peaking in 2004 at 3.1%, average annual inflation should be back somewhat below 3% from 2005 onwards. There is no indication from the Latvian government that the peg that holds the lats to the SDR will be removed this year. We assume that following a short adjustment period mandated by the European Union, Latvia will join the EMU in 2007 at the earliest.

The Stability and Growth Pact in the run-up the EMU membership will ensure that Latvia maintains a healthy fiscal policy, which in turn will keep current account deficits in check.

With the government hopefully restricting domestic demand through tighter fiscal policies, and exports benefiting from stable demand in both Western Europe and Russia, the trade deficit as a percentage of GDP should decline to near 23% by 2007. That trade trend will result in moderating current account deficits, which are projected to fall from 8.8% of GDP in 2002 ($659 million) to 5.1% of GDP in 2007 ($705 million), assuming tighter fiscal policies are implemented and sustained. In the longer term, Latvia is expected

to benefit from large transfers of funds from the European Union, higher inflows of foreign direct investment (particularly as corruption becomes less of an issue), and increased trade with Western Europe. Compared with Estonia, however, Latvia is likely to maintain a slightly higher proportion of trade with Russia and CIS countries due to its geographical location and business tendencies.

LATVIA

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	3.9	8.6	8.9	8.9	9.5	10.9	11.1	11.7
Per Capita GDP	*Current Euro*	1588	3619	3784	3807	4104	4748	4871	5149
GDP, Growth Rate	*Percent*	3.7	7.9	6.1	7.4	6.1	5.9	5.8	5.7
Average Annual Inflation	*Percent*	17.6	2.5	1.9	2.9	3.1	2.6	2.3	2.1
Population (end-year)	*Thousand People*	2468	2366	2346	2331	2315	2298	2282	2266
Unemployment Rate	*Percent*	7.2	7.7	7.6	8.2	7.9	7.7	7.6	7.4
Exchange Rate, End-Year	*Lats/EUR*	0.702	0.561	0.610	0.674	0.684	0.684	0.684	0.684
Fiscal Balance	*% of GDP*	-1.1	-2.1	-2.8	-2.8	-2.5	-2.0	-1.5	-1.5
Net Foreign Debt	*Percent of GDP*	18.9	41.5	53.0	51.7	48.1	46.1	49.8	49.9
Exports	*Million Euro*	1110	2235	2407	2520	2600	2841	3109	3262
Imports	*Million Euro*	1784	3917	4267	4588	4696	5077	5485	5704
Current Account Balance	*Percent of GDP*	-5.5	-9.6	-7.8	-9.3	-7.5	-6.4	-6.3	-5.7

Lithuania

If current policies are continued, Lithuania should easily be able to maintain a healthy rate of expansion for the next several years. Growth will be boosted in the medium term by the restructuring that has already occurred in the country's industrial sector and the impact of foreign investment on the economy. In addition, continuing privatization will benefit the overall economy by attracting better management and more investment. Consequently, we forecast that annual average growth will remain at 5.7% in 2004-07, despite a slowdown in 2004-05 due to the closure of the Ignalina nuclear power plant and the consequent plunge in exports. Despite the drop in energy output in 2004–05, industrial production should average over 6% annual growth through 2007 as a result of continued privatization and restructuring, boosted further by growing integration with the EU market. During 2004-07, annual growth of personal consumption averages 5.1%, as growing productivity allows for larger real wage gains, while unemployment declines. Government consumption will remain more subdued in order to keep domestic demand under control, despite higher expenditures to prepare for EU and NATO membership. But gross fixed capital investment should remain at healthy levels due to private-sector investment. Lithuanian firms will need to rapidly update equipment and plant if they are to increase their competitiveness in comparison with Western firms, resulting in average annual investment growth of around 9% for the next several years. Fiscal tightening will help reduce the current account deficit and moderate the pace of debt accumulation.

