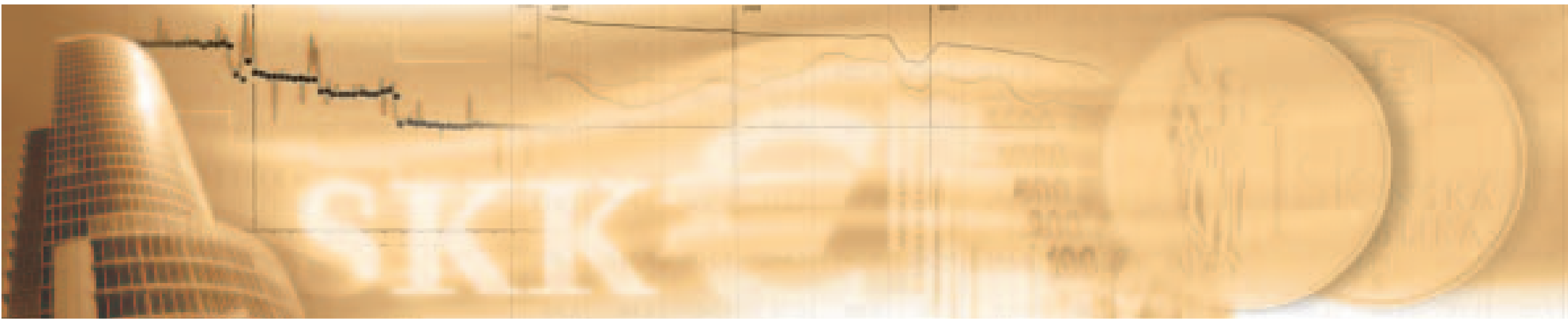
A. EXTERNAL ECONOMIC ENVIRONMENT



1. WORLD ECONOMY

Global trends in output and prices

In the first half of 2003, the development of the world economy was adversely affected by geopolitical uncertainties and the consequences of the SARS epidemics, but in the second half of the year the pace of growth accelerated. Rapid growth in industrial production was accompanied by a revival of international trade and restored confidence on the part of businesses and consumers. The global output rose by 3.9% for the year 2003 taken as a whole. Nevertheless, imbalances between individual regions of the global economy deepened in the course of global development. As a major factor, the current account deficit in the United States increased again and the US dollar markedly weakened.

The global recovery resulted from accelerated growth in the United States and Asia, where in addition to a rapid expansion of the Chinese economy, the Japanese economy once again reinstated its growth trajectory. On the contrary, the growth in the euro area continued to decelerate. Also in 2003, the transition economies of Central and Eastern Europe maintained their relatively high growth rate. A considerable acceleration of growth was recorded in Russia.

A general growth factor in global production consisted of expansionist economic policies in place and rapid growth in private consumption. Business investment growth was considerably differentiated in individual regions of the world economy. The global recovery did not put the group of industrially developed countries under any substantial inflationary pressures due to rapid growth in productivity particularly in the US but also because of the persisting under-utilisation of capacities. Consumer prices in this group of countries grew by 1.8% year-on-year, which was just slightly more than in 2002, when they increased by 1.5%.

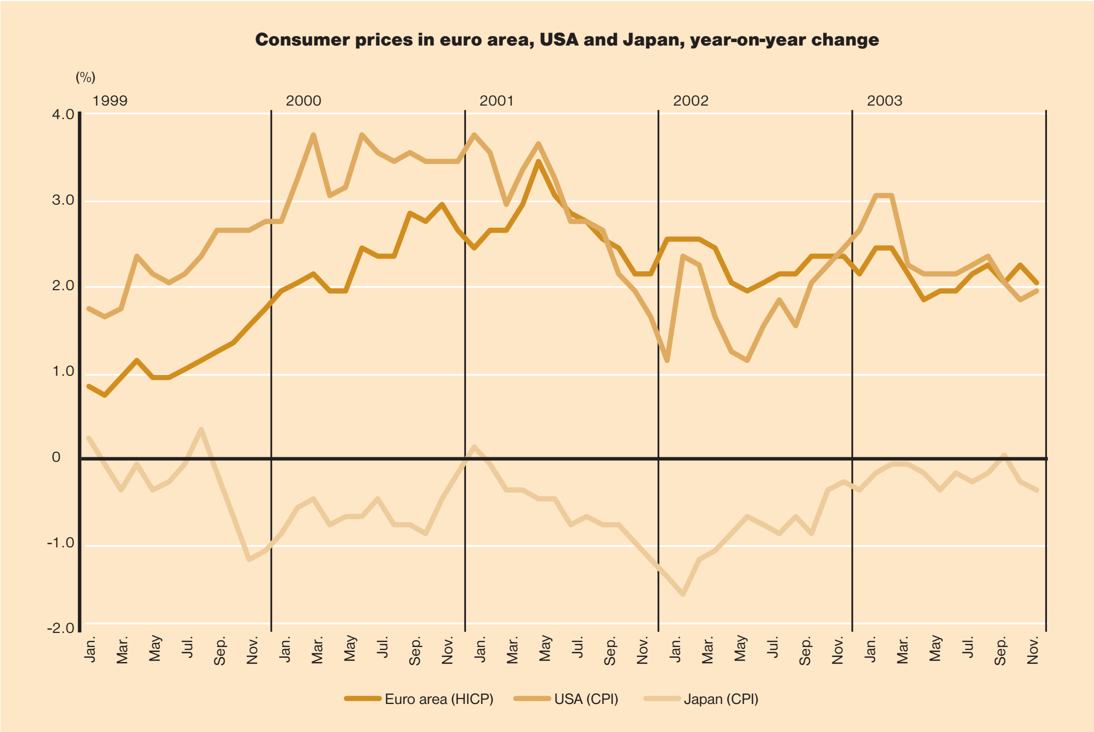
Geopolitical tensions, the position in the business cycle and supply shocks were reflected in commodity markets. The price of crude oil culminated in April, when it exceeded USD 34 per barrel, and its decline was hampered by a slower-than-expected recovery of oil exploitation in Iraq, but also by low stocks of crude oil and „impeded" demand, notably in developed countries. It declined more distinctly only in September. On the year average, the price of crude oil increased by 15.8% to USD 28.9 per barrel, with a substantial portion of this increase resulting from a permanent depreciation of the USD. The average prices of non-energy commodities rose by 7.8% annually, with growth being distinctly influenced, apart from the business cycle factor and dollar

Table A1 **Global output** **(year-on-year growth in %)**

	2002	2003	2004 [1/]
Global output	3.0	3.9	*4.6*
Developed economies	1.7	2.1	*3.5*
USA	2.2	3.1	*4.6*
Japan	-0.3	2.7	*3.4*
European Union (EU-15)	1.1	0.8	*2.0*
Euro area	0.9	0.4	*1.7*
Emerging Asian markets	5.1	3.0	*5.3*
Central and Eastern Europe	4.4	4.5	*4.5*
EU acceding countries (ACC-10)	2.4	3.6	*4.0*
Russia	4.7	7.3	*6.0*
China	8.0	9.1	*8.5*
Brazil	1.9	-0.2	*3.5*

1/ Prognosis.
Source: World Economic Outlook, April 2004; Economic Forecasts Spring 2004, European Economy No. 2, 2004.

