The Big Four in CEE: a comparative analysis

Raymond Beimers and Harm Schonk of ABN Amro find out how Poland, Hungary, the Czech Republic and Slovakia are faring in the run-up to EU membership.

For the first time in many years, the economic growth outlook for all Visegrad countries (Poland, Hungary, the Czech Republic and Slovakia) is positive. The export sector is the main driver behind the growth rates, as economic recovery in the EU and Russia boosts external demand.

Despite this, though, there are still some clouds in the sky. Inflationary pressures have increased in Poland and Hungary because of oil price movements and rising food prices. Strong domestic demand has fuelled imports in Poland with dire consequences for the current account balance. And the political uncertainty in the Czech Republic and Slovakia, although apparently receding, could yet slow the future pace of structural reform.

However, because the EU seems to have opted for group accession, we believe all Visegrad countries will be ready to join the EU together in 2005.

TABLE 1

Long term foreign currency ratings

Foreign currency ratings*	Fitch	Moody's	S&P
Czech	BBB+	Baa1	A-
Hungary	BBB+	Baa1	BBB+
Poland	BBB+	Baa1	BBB+
Slovakia	BB+	Ba1	BB+

Poland and Hungary: at the peak of their business cycles

Poland and Hungary opened their markets to foreign investors immediately at the outset of the transition process, which led to large inflows of foreign direct investment. As a result, corporate restructuring took place rapidly and intensively, leading to the current situation in which the majority of companies are in healthy shape both financially and structurally.

In 1993, both countries started reaping the benefits of their fast changeover to capitalism, with the export sector and fixed capital investments stimulating economic growth. In 1996, spill-over effects to private consumption were discernible, despite substantial repatriation of profits by foreign investors and rising unemployment. Because of the improved business and institutional environment, however, we believe these economies have the potential to keep up their strong growth trend for the next five years. But higher-than-expected inflation rates could force the monetary authorities to tighten monetary conditions.

In Poland, the Monetary Policy Council (MPC) has already decided to increase interest rates by 600 basis points (bp) after missing its 1999 inflation target. Although this was not stated explicitly, serious external imbalances may have been a more important reason for this aggressive move. The interest rate hike dented GDP growth in the second quarter of 2000, which fell to 5.2% from 6% in the first quarter. This was mainly due to slower growth of domestic demand, which fell to 3.3% from 5.1% in the first quarter of the year. This signals that economic growth rates in Poland are peaking but tight monetary policy will lead to a full year growth rate of 5%. Next year, we expect growth to decline to 4.5%, as high real interest rates curb investments and private consumption.

> The export sector is the main driver behind the growth rates as economic recovery in the EU and Russia boosts external demand

Hungary, meanwhile, has maintained its expansionary monetary stance, with the two-week deposit rate falling from 14% at year-end 1999 to its current level of 10.75%. In its interest rate decisions, the Central Bank of Hungary followed the yield curve, which was on a steep downward slope because of the improved external situation, favourable news from the rating agencies and the positive inflation outlook.

However, the recent deterioration of the latter will force the National Bank of Hungary (NBH) also to shift to a more neutral monetary policy, reducing the odds of further rate cuts. We project GDP growth of 6% for the full year, following growth rates of 6.6% and 5.8% in the first and second quarters respectively. In 2001, GDP growth is forecast to fall to 5.0% due to a downturn in domestic demand in response to the neutral monetary policy stance.

Improving business environment in Czech Republic and Slovakia

Unlike Hungary and Poland, the Czech Republic and Slovakia opted for voucher privatisation, with only modest foreign participation. Most companies were too indecisive to immediately push through corporate restructuring, while insufficient transparency was largely to blame for weak corporate governance.

Under these conditions, economic growth was nevertheless healthy until the

FIGURE 1

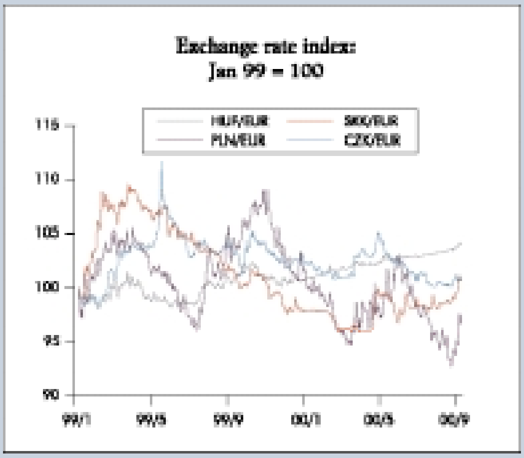
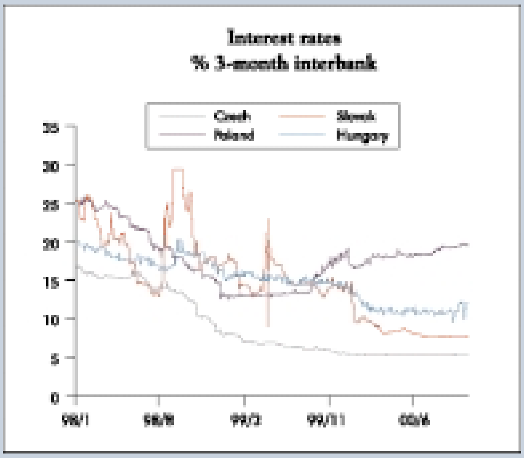


