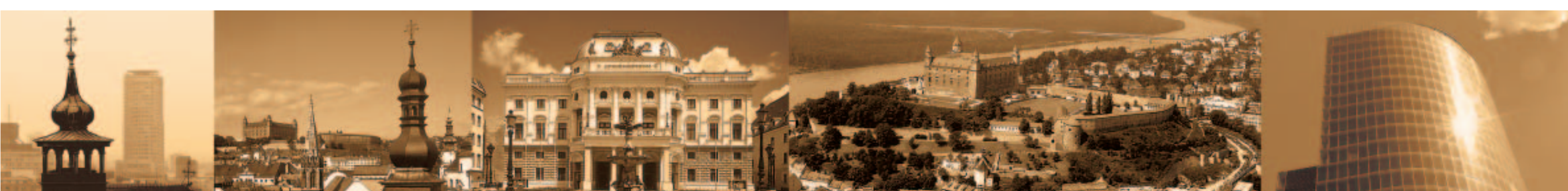
A. EXTERNAL ECONOMIC ENVIRONMENT



1. WORLD ECONOMY

Global trends in output and prices

After a major slowdown in economic activity in 2001, the global economy saw a rebound in 2002. Global output increased by 3% in 2002 to slightly exceed expectations of leading international institutions, but the speed of recovery slackened in the second half of the year. Market expectations reflected increased financial market volatility accompanied by yet another fall in equity prices, and rising geopolitical tensions.

The growth in global output came on the back of economic recovery in the United States, coupled by a strong comeback in Asia's newly industrialised countries and a continuing relatively high pace of economic growth in transition and developing countries. In the euro area, growth lost its momentum, while Japan recorded a stagnation trend. Real output of the Latin America region slipped in 2002 in absolute terms (-0.1%) driven largely by a severe crisis which hit Argentina (its GDP tumbled by 11%), while the two other largest countries – Brazil and Mexico – recorded only a meagre growth. The uneven pattern of recovery in the world's economic regions, combined with economic and geopolitical uncertainty, led to just a slight increase in world trade dynamics. The volume of global trade grew by 2.9% in 2002, thus trailing global output.

The main cause behind the economic setback in the euro area was a stifled domestic demand, compensated in part by increased export opportunities opened up by the U.S. economic recovery. In contrast, just a slight decline in the growth rate in the countries of Central and Eastern Europe, whose transition economies had already developed firm ties with the euro area, or the European Union, came as a result of a strong domestic demand which made up for losses in exports to the EU countries. A fairly high rate of growth seen across the whole cluster of emerging economies was partly due to a continuing rapid growth of the Russian economy. The engine driving growth in the East Asian region was a high demand in China, whose stepped-up economic growth, and, at a time of Japan's economic stagnation, offered a considerable export potential to other newly industrialised economies in the region.

Global output in 2002 **(year-on-year growth in %)**

	2001	2002	2003 (forecast)
Global output	2.3	3.0	*3.2*
Advanced economies	0.9	1.8	*1.9*
USA	0.3	2.4	*2.2*
Japan	0.4	0.3	*0.8*
Euro area	1.4	0.8	*1.1*
United Kingdom	2.0	1.6	*2.0*
Newly industrialised Asian countries	0.8	4.6	*4.1*
Transition economies	5.1	4.1	*4.0*
Central and Eastern Europe	3.0	2.9	*3.4*
Russia	5.0	4.3	*4.0*
Developing countries	3.9	4.6	*5.0*
China	7.3	8.0	*7.5*
Brazil	1.4	1.5	*2.8*

Source: World Economic Outlook, April 2003

A sluggish recovery in the global economy created a good setting for price development. After a general price decline on commodity markets in 2001, the aggregate index of primary commodity prices picked up by some 3% in 2002. The average oil price recorded only a slight increase to USD 25/barrel. However, given its low baseline and marked growth in the second half of the year in particular, in December 2002 it stood 50% (about USD 28.50/barrel) higher than in December 2001. Rising oil prices in 2002 had nothing to do with short supply – OPEC's (excluding Iraq) production outran its targets throughout the year – but rather with markets fearing possible oil supply disruptions as a result of an imminent U.S. armed intervention in the Middle East. It was only a supply-side shock in the shape of a general strike in Venezuela in December that triggered a major rise in oil prices. Prices of non-energy commodities also grew rapidly, notably food, beverages and agricultural raw materials, but stayed below historical standards. The price growth in these items was largely the result of adverse weather conditions in leading agricultural countries.

On the global scale, consumer price growth was slower in 2002 than in 2001. The consumer price index edged up by 1.5% year-on-year (as compared to 2.2% in 2001) in the group of advanced economies. A slowdown was also observed in developing countries (down to 5.4% from 5.8% in 2001) and transition economies (11.1% as compared to 16.3% in 2001). In the twelve EU candidate countries, inflation averaged 5.7% in 2002 (as compared to 9.8% in 2001).

Stock prices took yet another fall in 2002. Broad equity market indexes in U.S., euro area and Japanese markets displayed a basically similar pattern during the year. A sharp drop in stock prices accompanied by extremely high volatility occurred in particular during the May-July period amid revelations of corporate accounting rules. Stock prices were also depressed by lower than expected corporate profits and worse global economic outlooks. Although the downward pressure on prices eased up in the second half of the year, stock market volatility remained high in the euro area. Overall, stock prices in the euro area, measured by the broad Dow Jones EURO STOXX index, slumped by 35% in 2002, with technological, telecommunications and financial sector stocks coming out the worst losers, as their share in the total index slump exceeded one-half. In the U.S., the Standard and Poor's index fell by 23%, but the fall was much sharper in technological sector stock prices quoted by the Nasdaq Composite index which lost 32%. In Japan, the Nikkei 25 index dropped by 19%, mainly due to domestic factors.

The development in bond markets in the U.S. and in the euro area in 2002 was affected primarily by stock market turbulences, which triggered a „flight to safety" in securities portfolios (from shares to Government bonds). This resulted in a decrease in yields on 10-year Government bonds by 90 basis points in the euro area and by 130 basis points in the U.S., to the year-end 4.3% and 3.8%, respectively, however, the negative differential in U.S. bond yields was recorded from the beginning of the year onwards. Returns on long-term Government bonds in Japan were less exposed to global factors than to worsening recovery prospects for the national economy and the situation in the banking sector. After staying relatively steady around 1.4% in the first half of the year, yields on Japanese 10-year bonds fell to 0.9% at the end of 2002.