Chart A1



exchange rate development, by rapidly increasing demand in China.

International foreign exchange markets saw a continuing tendency in 2003 towards appreciation of the euro against other major currencies. The strongest appreciation was recorded for the euro against the US dollar and currencies of Asian countries tied to the US dollar. The euro also appreciated against the Japanese yen, British pound and Swiss franc, whilst weakening against the Australian dollar. The euro's continuous appreciation was temporarily disrupted in the summer by positively revised market expectations with respect to economic revival in countries outside the euro area. Towards the end of the year, however, the euro strengthened again as a consequence of growing concerns over a disproportionate deepening of global regional imbalances. The main concern, reflected in a distinct year-on-year weakening of the US dollar against the euro, became the issue of financing the US current account deficit. On 30 December 2003, the euro reached the value of USD 1.25, which represented an almost 19.5% appreciation compared to the exchange rate at the beginning of the year. Its average level for 2003 was 32% higher in comparison with that for 2002. The issue of financing the US current account deficit was at the forefront of G7 group negotiations in Dubai, on which occasion proposals were made to introduce greater flexibility with respect to exchange rates with a view to supporting a smooth and general adaptation of the financial system based on market mechanisms. The Dubai summit was notably reflected in a temporarily strong pressure towards appreciation of the Japanese yen. Also for this reason the appreciation of the euro against the yen was substantially softer than against the US dollar: at the end of 2003, the exchange rate of the Japanese yen against the euro stood at 133.7, which means a year-on-year appreciation by 7.5%; the annual average of the exchange rate of the euro against the yen was 13% higher in 2003 than in 2002.

Global bond markets were marked by considerable yield fluctuation in 2003, but yields on major economies' bonds moved largely in a similar fashion. The volatility of yields was caused by market players' changing views as to the outlook for economic growth, inflation and subsequent monetary policy reactions. In the first half of the year, geopolitical uncertainties provoked sizeable portfolio shifts from equity markets to bond markets. In the second half of the year, hand in hand with lessening uncertainties and growing signs of recovery in major economies, a partial redirection in flows between the two markets was observed. In the aggregate for 2003, yields on ten-year government bonds of the euro area and ten-year US treasury bonds rose by roughly 10 and 50 basis points, respectively, both reaching 4.3% in the final weeks of the year. Nevertheless, over a prevalent part of the year, yields on US Treasury bonds were lower, compared to yields on long-term euro area bonds. Yields on Japanese long-term bonds moved in approximately the same way as yields on both, the US Treasury bonds and and euro area bonds, but at substantially lower levels (reaching their historic low of 0.4% in mid-June). At the end of the year they stood at 1.4%.

Upon the completed correction of high levels dating back to 2000, prices in the major equity markets went up again in 2003. The broadly based equity market indices in the US, euro area and Japan developed almost identically in the course of the year. „The flight" from shares to bonds, which in addition to geopolitical and economic uncertainties, was also caused by concerns regarding the quality of corporate profits owing to recent accounting scandals, brought about a decline in share prices in the first quarter. In the remaining part of the year, share prices followed an upward trend, stimulated by more favourable prospects for investors. On the whole, the US share prices in 2003, measured by Standard and Poor's 500 index, grew by 26%. Share prices in Japan, measured by the Nikkei 225 index, rose by 24%. With regards to the euro area, the Dow Jones EURO STOXX index went up 18%.

Economic developments in the main currency areas: the United States, Japan and the euro area

The recovery in the **United States** begun in 2002, slowed down at the beginning of 2003 as a consequence of geopolitical uncertainties concerning the Iraq war and the associated adverse development of business and consumer confidence. In the second half of the year, growth in the economy substantially accelerated. In 2003, GDP growth reached 3.1% (2.2% in 2002). Economic growth was mainly driven by a persistently high level of household expenditure, fuelled by tax reductions and favourable mortgage financing terms. Real private consumption grew by 3.1%. The high consumption level persisted despite deteriorating labour market conditions and the unemployment rate reaching 6% (5.8% in 2002). Owing to a strong housing market, real domestic investment rose by 5.1%. After two years of decline, business investment also grew by 4.3%, facilitated by favourable financing terms, growing profits and the prospect of further rising demand. The growth of domestic demand in 2003 was reflected in the further deepening of the current account deficit , which exceeded 5% of GDP. In 2003 the development of consumer and producer prices was marked by accelerated inflation of 2.3%, and 3.2%, respectively, compared with 1.6% and -1.3% in 2002. However, after making adjustments for the effects of energy prices, inflationary pressures were generally negligible due to rapid growth in productivity and the low utilisation of capacities.

After two years of stagnation and even real decline in its performance, the economy of **Japan** took a more distinct growth trajectory in 2003 owing to exports and private investment, with GDP rising by 2.7% as a result. Exports to China accounted for almost half of the total increment in exports, and in terms of commodities, the greatest dynamics was recorded in exports by the mechanical engineering and electrical engineering sector, which was reflected in rapid growth of output in the respective industries. Growth in private investments originated mainly from non-residents. Private consumption spending was relatively low owing to the persistently unfavourable situation on the labour market, with an unemployment rate of 5.3%. Deflationary pressures in price development weakened, but they were not overcome in 2003 either. On the annual average, the consumer price index dropped by 0.3% (compared to -0.9% in 2002).