FIGURE 2



end of 1996. After, problems in the debt-laden corporate sector spilled over to the banking sector through a spate of non-performing loans. And the governments were forced to implement a second phase of privatisation, this time with full participation of foreign investors.

Since the Czech Republic fell into recession in 1997, progress has been made in improving the business environment. The export sector in particular is performing well, propelling the recent pick-up in economic activity.

A convincing recovery in private consumption, though, is still a long way off. This is hindered by rising unemployment, the moderate wage trend and the weak banking sector, which is still wary about supplying credit.

In Slovakia, the second phase of privatisation only started at the beginning of 1998, when a democratic coalition took over from the autocratic leader Vladimir Meciar.

At the moment, the country is in the middle of restructuring, and its huge fiscal imbalances require prudent economic management. It is therefore surprising that it has managed to stay out of recession.

Saving the day was the export sector, which benefited from the positive macroeconomic situation in Europe. The pace of economic restructuring is picking up, but similar to the Czech Republic, consumer demand will remain weak in the coming years due to high unemployment and low real wages.

Both the Czech Republic and Slovakia are at the beginning of their business cycles, which means that it will take another two years before a growth level of more than 5% can be reached.

Inflation outlook deteriorating in the short run

Because their business cycles are out of sync, both countries also have varying inflationary trends. Hungary and Poland repeatedly had problems meeting inflation targets. Chiefly to blame for this inflationary pressure is strong domestic demand in recent years. However, supply factors, such as the deregulation of energy prices, high oil prices and rising food prices due to recent droughts, play an important role as well.

Long term, we are more optimistic about inflation, as increasing competition will bring down retail prices and fiscal policy will be aligned with the EU's as the countries prepare to join ERM-2.

Despite Poland's aggressive interest rate hikes, its inflation target of 5.4%–6.8% for 2000 will, again, prove too ambitious. Besides higher prices for energy and food, the sharp increase in public sector wages (which have risen more steeply than private sector wages) has also contributed to higher inflation. Despite these developments, we believe inflation rates are at a turning point, thanks to one-off measures proposed by the government, such as abolishing tariffs on imported fuel and increasing duty-free grain imports. Base year effects are also likely to bring inflation down to 9% at the end of the year. In August, the MPC announced an inflation target for 2001 of 6%–8%, which is more realistic than in previous years.

> If the EU makes no commitment to these countries, we foresee reform fatigue and flagging discipline towards making structural reforms

Hungary will also overshoot its inflation target (6%–7%) for the second year running, ending the year at 9%. No significant progress in fighting inflation can be expected until oil prices fall and the euro rebounds, which we anticipate in the course of next year.

We expect Hungary to stick to its current crawling peg system, at least until the beginning of 2002. The internal inflation ceiling beyond which the peg will be abandoned is 5% – a level which will not to be reached until at least early 2002. Despite the higher-than-expected inflation rate, we believe Hungary will lower the depreciation rate of the crawling peg system from 0.3% to 0.2% before the end of this year.

No structural inflationary pressure in former Czechoslovakia

Inflation in the Czech Republic all but vanished after the country fell into recession. With domestic demand persistently weak, there is still little inflationary pressure from the demand side. Supply effects from rising oil prices have been mostly absorbed by regulated prices. But we do foresee a modest increase in inflation rates. We expect domestic demand to start picking up, while the Czech government will also have to speed up the deregulation of prices. In reaction to next year's higher inflation rate, we expect the Czech National Bank (CNB) to tighten its monetary policy by 50bp. However, large FDI inflows will limit the upside of inflation to 6%, due to CNB sterilisation measures and the strong koruna.

In Slovakia, the high inflation rate early this year was attributable to one-off measures, including a VAT hike and higher import duties, aimed at restoring economic imbalances. With real wages plummeting, pressure from domestic demand remained non-existent. We expect inflation to continue its downward trend until the end of 2001, when we will see the first signs of a pick-up in private consumption. Early next year, we also expect the country to resume the delayed process of price deregulation.