The main characteristic of the development in foreign exchange markets in 2002 was a considerable weakening in the U.S. dollar exchange rate. The dollar lost much ground to the euro in the first half of the year due to less optimistic recovery prospects for the U.S. economy and the fallout of scandals over U.S. corporations' accounting rules on the markets. The U.S. dollar experienced yet another setback against the euro late in the year, this time fuelled by increased negative interest differentials as compared to the euro area, rising market concerns about a widening U.S. current account deficit and the rise of a fiscal deficit, as well as by geopolitical pressure. At the end of 2002, the euro/dollar exchange rate reached 1.05 EUR/USD, which was 16% up from the beginning of the year and 17% above the 2001 average. The yen held relatively steady against the euro during 2002, but then depreciated at the end of the year amid uncertain growth prospects in Japanese exporters' key markets and market uncertainty about solutions of woes afflicting Japan's financial sector. The JPY/EUR exchange rate finished the year at 124.39, meaning that the euro appreciated by 4.1% year-on-year and by 14.5% against the 2001 average.

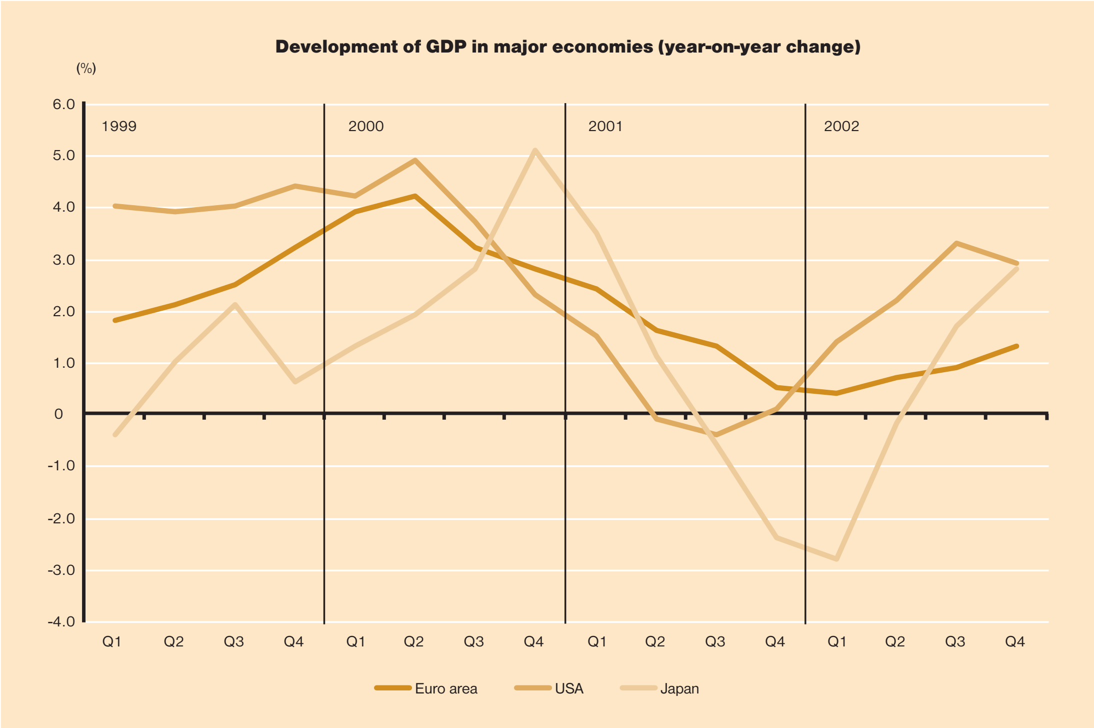
Economic development in the main monetary areas: United States, Japan, Euro Area

The **U.S.** reported 2.4% GDP growth in 2002, which was well above the 0.3% it registered in 2001 due to an absolute decline in performance in the first three quarters. Its recovery was marked by rapid growth in productivity in the non-farming business sector. Heavy household spending, both on consumption and investments, added the largest share to the GDP growth. These expenditures were supported by tax cuts in 2002 which led to increased disposable income. The upsurge in consumption was most obvious in the long-term consumer goods sector (automobiles). Favourable conditions in the real estate market, with mortgage rates reaching historical lows, spurred household investments. Despite generous spending, the rate of savings from disposable income increased to 3.9% in 2002 from 2.3% in 2001, which was probably related to greater uncertainty by financial market turmoils and deteriorating prospects in the labour market. Public sector spending remained high, while corporate investments fell again in 2002 as a result of relatively low corporate profits. A distinct increase in productivity combined with low utilisation of production capacities created good conditions for price development in the U.S. economy. Inflation (measured as the consumer price index) reached 1.6% in 2002 (2.8% in 2001) and producer prices recorded a fall of 1.3% (as compared with the increase of 2% in 2001) despite a rise in oil prices. The unemployment rate picked up 1 percentage point from a year ago to 5.8%. With import's growth rate outpacing export's growth rate of goods and services, the current account deficit widened to 4.8% of GDP in 2002 (3.9% in 2001).

All these developments in the U.S. economy combined to maintain the existing internal and widen external imbalances, marked by a high level of domestic demand satisfied at the cost of growing accumulation of household debt and overall national debt. Household debt is the largest component in internal debt with approximately 70% of GDP. Since 2001, foreign debt has been rising at a considerable pace as well, as investors shift their focus from private stocks to Government bonds, which implies possible problems with sustaining the current account deficit in the future.

Japan's economy showed signs of a slight recovery in the first half of 2002, as rising exports to new Asian economies in particular supported growth in industrial production. As geopolitical pressure increased, the growth in foreign demand subsided which, coupled with slow growth in private investments against a backdrop of unused capacity, led to a meagre GDP growth of 0.3% (0.4% in 2001) and an increase in unemployment rate to 5.4% (5.0% in 2001). The price development again followed a deflationary trend in Japan in 2002, with the consumer price index falling by 0.9% in average (as compared to a 0.7% decline in 2001). External conditions allowed the country to increase its current account surplus to 2.8% of GDP (2.1% of GDP in 2001).

