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Global Economy

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Global Outlook

- **Broadly based global growth continues**
- **US and Asia leading the growth league**
- **Better news from the euro-zone**
- **Inflation picking up, monetary tightening in the US**
- **Fiscal challenges yet to be addressed**
- **Euro-dollar exchange rate stable**
- **Record-high commodity prices**

The global economic upswing continued in recent months and growth now appears broadly based. This supports our generally optimistic forecast from the previous quarter, which we maintain. The differences in economic performance among the major regions have remained largely unchanged. The euro-zone still appears to be the weakest link in the global upturn, though there has been some optimistic news here too. Recent months have seen an increase in inflationary pressures, though partly due to price developments in oil and other commodities. Responding to such trends, the US Fed opted to raise interest rates, starting a period of gradual monetary tightening that is expected to continue over upcoming quarters. The generally optimistic outlook may be undermined by a combination of factors, such as instability of oil and other commodity markets and the tense geopolitical situation with a perceived risk of terrorist attacks, all of which could undermine consumer and business confidence.

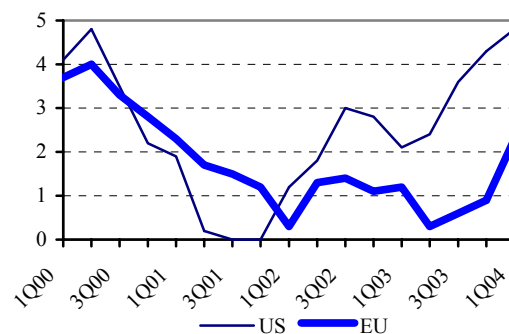
The growth composition of the major economies has broadened somewhat recently, with the US and Japanese economies mainly driven by a combination of solid consumption and investment outlays and the euro-zone upturn still largely by exports. Business confidence surveys in the US, Japan and Europe have generally given optimistic signals. Consumer attitudes in the euro-zone are somewhat more mixed.

The euro dollar exchange rate has been very stable in May-July and we do not anticipate any significant exchange rate movements of the major currencies in 2H04. Future trends will be to some extent determined by monetary policy patterns. In late June, the US started a period of monetary tightening and interest rates are expected to rise

further in upcoming months. By contrast, the ECB is unlikely to tighten its policy until early 2005. The somewhat stronger than expected surge in inflation is largely down to the impact of oil prices, with Brent averaging US\$35.45 per barrel in 2Q04, 11% above its 1Q04 level and 35% above its level in 2Q03. Stock markets in the US, Japan and the euro-zone declined strongly in May before regaining some of the losses in June. July brought another wave of stock market weakening, with S&P at record 2004 lows late in the month as investors expected a slowdown in corporate profits following particularly good 2Q04 results.

The US continued its robust expansion. Growth also remained strong in Japan and other Asian economies, while optimistic news from the euro-zone centred on economic recovery gaining momentum somewhat faster than earlier expected. Germany, however, continued to lag behind, while EU economies from outside the euro-zone continued to expand strongly with optimistic outlooks for upcoming quarters. High commodity prices underpin the very strong output expansion in the former Soviet Union region and the latest data from Latin America confirm the strength of the economic recovery there.

US and EU GDP growth, 2000-2004
(% change, yoy)



Source: FedStats, Eurostat

In global monetary policy, the most important event of the last few months was the 25 basis point increase in US official interest rates in late June. The ECB did not introduce any corrections to its monetary policy stance, while the Bank of England increased its rates twice in 2Q04. There was little change in the fiscal stance among the major economies, with large budget deficits expected in the US and in the major European economies.