Oil prices harm current account

The steep rise in oil prices has led to mounting pressure on the current account balance. The share of mineral fuels and lubricants in imports rose sharply in US dollar terms in the first four months of 2000, according to the OECD. Because of the surge in oil prices since April, we expect this share to expand further during the rest of the year.

In Poland, the share of fuel-related products in total imports increased to 10.5% in the first four months of the year compared to 7.1% in 1999. Of CEE's big four, Slovakia is historically the most dependent on imports of fuels and lubricants, but this is party related to crude oil imports for refining activities, which are exported afterwards. In the Czech Republic and Hungary, the share of fuel in imports has also grown, but less so than in the other countries.

Despite these negative trends, we do not foresee a serious deterioration of the current account balance. The pressure from the import side is offset by a steep rise in exports in all these countries. In fact, only the Czech Republic will see a slightly higher current account deficit this year compared to last year, but this is mainly due to catch-up import demand after last year's recession. Poland's current account deficit has been a worry in the first few months of the year, but the floating of the zloty and the increase in exports and unclassified trade flows have improved the country's short-term current account outlook. However, the deficit is still too high to be sustainable over a longer period. One of the main culprits is the composition of Polish exports. According to the standard international trade classification (SITC) trade classification system, the share of high added value exports (defined as machinery and transport equipment) was only 30.2% in 1999, compared to 57.2% for Hungary and 43.2% for the Czech Republic. This means that the bulk of Polish exports is basic goods, which are more vulnerable to price fluctuations. The euro's current weakness does not help in this respect, as around 70% of Polish exports go to the EU. Another problem is that the current account deficit has been financed by large FDI inflows into Poland. As in Hungary, we expect these flows to slow in the coming years. On the other hand, Slovakia and the Czech Republic will witness a sharp increase in FDI inflows with banking sector, telecom and utility privatisations on the cards.

TABLE 2

How have the Big Four performed?

Transition indicators*	Cz	Hu	Po	Sk
Large scale privatisation	4	4	3+	4
Small scale privatisation	4+	4+	4+	4+
Enterprise restructuring	3	3+	3	3
Price liberalisation	3	3+	3+	3
Trade & FX system	4+	4+	4+	4+
Competition policy	3	3	3	3
Bank reform and interest liberalisation	3+	4	3+	3-
Securities market & non-bank financial institution	3	3+	3+	2+
** 1 is the lowest score, 4+ the highest*				

Source: EBRD Transition Report 1999

Hungary remains front runner on the road towards EU accession

Current developments in the EU and the Visegrad countries strengthen our view that 2005 is the most likely entry date for the first group of candidates for EU accession. This scenario is based on two important developments.

First, the EU is making hardly any progress on institutional reform, which is necessary for it to be able to include the acceding countries. The current framework leaves room for only five new member countries, because the biggest EU members agreed at the Amsterdam summit to offer their second commissioner's seat to the new members. Agreement is unlikely to be reached on all these institutional reforms at the intergovernmental conference in Nice at the end of this year. A new conference will be needed, which means that the institutional reforms will not be completed before 2003.

After that, the reforms and the accession of new members need to be ratified by all national parliaments. This could be challenging if one considers the current extreme right coalition government in Austria and the referendum being held in Denmark.

Second, statements by EU officials still lead us to believe that eastward expansion of the EU will take place in groups, and that the joint entrance of the Visegrad countries has the highest priority. This seems to rule out early entrance for Hungary, which is leading the pack on all fronts. It also means that the entrance date of 2003 is not feasible, because that would seem too soon for the Czech Republic, Slovakia and even Poland.

The Czech Republic and Slovakia are catching up, and their increased commitment towards structural reforms has aided their accession process. However, political uncertainties, such as the minority government in the Czech Republic and the fragmented coalition in Slovakia, Mercia's failure to accomplish at least 50% participation in the referendum on early elections in Slovakia is, however, a positive sign for the ruling coalition.

Slovakia, which only recently started negotiations with the EU, will have to make up for the two years' head start of the other countries. According to the progress reports of November 2000, Slovakia has a functioning market economy. Poland could benefit from a political shift to the left. The current Solidarity government has a great deal of support in the loss-making state-owned industries and in rural areas. If the Socialist Party (SLD) comes into power, it could speed up the restructuring of these economic sectors.

Polls in various countries in Central and Eastern Europe show declining support for EU accession. Time and again, the EU has refused to give acceding countries a clear time schedule. If the EU makes no commitment to these countries, we foresee reform fatigue and flagging discipline towards making structural reforms. ■

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