After initial signs of recovery, economic development in the **euro area** was marked by



low dynamics throughout 2002, resulting in further year-on-year slowdown in GDP growth to 0.8% (1.4% in 2001). An uncertain global economic environment led to a significant reduction in capital expenditures reflected in a 2.5% drop in gross capital formation, which cut the contribution of domestic demand to GDP growth in the euro area to 0.2% in 2002. The contribution of net exports reached 0.6%, as exports picked up by 1.2% and imports decreased by 0.3%.

The setback in corporate investments in the euro area in 2002 was driven both by doubtful recovery prospects and falling profitability of European firms in the face of an economic downturn and a strong euro, forcing firms to adapt pricing policies in order to hold on to their positions in export markets, and probably by a sharp decline in stock prices implying higher cost of new capital, and lower household demand for housing investments. Flagging growth in private consumption, down from 1.8% in 2001 to 0.6% in 2002, came as a consequence of lower growth in real disposable household income due to slower employment growth.

With market services posting a 1.3% rise, the service sector was once again the engine of economic activity in the euro area in 2002. A scant 0.2% increase in value added in industrial production (excluding the construction industry) echoed the 2001 contraction. In the first half of 2002, the industry experienced a recovery kindled by rising foreign demand. However, as economic outlook worsened, industrial activity slowed down to record another fall in the last quarter on a quarterly basis. The output of the construction industry, measured as real value added, dropped by 1.5% in absolute terms in 2002.

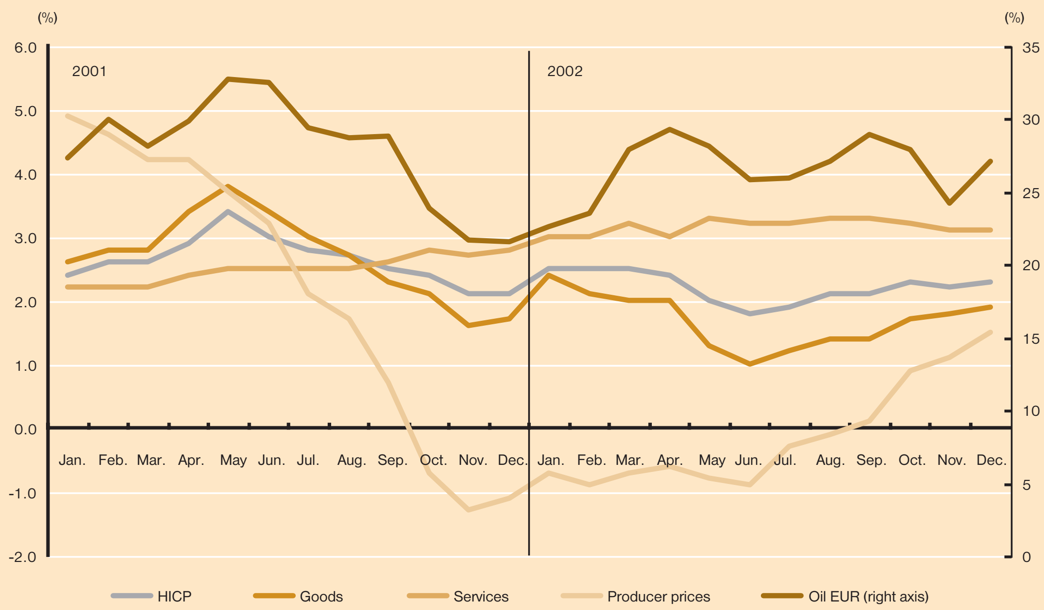
Falling performance of the German economy in 2001 gave way to stagnation in 2002, when annual GDP growth reached 0.2% thanks to a kind of recovery in the last quarter. Moderate export growth could only partly compensate for dull domestic demand, reflecting a setback in fixed investments and slow growth in private consumption. The main reason behind decreasing investment activity was the continued collapse in the construction industry in Eastern Germany. In 2002, however, some more general problems faced by the German economy came into play, related to falling corporate profitability and a decreasing ability to pay off sizeable loans taken up during the economic boom. The spotlight was also on falling efficiency of the German banking sector, facing the necessity of a more radical restructuring which, however, is hampered by rigid employment laws.

Economic growth slowed down in all euro area countries except Finland (where signs of a recession peaked at the turn of 2001 and 2002). Greek economy grew the fastest (4.0%), while GDP growth in Ireland, which has boasted of having the most dynamic economy for a long time (an average 9.8% in 1995-2000), dropped to 3.3%. As a result, the growth rates in euro area economies came closer together again in 2002, as the gap between the fastest (Greece) and the slowest (Luxembourg with 0.1% of GDP) narrowed to 3.9% (from 5.1% in 2001). Among the large economies, above euro area average GDP growth was recorded in France (1.1%) and Spain (2.0%). In Italy, growth slowed down to 0.4% of GDP. In most small economies, the pace of growth was near the euro area average (0.7-0.8% of GDP).

The downturn in economic activity gave rise to worsening conditions in the labour market, where decreasing job opportunities led to a slight increase in unemployment. The standardised unemployment rate in the euro area averaged 8.3% in 2002, i.e. 11.4 million jobless. The development in the euro area labour market was quite general in 2002, with no specific impacts on individual groups of workers and no major differences between national labour markets.

The average rate of inflation in the euro area, measured as the Harmonised Index of Consumer Prices (HICP), was 2.2% in 2002 (2.4% in 2001). Inflation travelled an uneven path during the year as a consequence of the fallout of earlier shocks in oil and food prices, as well as the depreciation of the euro. Disregarding more volatile components of unprocessed food and energy, HICP rose from 2.0% to 2.5% year-on-year. This rise was caused by rapid growth in services prices. Prices of certain types of services shot up early in the year in connection with the introduction of euro banknotes and coins. However, faster growth in services prices, by an average 3.1% a year

Price development in the euro area, year-on-year change



(2.7% in 2001), can be attributed in particular to the development in unit labour costs.