Our baseline scenario for 2004-2005 remains largely unchanged from the previous quarter. We have left the US growth forecast unchanged, while slightly upgrading the 2004 and 2005 outlook for Japan and the euro-zone. The GDP of OECD economies is set to rise by 3.3% in 2004 followed by a 3.1% increase in 2005. The 2004 inflation forecast has been increased for the US and the euro-

zone. We think euro-zone HICP will fall below 2% in 2005, not before. We now expect the Fed to continue raising rates in 2H04, while the ECB is unlikely to decide on tightening policy until year-end. The dollar is expected to remain broadly stable against the euro. <WP>

GDP in selected countries, 1999-2005 (% change, yoy)

	1999	2000	2001	2002	2003	2004 ^f	2005 ^f
OECD	3.2	3.9	1.0	1.7	2.2	3.3	3.1
USA	4.5	3.7	0.5	2.2	3.1	4.5	4.0
European Union	2.8	3.3	1.7	1.0	0.7	2.1	2.5
Euro zone	2.8	3.4	1.5	0.8	0.4	1.8	2.3
Germany	2.0	2.9	0.6	0.2	-0.1	1.6	1.9
France	3.2	3.8	2.1	1.2	0.5	2.0	2.4
Italy	1.6	2.9	1.8	0.4	0.4	1.2	2.0
United Kingdom	2.4	3.0	2.1	1.6	2.2	2.9	2.9
Czech Rep.	0.5	3.3	3.1	2.0	2.9	3.2	3.4
Hungary	4.2	5.2	3.8	3.5	2.9	3.4	3.7
Poland	4.1	4.0	1.0	1.4	3.8	5.7	4.8
Russia	5.4	8.3	5.0	4.7	7.3	6.5	4.5
Turkey	-6.1	6.3	-9.5	7.8	5.9	6.0	5.0
Japan	0.1	2.8	0.4	-0.4	2.7	3.5	2.3
China	7.1	8.0	7.2	8.0	9.1	9.0	7.5

Notes: f – forecast.

Source: OECD, IMF and statistical agencies (data); CASE and market consensus (forecast).

CPI in selected countries, 1999-2005 (% change, yoy)

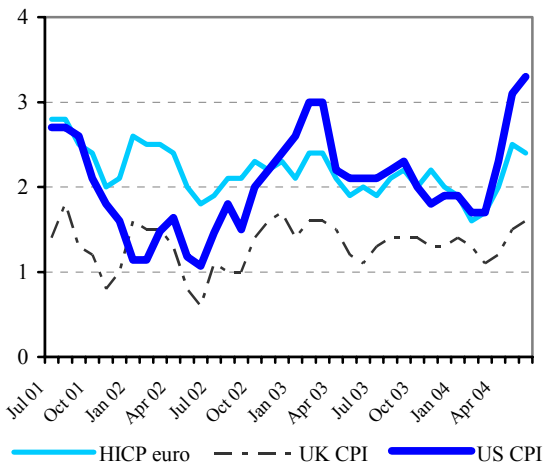
	1999	2000	2001	2002	2003	2004 ^f	2005 ^f
USA	2.2	3.4	2.8	1.6	2.3	2.2	2.3
Japan	-0.3	-0.7	-0.7	-0.9	-0.2	-0.1	0.1
European Union	1.2	2.5	2.5	2.2	2.0	1.7	1.8
Euro area (HICP)	1.1	2.1	2.3	2.3	2.1	2.1	1.9
United Kingdom (HICP)	2.3	2.1	2.1	1.3	1.4	1.6	1.8
Czech Rep.	2.1	3.9	4.8	1.8	0.1	2.7	2.9
Hungary	10.0	9.8	9.2	5.3	4.7	6.8	4.5
Poland	7.3	10.1	5.5	1.9	0.8	3.5	3.3
Russia	85.7	20.8	21.6	16.0	13.5	10.5	10.0
Turkey	64.9	54.9	54.4	45.0	25.3	10.5	10.0
China	-1.4	0.3	0.7	-0.8	0.8	4.0	3.5

Notes: f – forecast.

Source: OECD, ECB, IMF and statistical agencies (data); CASE and market consensus (forecast).



World inflation, 2001-2004 (% change, yoy)



Source: Eurostat, Bureau of Labor Statistics, National Statistics

Country Updates

United States

- Firm growth to continue in 2004-2005
- Job growth strong
- Inflation upturn

The stable and solid expansion of the US economy continued in 1Q04, with GDP rising 4.8% yoy. Growth is broad based, with significant contributions from individual consumer spending, investment, particularly on equipment and software purchases but also from exports and, finally, government spending. Available data suggest that similar growth dynamics were probably maintained in 2Q04. Industrial output was 6.3% yoy in May and capacity utilisation edged up. The Conference Board's Consumer Confidence Index rose in June, following a flat reading in May. The employment outlook remains upbeat. Indeed, optimism in this sphere appears justified after another piece of good labour market news that nearly 250,000 new jobs were added in May. On the other hand, the pace of payroll growth slowed in June and retail sales figures came out below expectations.