On a year-on-year basis, the GDP growth in the **euro area** slowed down again, reaching 0.4% in 2003 (0.9% in 2002). Economic recovery lagged behind expectations. After three quarters of stagnation, the economy began to grow only in the second half of 2003. Positive effects from growing foreign demand for exports from the euro area were to a considerable extent eliminated by the euro's appreciation. Thus, the contribution of net exports to GDP growth, also due to a rapid rise in imports in the last quarter, reached a negative value of 0.6 percentage points. The exclusive share of domestic demand in the growth of GDP in the euro area in 2003 was in particular caused by the replenishment of inventory, the stock of which had been falling for two years. The contribution of a change in the inventory to GDP growth in 2003 reached 0.3 percentage points. Over a major part of the year, final domestic demand was dampened and its contribution to GDP growth was 0.7 percentage points. Fixed capital formation went down, but at a decreasing pace, and in the last quarter it attained a positive growth rate. On the contrary, private consumption gradually levelled off, compared to a mild growth at the beginning of the year.

In the same way as in other areas of the world economy, uncertainties related to the Iraq war were the main factor of reduced domestic demand in the euro area in the first half of 2003. Fears over future developments outweighed favourable domestic investment and consumer conditions created by a low level of interest rates, and the appreciation of the euro on top of that raised the real income. The growth of GDP in the euro area was mainly attributed to the recovery in the industry in the second half of the year thanks to enlarged export opportunities. The market services sector performance was relatively poor and even lagged behind the level at the time of recession in 1993.

Germany, the largest euro area economy, was in recession for a prevailing part of the year. Signs of a mild recovery were appearing in the second half of the year owing to accelerated export performance. The final domestic demand was on increase only in the segment of capital equipment,

Chart A2

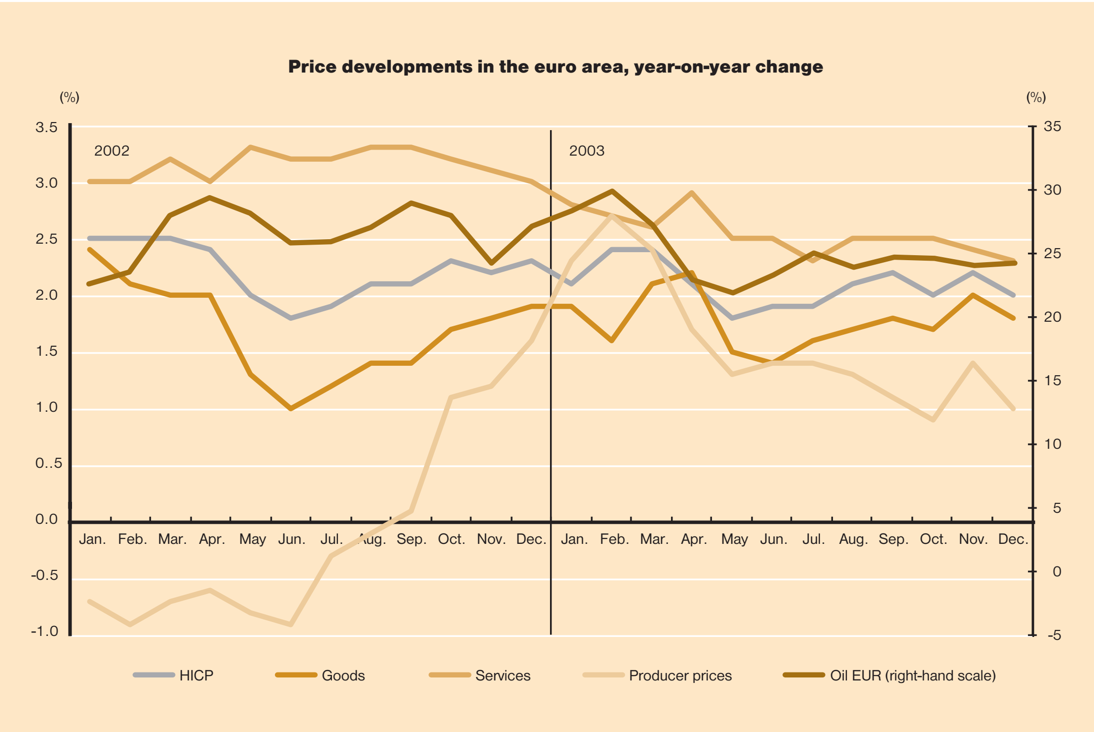
and the halting of several years' decline in construction output was also a stabilising element. Consumption continued to fall, especially due to a considerable drop in retail sales and new registration of cars. Low consumer confidence was caused by sceptical expectations concerning future developments in the pension area after the suspension of certain special payments, but also by fears of the impact of health system reform (a partial transition to paid services) and general uncertainty in connection with other measures to strengthen the effectiveness of social systems. A yearly decrease in GDP growth by 0.1% was the result of a substantial decline in domestic demand, as well as net exports, which was to a considerable extent offset by an increase in inventories.

Growth decelerated in the majority of euro area countries in 2003, except for Belgium, Spain and Greece, where the pace of GDP growth somewhat quickened compared to 2002, and Italy, where it remained basically unchanged. The greatest growth was recorded in Greece (4.7%), followed by Spain (2.4%), Finland (1.6%), Ireland and Luxembourg (1.2%), Belgium (1.1%) and Austria (0.7%). A slightly smaller than average GDP growth for the euro area (0.4%) was recorded in Italy (0.3%); the growth trend was maintained by France (0.2%). Three countries saw a decline in real GDP in absolute terms: Germany (-0.1%), the Netherlands (-0.8%) and Portugal (-1.3%).

The varying pace of economic growth between euro area countries reflected in particular the differences in real domestic demand and real housing prices in individual countries. Whereas in Germany both demand and housing prices stagnated, in Greece, Ireland and Spain they rose. The stated differences were to a certain extent influenced by persisting differences in real interest differentials caused by single level of interest rates in the euro area and different rates of inflation in the Member States.

In 2003 average inflation in the euro area measured by the Harmonised Index of Consumer Prices (HICP) reached 2.1%, falling by 0.2 percentage points compared to the previous year. The slowing down of price increases was primarily caused by the lower average annual price growth

Chart A3



in non-energy industrial goods and services. Movement of the HICP during the year reflected the developments in its more volatile components, i.e. mainly energy and unprocessed food prices. However, growth in crude oil prices denominated in US dollars was dampened by the euro's appreciation. Cost pressures in the course of the year were weak, even though in the first quarter, as a result of a decline in the growth of labour productivity associated with a low level of economic activity, the growth of the unit labour costs accelerated. This trend ceased as the economy recovered.