The introduction of euro banknotes and coins caused an abrupt increase in perceived inflation with the population, as price hikes were concentrated in a narrow basket of the most common services (restaurants, hairdresser's and cleaner's shops) and goods of everyday consumption (foodstuffs) with relatively large effects from rounding-up in the new currency and standing payments in cash. The phenomenon of very high, perceived inflation was short-lived, and public inflation expectations in fact decreased during the year. The inflationary effect of the introduction of the euro was reckoned at 0.2-0.6% in different countries, being largely dependent on national retail network structures.

Price growth in individual euro area countries in 2002, reflected the varying impacts of energy and food price shocks on national economies, different development in labour costs, changes in regulated prices and indirect taxes, as well as the effect of the introduction of euro banknotes and coins. Price growth (measured as HICP) reached 1.3% in Germany (the lowest in the euro area). Below euro area average (2.2%) price growth was reported by France (1.9%), Belgium, Austria and Finland. The highest inflation, moving up from a year ago, was recorded in Ireland (4.7%), Greece (3.9%) and Spain (3.6%). Above-average inflation was also recorded by Italy (2.6%) and, despite a decline from a year ago, by the Netherlands (3.9%) and Portugal (3.7%). The inflation differential between euro area member states was 3.3 percentage points in 2002 (Ireland vs. Germany), equalling the 2001 figure.

Industrial producer prices (excluding the construction industry) in the euro area edged down by 0.1% in 2002 (after gaining 2.2% in 2001). A more obvious drop, by 2.4%, was seen in the energy component (in contrast to a 2.8% rise in 2001), largely due to the euro appreciating during the year (with dollar oil prices virtually unchanged from a year ago, oil prices dropped by some 5% in euro terms). Producer prices were also held back by limited demand, which prevented firms from raising prices.

The current account of the euro area closed 2002 with a surplus of EUR 62.1 billion (as opposed to a deficit of EUR 13.8 billion in 2001) thanks to a significant increase in the surplus of the balance of trade (EUR 102.7 billion as opposed to EUR 49.7 billion in 2001) resulting from a moderate increase in exports and, in particular, from lower imports of capital goods amid subdued domestic demand, as well as from diminishing effects of the euro appreciation on the value of imports. In the light of an unconvincing recovery in foreign demand, the export growth was probably due to European exporters trimming their profit margins to make up for the adverse impacts of a strengthening euro on their competitiveness.

The aggregate account of direct and portfolio investments of the euro area recorded a net inflow of EUR 29.4 billion in 2002, as compared to a net outflow of EUR 63.4 billion in 2001. This turnaround was due, for the most part, to a reduction in net outflow of direct investments coming in the wake of an abrupt slump in international mergers and acquisitions, as well as to a large net inflow of portfolio investments into the euro area. Portfolio flows were influenced primarily by the category of debt instruments. Resident investments in foreign debt instruments decreased, while domestic bond purchases by non-residents rose sharply. The year 2002 also brought a major increase in cross-border investments (both in- and outflow) in money market instruments, which was presumably related to global uncertainty in the corporate sector.

Although macroeconomic conditions in the 3 EU countries outside the euro area (Denmark, Sweden and the United Kingdom) are not affected directly by the single monetary policy implemented by the ECB, the EU Treaty stipulates that the ultimate monetary policy goal of each EU member state is to maintain price stability. Their economic development and fulfilment of commitments to fiscal stability under the Stability and Growth Pact is subject to regular reviews by EU institutions.

In Denmark, GDP growth reached 1.6% in 2002 (1.4% in 2001) due to domestic demand, notably private consumption encouraged by a tax reform. The unemployment rate remained at 4.5%, inflation (HICP) reached 2.4%. Increased job opportunities eased the wage pressure and, coupled with rising productivity, helped the Danish economy to keep its competitive edge. Denmark has consolidated public finances with a budgetary surplus of 1.9% of GDP despite the implemented pension system reform. The government debt is on the wane, reaching 45.2% of GDP in 2002. In 2002, Denmark was the only country participating in the ERM II, with the narrow band of ±2.25% of the central parity of DKK against EUR. In 2002, DKK moved little inside the appreciation zone.

Sweden's GDP growth picked up to 1.9% in 2002 (1.1% in 2001), fuelled by net exports and a rebound in domestic private spending bolstered by tax cuts, lower interest rates and low unemployment (4.9%). HICP inflation reached 2% in 2002. The fiscal sector saw a turnaround from a surplus of 4.5% of GDP in 2001 to 1.2% of GDP in 2002 deficit as a result of lower taxes and increases in certain types of expenditures. The ratio of public debt to GDP decreased to 52.4% of GDP. The Swedish central bank applies a flexible exchange rate and a monetary policy based on an explicit inflation target for 2% growth in the consumer price index with a tolerance margin of ±1 percentage point. The exchange rate of the Swedish krona was influenced by developments in financial markets and speculations surrounding the adoption of the euro by Sweden. During the year, the currency gained about 1.5% on the euro.

In the United Kingdom, GDP growth slowed to 1.6% in 2002 (from 2.0% in 2001), speeding up in the second half of the year due to growing private consumption and public spending. Business investments recorded a decline, caused primarily by falling stock prices and uncertain export prospects. HICP inflation reached 1.3% as prices of services gained considerable momentum and prices in the tradable sector were flat, due to low demand and strong competition on global markets. The unemployment rate reached 5.2%. The public budget, after the surplus of recent years, closed with a deficit of 1.4% of GDP in 2002 caused by higher government expenditures and reduced revenue from direct, in particular corporate, taxes. The debt ratio decreased slightly to 38.6% of GDP. The monetary policy pursued by the Bank of England is based on a flexible exchange rate and an explicit inflation target set by the government as a 2.5% yearly increase in the retail price index excluding interest payments on mortgages (RPIX), (RPIX inflation was 2.2% in 2002). The exchange rate of the British pound against the euro depreciated slightly during the year.