The inflationary pressures that were anticipated three months ago did indeed materialise in 2Q04, partly explained by oil prices developments. However, core inflation measures were also on the rise. The annual CPI increased from 2.3% in April

to 3.3% yoy in June with the energy index up by 17% yoy and prices of all items, bar food and energy, up 1.9% yoy in June. In an environment of solid economic expansion businesses are finding it easier to raise prices.

Positive tendencies have been maintained in the corporate sector. Business confidence in both manufacturing and services sectors points to further expansion over the medium term, though possibly at a slightly lower rate than earlier anticipated. A June survey by the Institute for Supply Management indicates a continuation of earlier trends in manufacturing, with some moderation in the upturn in services.

The balance of medium-term risks is positive and we have upheld our forecast of 4.5% of GDP growth this year, followed by 4% in 2005. Output expansion is expected to remain relatively broad based, with buoyant consumer spending and investment. Given recent oil price developments, inflation is now forecast to edge higher. The scale of fiscal imbalances continues to cloud the longer-term outlook for the US economy. <WP>

European Union

- Stronger exports drive euro-zone growth
- Solid output expansion in new member states
- Inflation pick-up: will it last?
- Fiscal problems not resolvable quickly

Judging from the experience of the first months of the functioning of the EU25, enlargement has not complicated the EU's operations. In June, the Heads of States agreed on a compromise and adopted the Constitutional Treaty, surprising some observers. However, it is far from certain that the Constitution will enter into force as its ratification will be subject to national referenda in a number of countries. The catastrophic forecasts of labour market disruptions in the EU15 following major labour migration flows from the accession countries have proved unjustified and it now appears more likely that the twelve (old) member states that adopted transition periods will ease labour migration restrictions after a two-year period.

Euro-zone

1Q04 brought some cautiously positive news from the euro area, with GDP increasing 0.6% qoq and 1.3% by annual comparison – a visible acceleration from 2002-2003. Net exports contributed a great deal to this, despite the strength of the euro, indicating that the impact of economic revival in euro-zone trade partners was dominant. There were mixed signals from domestic demand. Private consumption turned out relatively strong (0.6% qoq and 0.7% yoy), but investment remained nearly flat in both annual and quarterly terms. The growth in government spending was somewhat weaker than in previous quarters. There were also significant differences between growth components in the major euro-zone economies. From the sectoral perspective, results in industry were much better than in previous quarters. Growth momentum was maintained in the services sector, while construction remained weak.

The somewhat stronger output dynamics have to date had no effect on labour market conditions. The euro-zone seasonally adjusted unemployment rate stayed at 8.9% in 1Q04, increasing to 9% in April and May. The lowest rates are in Austria, Ireland and Luxembourg (4.2-4.9%). At the other end of the spectrum unemployment in Spain has stayed at over 11% and in France and Germany at over 9% in recent months.

Contrary to our expectations, HICP inflation climbed above 2% in 2Q04 largely owing to oil price developments and administrative price increases. In June it stood at 2.4%. The key question now is whether these temporary influences on inflation will feed into inflationary expectations and wage settlements. An interesting example of wage flexibility was provided by Germany's Siemens, where workers (at one of the plants) recently accepted an increase in their working week from 35 to 40 hours, thus in effect agreeing to wage cuts. Similar arrangements were subsequently agreed in other companies in Germany and France. We view this as a positive development that could at least partially help to address the problem of the labour cost bubble in Germany. There are no signs of fiscal consolidation in the major euro-zone economies. The Stability and Growth Pact appears now completely irrelevant and unable to provide external incentive to bring deficits down. A recent example included the Silvio Berlusconi defence

against Italy being handed down an excessive deficit warning. Euro-zone finance ministers have thus been consistent in disregarding the SGP.