A relatively distinct increase occurred in the processed foodstuffs group, especially due to increases in the prices of tobacco and indirect taxes in certain countries, which was reflected in the 0.4 percentage points contribution of this component to the headline inflation.

Price development in the euro area in 2003 was characterised by a slowing down in the growth of prices of services, which grew considerably in 2002. The year-on-year increase in prices of services in December 2003 reached 2.3% (3.0% in December 2002). In 2003, the growth of prices of services contributed to the overall HICP inflation by 1 percentage point, making up roughly half of the total. The inflation rate within the group of non-energy industrial goods and services maintained its level of around 0.8% on a year-on-year basis (1.2% in 2002), which means that this group contributed to the overall price index by 0.2 percentage points.

The growth in industrial producer prices (excluding construction) slowed down during 2003, reflecting the effects of exchange rate appreciation of the euro on crude oil prices and other commodities, as well as a low level of economic activity. On a yearly average, producer prices in the euro area increased by 1.6%. The development of wage costs in the main sectors of the economy did not represent any inflation risks either. The growth in compensation per employee in the industry showed a downward trend throughout the year as a result of the low degree of industrial activity. Wage cost development in the services sector was basically stabilised and, taking into account a higher proportion of labour costs in this sector, this was a factor of relatively even price development in services during the year.

In 2003 the growth of consumer prices (HICP) in respective euro area countries ranged from 1.0% to 4.0%. The highest inflation was experienced in Ireland (4.0%), Greece (3.4%), Portugal (3.3%), Spain (3.1%) and Italy (2.8%). Inflation closer to the euro area average (2.1%) was recorded in Luxembourg (2.5%), France and the Netherlands (2.2%). The countries with the lowest inflation rate were Belgium (1.5%), Finland and Austria (1.3%), and Germany (1.0%).

Despite the decelerated GDP growth rate, the labour market in the euro area saw no substantial fluctuations in 2003. Over the course of the year employment was comparatively stable and, according to preliminary data, rose by 0.1 – 0.2% on the yearly average. Development varied in sectors: industry employment dropped, but was fully absorbed by the creation of new jobs in the services sector. A certain change in the behaviour of the euro area labour market is indicated by a falling number of hours worked per employee. A reduction in the number of hours worked starts to work as a new, more flexible regulator of employment in periods of recession, whereas in the past the growth slow-down was directly reflected in the change of employment. The average unemployment rate in the euro area grew to 8.8% in 2003 (8.4% in 2002). The unemployment rate went up in the majority of euro area countries, with the exception of Italy, where it fell, and Greece, Finland, Austria and Spain, where it remained approximately at the same level as the previous year. The lowest unemployment rate was recorded by Luxembourg and the Netherlands (4.1% and 4.2%), and the highest in the long run is found in Spain (11.3%).

Results of the external sector of the euro area in 2003 are characterised by a current account surplus of EUR 28.1 billion (0.4% of GDP), which, however, was substantially lower compared to 2002 (EUR 67.1 billion, 0.9% of GDP). The lower surplus resulted from a decline in the balance of trade and an increase in the deficit on the income account (caused mainly by appreciation of the euro). Imports of goods stayed approximately at the 2002 level, as the reduction in the surplus in goods resulted from the decline in the value of goods exported from the euro area. The decline in the value of exports was chiefly caused by a reduction in export prices, by which exporters compensated for price competitiveness losses caused by the appreciation of the euro. The volume of exports went down only in the first quarter, then, hand in hand with an increasing revival in foreign demand, it started to rise again.

In 2003, a net outflow of EUR 9.3 billion was recorded on the financial account of the euro area balance of payments, whilst a net inflow of EUR 61.9 billion was achieved in 2002. This result was caused by a lower net inflow of portfolio investments (by EUR 91.6 billion year-on-year), which was only partially offset by a slower net outflow of direct investments (by EUR 20.3 billion). The development of net portfolio investments was primarily influenced by transactions in debt instruments, where a direction reversal in comparison to the previous year and a net outflow were recorded. Especially in the second half of the year, along with the improving business cycle outlook, foreign investors started to massively reallocate their portfolios from money market instruments to more risky assets. At the same time, the net inflow of investments into bonds was reduced. The ensuing flow of euro area direct and portfolio investment into equity securities in 2003 can be roughly characterised by a balanced position. In the first half of the year, equity investment was hampered by economic and geopolitical uncertainties, as well as the SARS epidemics. With subsiding uncertainties and the revival of share prices, equity investment was gradually activated, whilst foreign direct investment in the euro area remained dampened.

With regards to the three EU states that are not members of the euro area (Denmark, Sweden and the United Kingdom), they have a commitment under the Maastricht Treaty to apply economic policies, „in matters of common interest.“ They are likewise obligated to abide by fiscal rules of the Stability and Growth Pact. Their national central banks are members of the European System of Central Banks (ESCB), and the operative target for their monetary policy is to maintain price stability. Macroeconomic, fiscal and monetary developments together with exchange rate developments of these countries is therefore subject to regular evaluation by European institutions.

The Danish economy recorded zero GDP growth in 2003 as a result of a decline in real domestic demand, especially demand for investments, as well as in exports. Weak economic activity led to an unemployment rate increase by 1 percentage point, reaching 5.6%. The per annum inflation rate (HICP) dropped to 2% thanks to a reduction in indirect taxes and low energy prices associated with the weakened US dollar. Turning to the fiscal area, Denmark is a country reporting a budgetary surplus. In 2003 this was slightly reduced to 1.5% of GDP as a result of lower tax revenues, but also due to an increase in mandatory social expenditure. Government debt decreased to 45% of GDP year-on-year. Currently, Denmark is the only country whose currency is fixed to the euro within the ERM II, in the agreed mode allowing for fluctuation of the currency around its central parity within a narrow band of ±2.25%. In 2003, the Danish crown fluctuated within a narrow band, with a marginal deviation towards appreciation.

Sweden's GDP growth stood at 1.6% in 2003 slowing down on the year-on-year basis, which was the result of a low level of domestic consumption and investment in the first half of the year. Relatively good results were recorded for exports, which contributed more than a half to GDP growth. A mild decline in employment was reflected in a distinct rise in labour productivity, whilst the unemployment rate stood at 5.6%. The average annual inflation (HICP) reached 2.3%, CPI inflation, which is a monetary target of the

Swedish central bank, dropped from 2.4% to 2.1% year-on-year. Public finances recorded an improvement, ending in a budgetary surplus of 0.7% of GDP, government sector debt was reduced to 51.8% of GDP. The Swedish central bank maintains a flexible exchange rate regime and a monetary policy targeting on inflation, with the explicit target of CPI growth at 2% per annum, within the tolerance range of ±1 percentage point. The Swedish crown fluctuated at the level of around 9.2 SEK/EUR, strengthening to 9.01 SEK/EUR in the last quarter. In a referendum on the introduction of the euro in Sweden held on 14 September 2003, voters rejected the participation of their country in the euro area.