Monetary conditions and fiscal policy

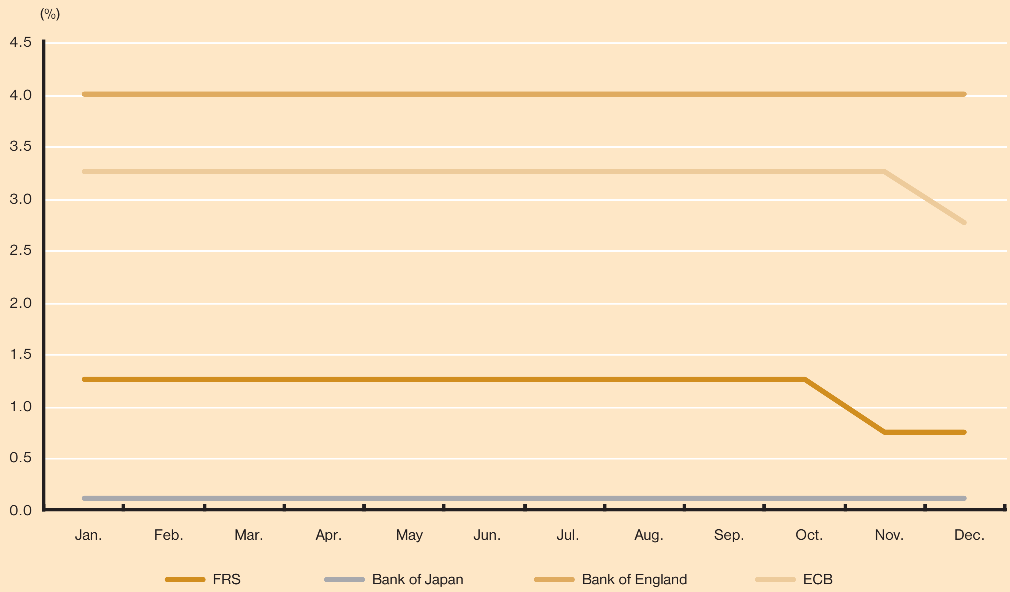
With an unconvincing start to recovery in the U.S. economy, interest rates stayed at historic lows in the country in 2002. After scaling down the target for the federal funds rate by 425 basis points overall in 2001, the Federal Open Market Committee (FOMC) of the **FRS** resorted to another rate cut by 50 basis points to 1.25% in November 2002. The U.S. fiscal policy was fairly expansive, as the federal budget closed the fiscal year 2002 with a deficit of 1.5% of GDP (down from a 1.3% surplus in 2001). The fiscal deficit was largely the result of discreet measures (the effect of a tax cut in the first half in 2001 and stimulating measures in March 2002), and in part due to the budget's automatic response to the economic cycle. The gross government debt increased in 2002 to reach 59.2% of GDP (57.7% of GDP in 2001).

Amid persistent deflationary pressure in the Japanese economy, in 2002 Japan's central bank raised its target range for balances in current accounts kept at the **Bank of Japan** pursued as its main operational aim within a policy of quantitative monetary expansion since 2001. In addition, the central bank substantially increased the amount of direct purchases of long-term government bonds. This new operational strategy will be applied until the annual rate of change in the consumer price index levels off at or above 0%. In October 2002, the government unveiled a bad debt rehabilitation scheme which seeks to halve the share of non-performing loans carried by leading Japanese banks by the end of 2004, and to pave the way to revitalising viable debtors. As regards fiscal policy, year 2002 saw an additional increase in budget expenditures intended to bolster the social security network of unemployed and promote small and medium-sized enterprises. The deficit in public finances reached 7.7% of GDP in 2002 (7.2% of GDP in 2001). The debt ratio went up by almost 10 percentage points to 154.4% of GDP.

Conditions for monetary policy setting in the euro area were indistinct in 2002. Despite flagging economic growth, HICP inflation posted only a slight decrease year-on-year and, at 2.2%, lay above the monetary stability benchmark of 2%. The **ECB** Governing Council therefore left its key refinancing rate at the 3.25% level during the whole year until December when, facing ongoing appreciation of the euro and a lingering economic depression amplified by growing uncertainty over geopolitical development, it moved to cut key rates by 50 basis points to 2.75%.

In its decision-making, the ECB Governing Council relied on analyses of trends in the broad money aggregate M3 (the first pillar of ECB's monetary policy strategy) which accelerated to an average 7.4% in 2002 (5.5% in 2001). Very low short-term interest rates, and thus low opportunity costs of holdings in the most liquid M3 components, were reflected in more rapid growth particularly in the narrow money aggregate M1 (all the way up to 8.8% in the 4th quarter). The three-month moving average of annual M3 growth fell as the year passed, but remained well above the 4.5% benchmark. Analyses of the second pillar, reviewing price developments and more general conditions of economic activity, showed that real GDP growth in the euro area in 2002 still

Key rates of major central banks in 2002



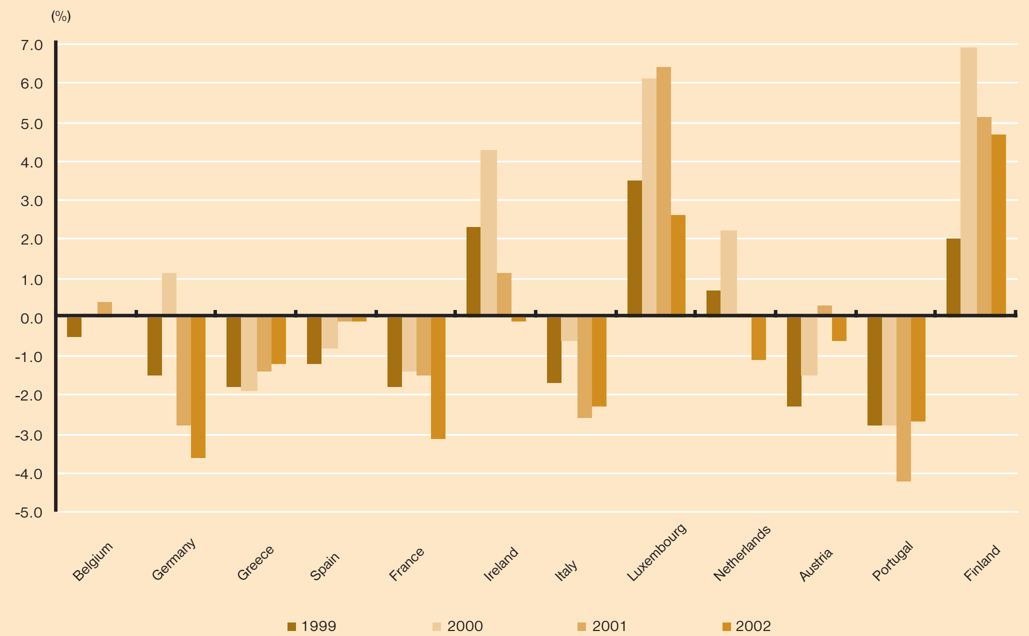
lagged behind the trend level of potential output. Developments in financial markets cast a shadow on global recovery prospects, and there was also some uncertainty about price developments. Apart from the usual risk of oil prices, consumer price growth in the euro area was relatively high, especially early in the year (in part due to the introduction of euro banknotes and coins and an abrupt hike in the price of certain consumer basket items). However, the main hazards to price stability lay in wage developments and rapid price growth in the services sector which, however, were gradually dampened by continued appreciation of the euro.