Our long-term outlook for Lithuania assumes a continuation of solid growth during the entire forecast period. Annual GDP growth rates should average 4.9% in 2008-25, as the economy benefits from continued development after accession to the EU. With population growth expected to be fairly stable over the long term, this results in a modestly higher per capita GDP in purchasing power parity terms, from $4,768 (in 1995 dollars) in 2002 to $14,169 in 2025. But this still leaves Lithuanians much poorer than even most citizens of other EU applicant countries. We assume that following an adjustment period

mandated by the EU, Lithuania will join the EMU in 2007-08. Consumer price inflation is projected to rise a bit above the average EU level for an extended period of time, as nominal increases in wages will push inflation up in the environment of a fixed exchange-rate regime. Once Lithuania joins the EMU, it will be forced to maintain a reasonably responsible fiscal policy, which, in turn, will keep current account deficits in check. In fact, we project that Lithuania could move into current account surplus by around 2020. Lithuania is expected to benefit from large transfers of funds from the EU, larger inflows of foreign direct investment, and increased trade with Western Europe. Those factors will also have a positive impact on the current account. Like Latvia, however, Lithuania is likely to maintain a slightly higher proportion of trade with Russia and CIS countries than Estonia does.

LITHUANIA

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	6.1	13.3	14.6	15.7	17.3	19.5	19.4	20.3
Per Capita GDP	*Current Euro*	1635	3810	4207	4534	5013	5678	5662	5917
GDP, Growth Rate	*Percent*	4.7	6.5	6.8	8.3	6.1	5.8	4.6	6.1
Average Annual Inflation	*Percent*	24.6	1.5	0.3	-1.2	0.1	1.1	1.2	1.2
Population (end-year)	*Thousand People*	3712	3491	3482	3463	3456	3449	3442	3435
Unemployment Rate	*Percent*	7.1	12.5	11.3	10.3	9.8	9.3	9.0	8.8
Exchange Rate, End-Year	*Litas/EUR*	5.0	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Fiscal Balance	*% of GDP*	-2.7	-1.7	-1.5	-1.5	-1.5	-1.0	-0.5	-0.2
Net Foreign Debt	*Percent of GDP*	19.7	30.3	26.1	21.9	20.5	21.1	24.1	25.3
Exports	*Million Euro*	2581	5121	5830	6358	6626	6996	7784	8270
Imports	*Million Euro*	3507	7099	8112	8560	9073	9851	10614	11072
Current Account Balance	*Percent of GDP*	-9.2	-4.8	-5.3	-7.0	-5.7	-5.5	-5.2	-5.1

Cyprus and Malta

Cyprus

The medium-term outlook for Cyprus is largely affected by the country's bid to join the European Union by 2004. The need to comply with EU economic standards with respect to fiscal balances and inflation will dampen growth rates in 2003–06. At the same time, the inflows of structural and regional fund from the EU should stimulate investment growth. The country will also remain highly dependent on tourism revenues, which currently generate around one-fifth of Cyprus' GDP. The performance of the agricultural sector, which is highly dependent on weather conditions, will also remain an important factor in the country's growth outlook. We currently expect that annual GDP growth will average around 3.3% over the medium term—significantly below the 4.4% in the 1990s.

CYPRUS

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	6.8	10.1	10.6	10.9	11.5	12.0	12.2	12.5
Per Capita GDP	*Current Euro*	9241	13252	13793	14145	14823	15374	15476	15739
GDP, Growth Rate	*Percent*	1.9	4.0	2.0	2.1	3.7	3.3	3.2	3.2
Average Annual Inflation	*Percent*	3.0	2.0	2.8	4.1	2.0	2.2	1.9	1.9
Population, End-Year	*Thousand People*	738	762	768	773	778	783	788	793
Unemployment Rate	*Percent*	3.4	3.1	3.5	3.3	3.2	3.2	3.1	3.1
Exchange Rate, End-Year	*Cyprus Pounds/EUR*	0.592	0.576	0.678	0.814	0.854	0.809	0.841	0.860
Fiscal Balance	*% of GDP*	-3.4	-2.8	-3.6	-6.0	-3.6	-3.2	-3.0	-1.8
Net Foreign Debt	*Percent of GDP*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exports	*Million Euro*	1070	1090	891	814	766	804	848	858
Imports	*Million Euro*	3064	4400	4312	3900	3669	3848	4050	4099
Current Account Balance	*Percent of GDP*	-5.2	-4.3	-5.1	-4.8	-4.2	-4.0	-4.0	-4.0

The need to comply with EU economic standards will reduce growth rates in the long run, bringing them closer to the growth pattern of EU countries, although some of this impact will be offset through stimulus provided to investment activity as a result of access to EU structural and regional funds. Following a GDP growth of 3.3% in 2003, the Cyprus economy is expected to gradually slow down to a more sustainable growth rate of 3.0-3.7 in the long run. While EU membership may represent an initial boost to the economy, the need to stay within EU targets would slow the economy down in the outer years of the forecast.