In 2003 the UK economy recorded an accelerated rate of GDP growth of 2.3%. Such accelerated growth resulted from a reduced negative contribution by net exports, which more than offset a decline in the contribution of domestic demand. The distinct reduction in the negative contribution of net exports to GDP growth (from -1.7% in 2002 to -0.5% in 2003) was attributed to improved price competition (owing to weakening of the pound against the euro) and a decline in British imports. Stable labour market conditions were characterised by an unemployment rate of 5.1%. The average HICP inflation rate stabilised at 1.4%. A substantial deterioration occurred in the fiscal area, with the public finance deficit for the year 2003 reaching 3.2% of GDP (1.6% of GDP for the year 2002). Deepening of the budgetary deficit was caused by high primary expenditure and a loss of revenues due to the changed GDP structure. The increased budgetary deficit translated into increased government debt, which stood at 39.8% in 2003.

The British central bank pursues its monetary policy under a flexible exchange rate regime, with an explicit inflation target. The Bank of England changed its key interest rate three times in 2003. After a repeated reduction by 25 basis points in the first half of the year, it made a correction in the reduction made in November, raising the rate by 25 basis points to the final 4%. Such a rise was justified by improving economic development outlooks, rapid growth in loans and generally rising inflationary expectations. In order to align more strongly inflationary expectations in the domestic economy with those in the euro area, beginning in December 2003 the Bank of England redefined its inflation target from the national CPI to HICP, which is used by the ECB in maintaining price stability in the euro area. The new inflation target has been defined as a 12-month HICP increase of 2%.

In June 2003 the British government announced its decision to postpone a referendum on the introduction of the euro in the United Kingdom, since the results of five economic tests by the Treasury show an unsatisfactory degree of convergence and flexibility in the British economy to be able to handle potential problems in the monetary union.

Monetary policy and public finances

The US interest rates remained at historic lows in 2003. The Federal Open Market Committee (FOMC), motivated in particular by the risk of an undesirable decline in inflation, scaled down the target for the federal funds rate by 25 basis points to 1% in June. It remained at this level until the end of the year. Fiscal policy was further loosened compared to a year ago, which was reflected in a rise in the fiscal deficit from 1.5% of GDP in 2002 to 3.5% of GDP in 2003. This was largely a result of introduced discrete measures, and to a lesser degree it was due to the budget's automatic response to the business cycle.

Amidst the persistent deflationary price development, the monetary policy of Japan's central bank in 2003 continued its special course of quantitative monetary expansion, under which it doubled its target range for balances on current accounts kept at the Bank of Japan during the year. In addition, it decided to temporarily purchase securities backed by assets in order to support the funding of small and medium-sized businesses. In an effort to push through consolidation of the fiscal sector, the government limited its expenditure for public investment. Nevertheless, the budgetary deficit increased again from a year ago, reaching 8.2% of GDP. Public debt, enormous for a long time, rose to 166.1% of GDP.

ECB monetary policy performance in the first half of 2003 was influenced by geopolitical uncertainties regarding developments in the Middle East, crude oil price growth and worried financial markets. After assessing inflation risks, the yearly inflation rate development and a low level of economic activity, which already in 2001 had fluctuated below the level of potential GDP growth in the euro area, the ECB Governing Council concluded that there was no potential for inflation to jeopardise price stability in the medium term.

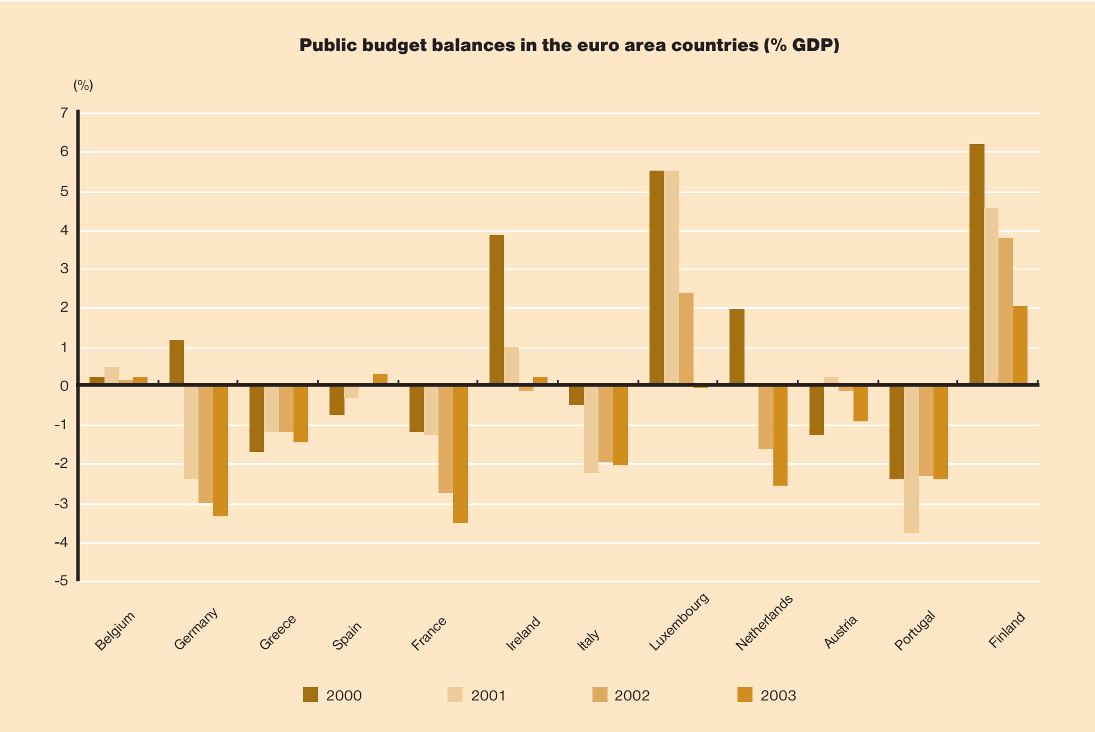
Such positive prospects in respect to price stability were not considered to be threatened by an intense monetary expansion in 2003, which was in part attributed to a high degree of uncertainty in the economy and financial markets and the related massive portfolio shifts to safer short-term liquid assets included in the M3 aggregate. The accumulation of surplus liquidity was therefore regarded as a temporary phenomenon.