On average, the **fiscal position of the euro area** took a turn for the worse in 2002, recording a deficit of 2.2% of GDP (1.6% in 2001). Fiscal performance was affected primarily by the action of automatic stabilisers against a backdrop of sluggish economic activity and, in many countries, by statistical revisions of 2001 data, expenditure overruns and reduced revenues resulting from implemented tax reforms. The only countries steering clear of a general easing of the fiscal policy were the Netherlands, Portugal and Spain, which, in fact, tightened their budgets compared to a year ago.

Fiscal problems were experienced mainly by countries which had already reported considerable fiscal imbalances in 2001 (Portugal, Germany). The 3% of GDP limit was broken by 2002 deficits in Germany (3.6%) and France (3.2%). In November 2002, the ECOFIN Council decided on the existence of an excessive deficit in Portugal in 2001, followed by a similar decision on Germany's 2002 deficit in January 2003 when it also gave a warning to France.

Generally, countries fell short of even the medium-term aims of fiscal consolidation for a balanced or surplus budget positions targeted in member states stability programmes of Stability and Growth Pact (SGP). To encourage consolidation efforts, the Eurogroup adopted a fiscal strategy in October 2002 for countries with persistent fiscal imbalances. Starting from 2003, these countries will have to continuously improve their basic fiscal balance (i.e. the structural balance net of economic cycle effects) by at least 0.5% of GDP a year.

Budget balance in euro area countries, % of GDP (+ surplus, - deficit)



The emphasis placed in 2002 in the EU – and especially in the euro area – on the need to speed up consolidation in public finance of member states and implement relevant systemic reforms was prompted by detection of missed opportunities for fiscal consolidation during the economic boom of 1999-2000, or as a result of overrated stability of economic performance leading to tax cuts not backed by an appropriate systemic approach to reforms on the budget expenditure side. Subsequently, the action of automatic stabilisers during the growth slowdown in 2001-2002 caused a disproportionate deterioration in fiscal imbalance. On the other hand, countries whose previous good budget performance was rooted in actual fiscal consolidation, managed to keep their budget balances at much better levels.

Adherence to fiscal rules laid down by the SGP, aimed primarily at achieving balanced or surplus budgets in member states in the medium term, provides systemic support to the objective of price stability in the euro area sought by ECB's single monetary policy. At the same time, it is a precondition for effective functioning of national fiscal policies, as the only economic policy instrument countries have to eliminate potential adverse impacts of the single monetary policy exercised by the ECB and other asymmetrical shocks on the conditions for economic development in individual member states.

The ratio of public debt to GDP decreased only marginally on average in the euro area in 2002 (by 0.1%) to 69.1%. Gross debt in the three heaviest debtors (Belgium, Greece and Italy) remained above 100% of GDP in 2002 despite falling by 2-3 percentage points in all these countries (in Italy, as a result of an one-off financial operation).

2. ECONOMIC DEVELOPMENT IN CANDIDATE COUNTRIES FOR EU MEMBERSHIP

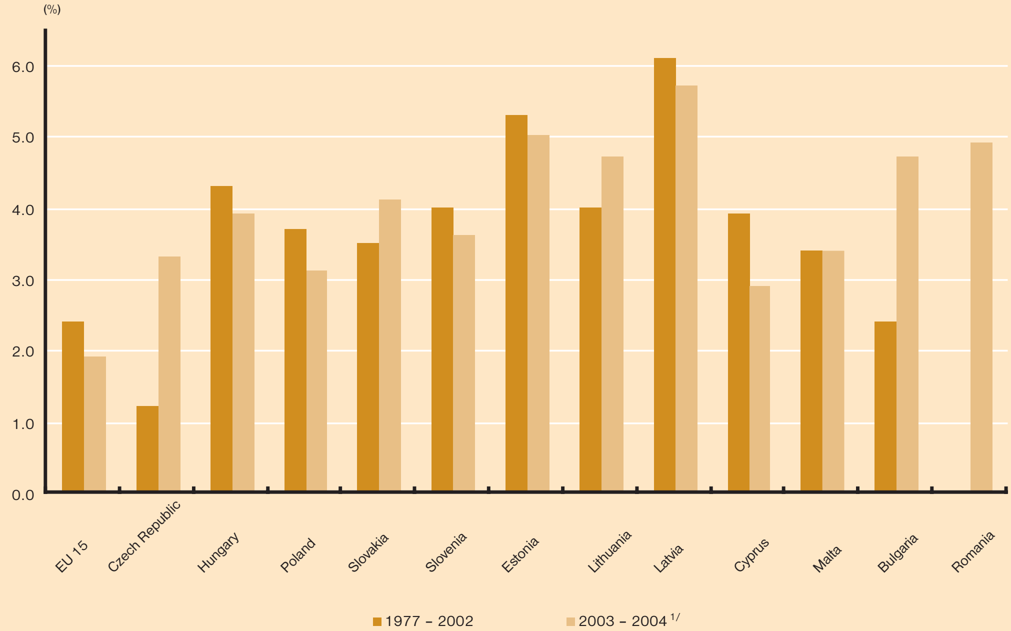
For EU candidate countries, 2002 was as an important milestone. At a December EU summit in Copenhagen, 10 candidate countries (out of 12, i.e. except Bulgaria and Romania) completed accession negotiations and received the invitation to enter the EU in May 2004, i.e. just in time to take part in the European Parliament elections in June 2004. In line with the criteria established for EU membership by the Copen-

Main macroeconomic indicators in candidate countries **(year-on-year change in %)**