In recent years, the government's restrictions on work permits for foreigners have created acute labor shortages in some businesses, particularly restaurants. The restrictions resulted from pressure by labor unions, which are still relatively powerful in Cyprus. In fact, labor-market rigidity is one reason for the erosion of the island's competitiveness in manufacturing and many services. To combat competitiveness problems, the government has implemented a series of measures, including a reduction in corporate tax rates.

Malta

Weak external demand, resulting from a still stagnant world economy, as well as a downturn in world tourism in the aftermath of the September 11 tragedy and the ensuing US-led war on terrorism, have hurt Malta's economy both in 2001 and 2002. Despite the efforts of the central bank, which lowered the reserve requirement ratio and cut interest rates, Malta's economy has contracted 0.4% in 2001 and only modestly recovered some ground last year, growing by 1.0% in 2002. Malta's ability to push through necessary reforms, the country's decision to approve the proposed EU accession in 2004 at a March referendum, and the ruling party's sweeping victory in the April elections on a platform promoting the country's EU membership and reforms, bode well for the country's economic outlook.

Malta's economic performance rebounded weakly in 2002. Malta's real GDP grew 1.0%, compared with a decline of 1.2% a year earlier, but significantly below the 1995-2000 average growth of 4.6%. All sectors of the economy remained stagnant in 2002, however, with the only signs of a recovery coming from the performance of private and government consumption as well as investment in the construction sector. The gross fixed capital formation growth in construction slowed down from its 2001 level, but remained strong at 7.4% last year on the back of strong building activity and development in the tourism sector. Already existing hotel overcapacity on the island, however, should prevent

new hotel construction from remaining a major contributor to growth in the future. A rebound in exports, which were down 4.7% in 2002, as well as a pickup in investment in other sectors in the economy besides construction, would be required in order for Malta's economy to have a more pronounced recovery. All sectors of the economy managed to grow, although unimpressively, last year, with the exception of the transportation and communications sector, which shrank 4.7%. The drop in the transportation sector comes as a result of reduced airline activity, following a drop in tourist arrivals tied to the United States' ongoing war on terrorism and a slower-than-expected rebound of the world economy.

MALTA

		1996	2001	2002	2003	2004	2005	2006	2007
GDP, Total	*Billion Current Euro*	2.5	4.1	4.1	4.1	4.3	4.6	4.7	4.8
Per Capita GDP	*Current Euro*	6754	10373	10386	10443	10787	11561	11680	11921
GDP, Growth Rate	*Percent*	4.0	-1.2	1.5	1.3	3.6	3.4	3.2	3.2
Average Annual Inflation	*Percent*	2.5	2.9	2.1	0.5	2.2	2.3	2.1	2.0
Population, End-Year	*Thousand People*	380	392	394	396	397	399	401	403
Unemployment Rate	*Percent*	5.0	5.2	5.6	5.3	5.1	5.1	5.0	5.0
Exchange Rate, End-Year	*Lira/EUR*	0.454	0.401	0.472	0.566	0.594	0.563	0.585	0.599
Fiscal Balance	*% of GDP*	-7.7	-6.0	-5.9	-6.1	-5.5	-4.5	-3.5	-3.2
Net Foreign Debt	*Percent of GDP*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exports	*Million Euro*	1331	2142	2194	2139	2033	2159	2305	2355
Imports	*Million Euro*	2150	2896	3052	3020	2874	3052	3259	3340
Current Account Balance	*Percent of GDP*	-12.2	-4.6	-1.5	-5.0	-3.5	-3.6	-3.7	-3.5