In March and June the ECB reduced its key rates by 25 and 50 basis points to the resultant historic low of 2% for main refinancing operations. They remained at this level until the end of 2003, since the price stability outlook remained favourable even under conditions of accelerating recovery and taking into account the ongoing appreciation of the euro.

This was the third year in a row that results from the euro area fiscal sector had worsened. In 2003, the fiscal deficit for the euro area averaged 2.7% of GDP (2.3% of GDP for the year 2002). The deterioration of the fiscal position was primarily affected by the action of automatic stabilisers at the stage of a sluggish economy, which lasted longer than expected. The majority of countries did not manage to accomplish the fiscal targets set in their stability programmes approved at the end of 2002, or at the beginning of 2003.

Fiscal developments aroused concerns especially in those countries that had already recorded considerable fiscal deficits in 2002. Germany and France's deficits approximated, or somewhat exceeded the level of 4% of GDP and, despite

Chart A4



temporary measures, Portugal's deficit closely approached the boundary of 3% of GDP; the deficit of the Netherlands reached 3% of GDP. On the expenditure side, the risen deficits were caused by an increasing volume of social payments and transfers as a result of growing unemployment. On the revenue side, they were due to insufficient growth in tax revenues, caused in particular by poor economic activity.

On 25 November 2003, the Ecofin Council, on a recommendation from the European Commission, decided not to apply sanctions against France and Germany in response to their excessive fiscal deficits. The Ecofin Council issued a recommendation for France, advising it to reduce its cyclically adjusted deficit by 0.8% of GDP in 2004 and by at least 0.6% of GDP in 2005. Such reductions would bring down the overall deficit below 3% of GDP by 2005 at the latest. At the same time, the Ecofin Council made a recommendation to Germany to reduce its cyclically adjusted deficit by 0.6% of GDP in 2004 and by at least 0.5% in 2005, in an attempt to lower its overall deficit below 3% of GDP by no later than 2005.

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

The Ecofin Council's decision to suspend the excessive deficit procedure against France and Germany was therefore met with disapproval on the part of the ECB, in whose judgement it, „introduced uncertainty into the future implementation of rules governing fiscal policy in euro area countries" and constituted, „a precedent of a lax implementation of the excessive deficit procedure that could weaken incentives for consolidation in the future."

Table A2 **Macroeconomic indicators for EU acceding countries** **(year-on-year change in %)**

	GDP			Inflation 1/			Unemployment rate 2/			Current account		
	2002	2003	2004 3/	2002	2003	2004 3/	2002	2003	2004 3/	2002	2003	2004 3/
Czech Republic	2.0	2.9	2.9	1.4	-0.1	2.8	7.3	7.8	8.2	-5.8	-6.5	-6.8
Hungary	3.5	2.9	3.2	5.2	4.7	6.9	5.6	5.8	5.7	.	-5.7	-5.4
Poland	1.4	3.7	4.6	1.9	0.7	2.3	19.8	19.8	19.6	-2.6	-2.0	-2.3
Slovakia	4.4	4.2	4.0	3.5	8.5	8.2	18.7	17.2	16.5	-8.2	-0.9	-2.5
Slovenia	2.9	2.3	3.2	7.5	5.7	3.6	6.1	6.5	6.4	1.7	0.2	-0.5
Estonia	6.0	4.8	5.4	3.6	1.4	2.8	10.5	10.0	9.7	-12.2	-13.7	-11.5
Lithuania	6.8	8.9	6.9	0.4	-1.1	1.0	13.6	12.7	11.5	-5.4	-6.1	-6.2
Latvia	6.1	7.5	6.2	2.0	2.9	4.0	12.0	10.5	10.3	-7.6	-9.1	-10.1
Cyprus	2.0	2.0	3.4	2.8	4.0	2.2	3.9	4.4	4.1	.	-4.4	-3.7
Malta	1.7	0.4	1.4	.	.	.	7.5	8.2	8.6	.	-3.4	-4.3
Total for 10 countries	2.4	3.6	4.0	2.7	2.1	3.8	14.8	14.3	14.1	.	-3.7	-3.9
Euro area	0.9	0.4	1.7	2.3	2.1	1.8	8.4	8.8	8.8	1.3	0.5	0.7

1/ HICP.
2/ Expressed as % of workforce.
3/ Projection.
Source: Economic Forecasts Spring 2004, European Economy No. 2, 2004.