	GDP			Inflation 1/			Unemployment rate 2/			Current account		
	2001	2002	2003*/	2001	2002	2003*/	2001	2002	2003*/	2001	2002	2003*/
Czech Republic	3.1	2.0	2.8	4.7	1.4	1.5	8.1	7.3	7.0	-5.7 3/	-5.3 3/	-4.3
Hungary	3.7	3.3	3.7	9.2	5.3	5.0	5.7	5.8	6.2	-3.4	-4.1	-4.4
Poland	1.0	1.3	2.5	5.5	1.9	1.1	18.2	20.0	20.6	-4.1	-3.6	-4.2
Slovakia	3.3	4.4	3.7	7.3	3.3	8.8	19.2	18.5	18.2	-8.6	-8.2	-6.9
Slovenia	3.0	3.0	3.4	8.5	7.5	6.0	6.4	6.4	6.3	0.1	1.8	1.4
Estonia	5.0	5.6	4.9	5.8	3.6	3.5	12.6	10.3	10.0	-6.1	-12.3	-10.3
Lithuania	5.9	5.9	4.5	1.3	0.3	1.0	17.3	16.9	16.2	-4.8	-4.4	-3.0
Latvia	7.9	6.1	5.5	2.5	1.9	2.5	13.1	12.3	11.1	-9.6	-7.8	-8.5
Malta	-0.8	3.0	3.1	2.9	2.2	2.7	6.5	6.9	6.6	-5.0	-4.7	-4.9
Cyprus	4.1	2.0	2.0	2.0	2.8	4.3	3.9	3.3	3.4	-4.3	-5.3	-4.3
Bulgaria	4.0	4.3	4.5	7.4	5.8	4.5	19.7	17.8	16.5	-6.1	-4.5	-5.0
Romania	5.7	4.9	4.9	34.5	22.5	16.0	6.6	8.4	8.7	-5.5	-3.4	-3.7

Source: Economic Forecasts for the Candidate Countries, Spring 2003. European Economy, EC, DG EFA 2003.
1/ CPI, annual average
2/ ILO definition
3/ after revision by the CNB in March 2003
**/ forecast*

GDP growth in candidate countries, period average



1/ EC forecast for 2003 – 2004 according to Economic Forecasts for the Candidate Countries, Spring 2003. European Economy, EC, DG EFA 2003.

hagen summit in 1993, the assessment reports by EU institutions concluded that these countries have become well-functioning market economies and will be able to cope with competition pressure in EU markets.

The candidate countries of Central and Eastern Europe generally performed best at achieving fairly rapid economic growth. Except for the Czech Republic, GDP growth has outstripped EU's for a long time, leading to a „catching up" in economic terms, helped by real appreciation of exchange rates. However, fast growth in these countries, except Slovenia, was reached at the expense of a quite significant external imbalances. In Poland and Slovakia, economic growth had only a limited effect on reducing the rate of unemployment. Disinflation proceeded most quickly in the Czech Republic and Slovakia.

In 2002, economic development in V4 countries (Czech Republic, Hungary, Poland, Slovakia) was affected by weakened economic activity in the EU, especially in Germany, as their main trade partner. In these conditions, the countries did well to keep up respectable GDP growth thanks to strong domestic demand, partly stimulated by more relaxed fiscal policies, as well as to growing confidence that the achieved macroeconomic stability is sustainable.

Price developments in the Czech Republic in 2002 were influenced primarily by a strong appreciation of the Czech koruna which, due to the cushioning effect of prices of tradable goods and prices of imported energy raw materials, prompted a decline in inflation. Also at work behind the slowdown in consumer price growth was lower growth in regulated prices. The deferral of several deregulation measures also contributed to low inflation in Slovakia. Price developments in Hungary were affected by relatively fast-spreading wage inflation, which did considerable damage to the country's competitiveness. Low inflation in Poland was associated with weak demand pressure at the bottom phase of the economic cycle and wage restrictions in the public sector.

The slowdown in GDP growth to 2% in the Czech Republic in 2002 came in the wake of August floods, an appreciating Czech koruna, a downturn in economic activity in the country's leading trade partners, and considerable oil price volatility. Economic growth was fuelled by private and public spending alike and, to a lesser extent, by exports. A major rise in disposable income was the result of very low inflation and real wage growth. Public consumption mounted substantially, driven by one-off military orders, flood-relief expenditures, and a heavy pressure on social welfare payments. A loose fiscal policy prompted an increase in the public finance deficit. As import prices fell by a greater margin than export prices, the trade balance deficit decreased year-on-year despite the fact that imports outpaced exports. High inflow of direct foreign investments fully covered the current account deficit.

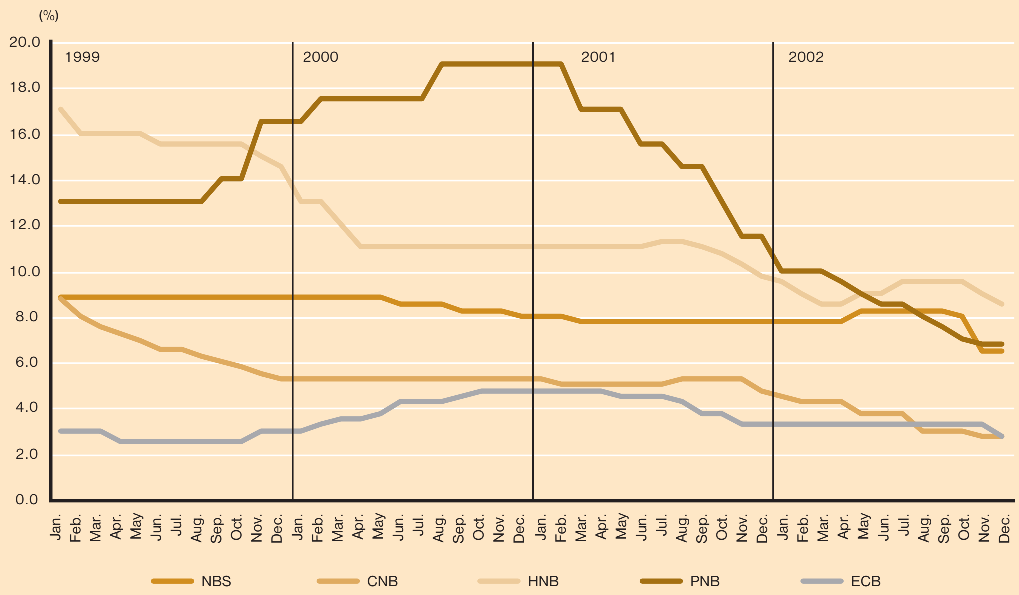
In Hungary, 2002 brought a major disruption to key macroeconomic balances, as consumption, fuelled to a large extent by rising wages in the public sector and a rise in the minimum wage, expanded at the rate (8%) that more than doubled the GDP growth rate (3.3%). A sharp upswing (by 20%) was recorded in the construction industry output, reflecting both a boom in private housing construction as well as massive public investments in road infrastructure. As several multinational investors closed their businesses, unemployment in the private sector began to rise, but was offset in 2002 by fresh employment growth supported by wage policy in the public sector and a pro-active labour market policy. The

Monetary policy and exchange rate regimes in candidate countries

Exchange rate strategy [1]		Characteristics
Currency board		
Bulgaria	Currency board to euro	Introduced in 1997
Estonia	Currency board to euro	Introduced in 1992
Lithuania	Currency board to euro	Introduced in 1994; change in the peg currency from USD to EUR in February 2002
Conventional fixed peg		
Latvia	Peg to SDR	Fluctuation band ±1%
Malta	Peg to currency basket	Currency basket (EUR, USD, GBP); fluctuation band ±0,25%
Unilateral peg to euro with fluctuation band ±15%		
Cyprus	Peg to euro with fluctuation band ±15%	
Hungary	Peg to euro with fluctuation band ±15%	Exchange rate regime combined with inflation target: 2.5–4.5% at end-2003
Managed float [2]		
Romania	Managed float	Currency basket (USD, EUR) used informally as reference
Slovakia	Managed float	Implicit inflation targeting
Slovenia	Managed float	Money aggregates playing central part; euro used informally as reference currency
Free float		
Czech Republic	Free float	Inflation targeting: 2–4% at end-2005
Poland	Free float	Inflation targeting: 3% (±1 percentage point tolerance margin) by end-2003

1/ based on IMF Annual Report on Exchange Arrangements and Exchange Restrictions, 2001
2/ based on IMF classification

Key central bank rates in V4 countries and of the ECB



fiscal policy was extraordinary expansive in 2002, with a high deficit in public finance resulting from one-off expenditures related to statistical reclassification of large extra-budgetary items into the central government budget, as well as from an increase in several permanent expenditures, especially wages and pension benefits, health care expenditures, social benefits and several subsidies. A strong appreciation of the Hungarian forint, coupled with mounting domestic demand, stepped up imports and adversely affected the current account.

After a sharp fall in 2001, the Polish economy experienced a slight recovery in 2002 as GDP growth reached 1.3%. Growth was fuelled by private consumption and net exports, while fixed investments experienced a sharp decline (-7.2%). Private spending remained strong despite constantly rising unemployment, supported by growing real household income on the back of a rapidly falling inflation, and probably by a rampant shadow economy as well. High export growth was supported in part by depreciation of the real effective exchange rate of the zloty which was primarily due to the euro gaining ground on the dollar. The main factor behind robust export performance, however, was a major improvement in the competitiveness of Polish exporters. Ongoing corporate restructuring, encompassing, in particular, agriculture, the mining industry, the steel industry and railways, was accompanied by considerable workforce layoffs and, combined with demographic factors, stands as the main culprit responsible for the country's high unemployment rate which reached 20%. The year-on-year increase in the fiscal deficit was caused, for the most part, by depressed economic activity and a relatively relaxed fiscal policy. Against a backdrop of weak growth in 2001-2002, Poland managed to get its external imbalance under control. Moderate growth in domestic demand and a very good export performance resulted in further decrease in the current account deficit.

Monetary and exchange rate policies are gradually being adapted to the declared intentions of central banks in the accession countries, namely to become, as soon as possible after EU accession, members of the euro area and to introduce the euro as a single currency. In 2002, favourable inflation developments, strengthening exchange rates and, finally, the space allowed for certain support of export

Balance of public budgets of candidate countries **(in % of GDP, ESA 95)**

	2001	2002	2003 */
Czech Republic	-5.5	-3.9	-5.8
Hungary	-4.7	-9.2	-4.5
Poland	-3.0	-4.1	-4.0
Slovakia	-7.3	-7.2	-4.9
Slovenia	-2.8	-2.6	-1.4
Estonia	0.2	1.3	-0.3
Lithuania	-2.2	-2.0	-2.1
Latvia	-1.6	-3.0	-3.1
Malta	-6.8	-6.2	-4.3
Cyprus	-3.0	-3.5	-3.9
Bulgaria	0.2	-0.6	-0.7
Romania	-3.3	-2.2	-2.5

Source: Main Results of the April 2003 Fiscal Notifications Presented by the Candidate Countries. EC, DG EFA, May 2003.
**/ forecast*

performance at a time of flagging international growth, combined with a high degree of harmonisation of monetary policy instruments with the European Central Bank's toolkit, enabled to cut (in several cases substantial cumulative annual cuts) key national central bank rates and narrow the gap to ECB rates. At the end of the year, the interest rates set by the Slovak, Hungarian and Polish central banks were approximately on level terms, while the Czech National Bank's rates have remained low for quite along time now (below ECB rates in the second half of 2002).

Besides the generally positive contribution of monetary and exchange rate policies implemented by the central banks of candidate countries to their macroeconomic stabilisation and disinflation, heavy and volatile inflow of foreign capital, maintenance of external competitiveness and simultaneous adherence to inflation targets towards price stability, constitute a persistent risk to their correct setting.

The principal risk factor affecting macroeconomic stability in V4 countries is the development of public finance, given the expansive tendencies in fiscal policy and slow implementation of structural reforms. The need for fiscal consolidation and to put the budgetary developments up to a sustainable pace is bound to become an increasingly urgent issue as these countries are expected to open negotiations soon to integrate their currencies into the ERM II exchange rate mechanism, as well as in connection with the commitments they will have to make as EU members under the Stability and Growth Pact.