2. ECONOMIC DEVELOPMENTS IN THE EU ACCEDING COUNTRIES

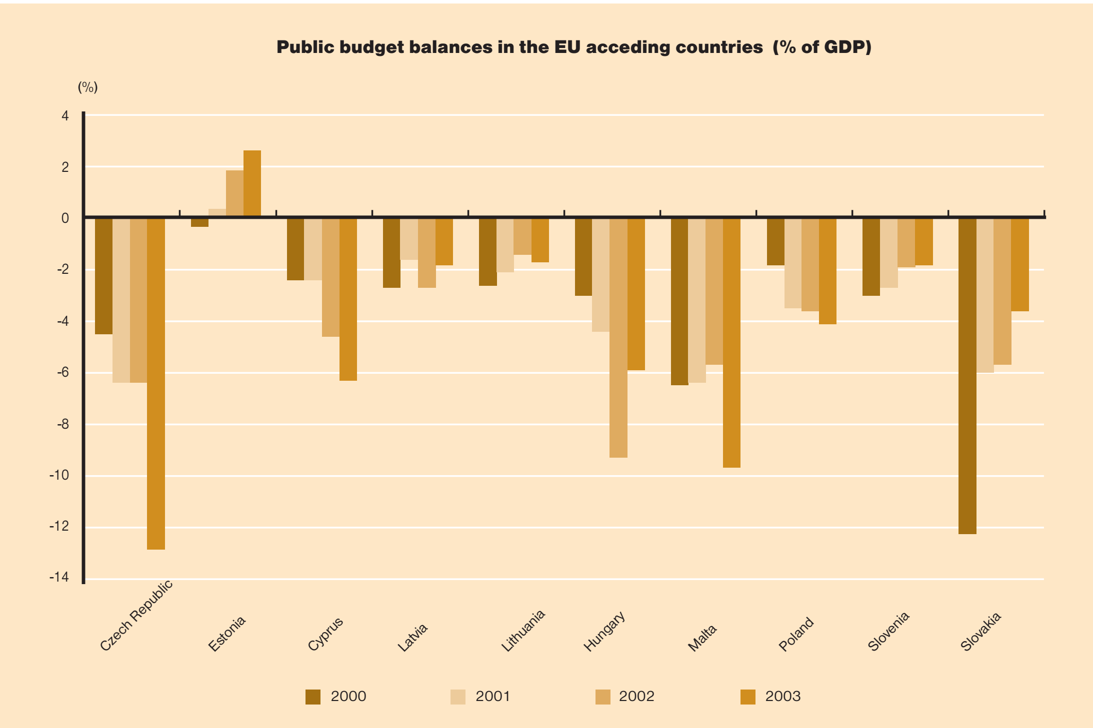
Summary overview

At an informal meeting of the European Council held in Athens on 16 April 2003, ten candidate countries and 15 EU Member States signed the Treaty of Accession. The Treaty of Accession created a framework and conditions for the EU enlargement to 25 members scheduled for 1 May 2004. The Treaty of Accession has been ratified by all future and present EU Member States. As part of the ratification process, national referenda were held in all candidate countries, in which with the exception of Cyprus[1] the public voted in favour of EU accession.

New-accession countries enter the EU with the status of „Member States with derogation" (as countries not having yet adopted the euro) and their central banks will become part of the ESCB. Once these countries meet Maastricht convergence criteria in a sustainable manner and adopt the euro, their central banks will become part of the Eurosystem. Immediately after accession to the EU, commitments ensuing from the Maastricht Treaty for all EU members will also be applied to the new Member States. In particular, there is an obligation to carry out an economic and exchange rate policy geared to EU common interests. They will also become fully (except for sanction mechanisms) subject to fiscal rules of the Stability and Growth Pact, including an obligation to submit and regularly update national convergence programmes. In conformity with the ECB's goal of price stability, national central banks will have to direct their monetary policies to enable a gradual alignment of the parameters of the domestic monetary environment with the conditions of the euro area and to create prerequisites for stability of the currency's exchange rate during its functioning under the ERM II. The timing of entry into the euro area is not predetermined by accession to the EU, but the majority of newly-acceded states already began developing their national strategies to introduce the euro in 2003.

Despite sluggish economic activity in the EU and especially the recession in the German economy, which is the main business partner to

Chart A5



[1] *As a consequence of the referendum results from April 2004, only the Greek part of the island became an EU Member State*

many acceding countries, the economic development of future EU Member States was also marked by a relatively rapid GDP growth in 2003. The rate of growth of 10 acceding countries averaged 3.6%, which was 2.8 percentage points higher than the average growth of 0.8% for 15 EU countries and bolstered the convergence process.

GDP growth particularly in the Czech Republic, Hungary and the Baltic countries was facilitated by a high level of domestic private consumption. Household expenditure was stimulated by a partially higher real disposable income, due to relatively low inflation, which stood at the level similar to that in a number of euro area countries. Another factor of rising household consumption was broader access to debt financing thanks to stabilised banking systems, but also the expenditure made in expectation of accelerated inflation in 2004 associated with raised indirect taxes.

On the contrary, investment activity was poor (except for the Baltic states), reflecting generally unfavourable conditions in the global environment, but also the consequences of as yet incomplete structural reforms taking place in individual economies.

In spite of weakened growth in the EU, export performance retained its generally good level. Exceptionally rapid export growth was attained by Slovakia thanks to new export-oriented production capacities. High export performance was also achieved by Poland, which was substantially aided by the depreciation of the zloty against the euro.

On average, the public budget balance for 10 EU acceding countries in 2003 was marked by a deficit at the level of 6.3% of GDP. There were, however, large differences as to the results of the fiscal sector in individual countries: from a deficit of 12.9% of GDP in the Czech Republic to a surplus of 2.6% of GDP in Estonia. In 2003, the 3% limit of GDP was exceeded by deficits in six countries. Apart from the Czech Republic this included Cyprus, Hungary, Malta, Poland and Slovakia.

Economic and monetary developments in V4 countries

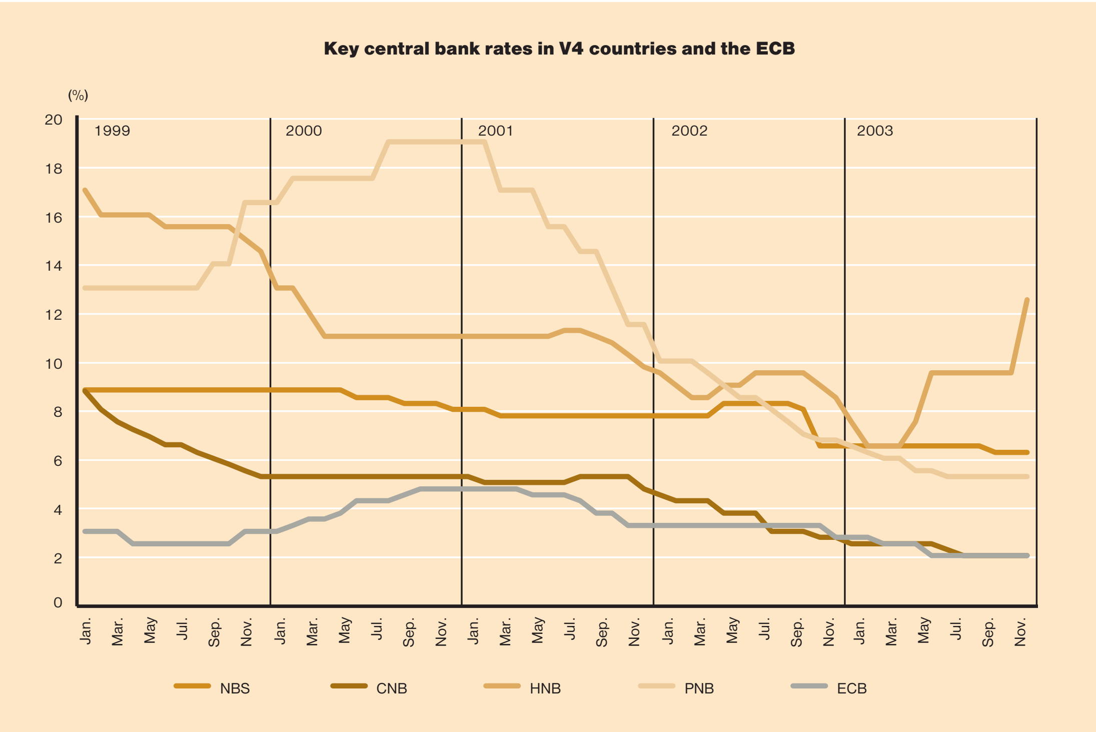
The acceleration of GDP growth in the **Czech Republic** (CR) in 2003 was facilitated by rising domestic private consumption, driven in particular by household consumption amid the stagnation of government sector consumption, but also by an increase in exports. Under the conditions of a growing unemployment rate, caused by restructuring processes in the corporate sector, the growth in household consumption resulted mainly from the combined effect of increased real disposable income and low interest rate levels, which stimulated the expansion of consumer loans. As for price development in the CR, the phenomenon of deflation was recorded for the first time. Since April 2002, the Czech National Bank's inflation target has been undershot, and in 2003 a decline was recorded in respect to the HICP on the yearly average. Despite rapid import growth driven by intense domestic consumer and investment demand, the trade balance deficit was reduced year-on-year thanks to favourable exchange rate development. An increased deficit on the current account in 2003 resulted from a smaller surplus in the balance of services, but was mainly due to the further increase in the deficit of the income account as a result of growing repatriated profits. Almost half of the high public finances deficit in the CR in 2003 was due to imputed sovereign guarantees, since without this operation the budgetary deficit would have reached 6.6% of GDP.

A mild slowdown in economic growth in **Hungary** in 2003 was attributable to low investment activity and the negative contribution of net exports. The achieved growth was, on the contrary, supported by a high level of domestic consumption, fuelled by fiscal expansion and the subsequent excessive growth of wages in both the public and private sectors. The enlarged current account deficit was caused by delayed effects of the loss of competitiveness as a result of the preceding strong appreciation by the forint, as well as high import levels supported by the disbursement of savings in the personal sector due to the impact of the unsustainable generously subsidised mortgage system to finance housing. On the yearly average, inflation went down, but the favourable trend of several years of disinflation stopped in mid-2003 and inflation started to rise. Also in 2003, the labour market situation was marked by rapidly-growing wages, especially in the public sector, and a slight increase in the unemployment rate, which still remained at a comparatively low level. Hungary did not manage to meet the forecast target in the area of public finances in 2003 either. Fiscal deficit was markedly exceeded especially as a consequence of higher current expenditure, as well as social benefits and interest payments. At the same time, forecasts concerning the revenue side were not met, particularly in both personal and corporate income tax collection.

Following a distinct slowdown in the previous two years, economic growth in **Poland** was accelerated in 2003. The growth momentum was stirred up by net exports, stimulated by a steep decline in the real effective exchange rate of the Polish zloty. Poor growth of real income kept private consumption at a low level, and private investment diminished for the third year in a row. On the contrary, GDP growth was facilitated by accommodative fiscal policy and favourable monetary conditions created by the loosening of the monetary policy and the depreciation of the currency against the euro. The low level of domestic demand and only mild growth in wages were only reflected in an indistinct price rise. Weakened domestic demand did not raise any pressure on imports, which along with swift export growth, maintained at a low level the deficit on the current account of the balance of payments. The unemployment rate has been high for a long time, and in 2003 it did not decline either, despite accelerated GDP growth. Owing to the ongoing restructuring process in both industry and agriculture, employment growth is hampered by the still high number of terminated jobs. A slight relaxation of fiscal policy was reflected in a year-on-year increase in the public finance deficit, although this was not dramatic.

GDP growth in **Slovakia** in 2003 remained at a relatively high level. On a year-on-year basis it nevertheless mildly slowed down as a consequence of the rapid decline in private consumption, as well as gross fixed capital formation prompted by fiscal restrictions and changes to

Chart A6



administrated prices. An exceptionally strong expansion of exports enabled by the launch of new pro-export capacities, on a substantially lower import growth, led to a net contribution by the external sector to GDP equalling 6.5% of GDP, and to offsetting losses in domestic demand. The boosted export performance was reflected in a rapid decline in the current account deficit. High year-on-year inflation in 2003 was a result of the most recent adjustments to regulated prices, changes in VAT rates and raised excise taxes. The unemployment rate remained high, but showed a gradual decline. Within the continued restructuring of the corporate sector, a more vigorous government policy in addressing the long-term structural problems of the Slovak labour market became the main factor in its lowering. In 2003 public finances in Slovakia saw a better-than-planned result achieved by fiscal restriction, but in particular by lower spending from the budget chapters of several government departments.

Monetary and exchange rate policies by the central banks of V4 countries are gradually being subordinated to the goal of creating conditions for the introduction of the euro as early as possible after EU accession. At an achieved high standard of harmonisation of monetary policy instruments with the range of instruments used by the ECB, the favourable development of inflation, along with the strengthening of exchange rates, but also room created for certain support to export performance under the conditions of a weakened international boom, led in 2003 to the lowering of key interest rates by the national central banks of the Czech Republic, Poland and Slovakia, and to the narrowing down of the differential against ECB rates. Towards the end of 2003, the Slovak and Polish central banks' rates were at similar levels, the Czech central bank's rates have been very low for a long time and in 2003 they fluctuated at the level of ECB rates. In the middle of 2003, the Hungarian central bank's (MNB) monetary policy came under pressure from growing inflation on the concurrent depreciation of the currency, prompted by an outflow of short-term capital after the revaluation speculation at the start of the year. The mass closure of investors' forint positions brought the country to the brink of a currency crisis. In an effort to sustain meeting its inflation target, the MNB substantially raised its key interest rates (on the whole by 600 basis points from June until the end of the year). Nevertheless, the exchange rate of the forint against the euro remained throughout 2003 below the level compatible with a risk-free accomplishment of the MNB's inflation target.

Also in 2003, the main risk factor for macroeconomic stability in V4 countries was the development of public finances owing to slowly-advancing structural reforms. The necessity for fiscal consolidation and getting budget development on a sustainable track will be an urgent task with regard to the envisaged early negotiations by these countries as new EU Member States concerning the integration of their currencies in the ERM II, as well as their commitments ensuing from the Stability and Growth Pact.