We have not made significant changes to our assessment of the euro-zone medium-term outlook. The recovery is expected to unveil gradually, with slowly rebounding investment joining external demand as the main growth factors. We expect GDP to increase 1.9% in 2004 and 2.4% in 2005. We view the current inflation pick-up as temporary, although there is some risk that it could feed into inflationary expectations, thus forcing the ECB to adopt policy tightening earlier than it would otherwise be needed.

Germany

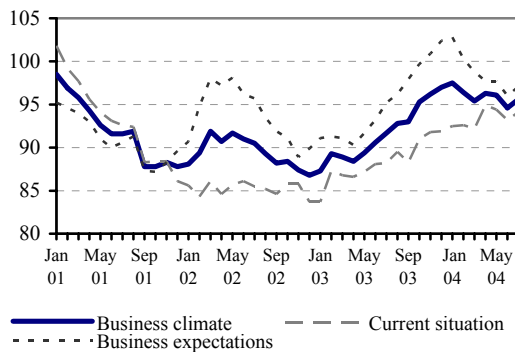
1Q04 witnessed some acceleration of growth, with GDP expanding 1.5% yoy, the fastest rate in three years. This was mainly driven by external demand, with export dynamics outpacing import growth. Domestic demand has remained weak and in fact contributed negatively to GDP on a quarterly basis. Household consumption and private investment have remained largely stagnant compared to 4Q03. Interestingly, there was a major increase in annual inflation, which jumped from 1.1% in March to 2.1% in May, close to the euro-zone average and above the short-term ECB rate, before easing to 1.9% in June. Employment continued to decline in 1Q04 and unemployment was on the rise in 1Q03 and since, reaching 9.8% in April. A potentially important reform to the unemployment benefits system was agreed in late June. From 2005 the currently very generous unemployment benefits scheme will be lowered, thus easing the fiscal burden and hopefully providing more incentives to seek work.

Most forecasting institutions have recently slightly upgraded their forecasts for the German economy for this year and next, though economic data have been giving some mixed signals. There are no signs of any stronger domestic demand revival, as illustrated by retail sales figures. On the other hand, the continued strong performance of exports is expected to gradually feed into investment. The Ifo continued to deteriorate between April and June. In view of all these developments we have upgraded our forecast only minimally to 1.6% GDP expansion in 2004, followed by a modest improvement to 1.9% in 2005. The 2005 fiscal



deficit is expected to be above 3% of GDP for the fourth year running.

Ifo business climate index, 2001-2004



Source: Ifo Institute for Economic Research.

France

1Q04 data confirmed earlier trends, with gradually strengthening growth (1.7% yoy) led by domestic demand. Public and private consumption increased strongly and investment data surprised on the upside with 3.1% adjusted qoq growth in 1Q04. Net exports continued to exert a negative impact on GDP. Business surveys have remained cautiously optimistic in 2Q04, with little change from the previous quarter. The relatively robust growth performance has not fed into the labour market, however. Employment was stagnant or declining in 1Q04 and the standardised unemployment rate remained flat at 9.4% in 1Q04, April and May. The French economy is expected to expand at a rate just above the euro-zone average in 2004 and 2005 (2% and 2.4%, respectively).

Other EU economies

The wedge between the euro-zone and growth rates in the other EU economies declined somewhat in 1Q04, though non-euro economies were still expanding visibly faster. The UK maintained strong growth momentum, as did virtually all the ten new member states.

UK

Revised figures point to GDP rising 3.4% yoy in 1Q04. As in previous quarters, the services sector led the way (3.6%). The construction sector also showed strong readings (an increase of 8.1% yoy), but manufacturing continued to lag behind with only 1% yoy growth. On the expenditure side,

strong economic activity is largely explained by domestic demand, with public and private consumption and investments all recording gains. Net exports contributed negatively to growth. Favourable labour market conditions have continued, with the employment rate at 74.8% in April (close to record highs) and the unemployment rate at a record low 4.8%. The UK is one of the only three EU15 economies to open its labour markets to the 10 new member states. Early experience suggests a very modest scale of job-seekers coming from other countries and there should be no significant negative impact on the labour market position of UK citizens. CPI inflation increased to 1.5% yoy in May, with much of the increase owing to higher fuel costs. We uphold our forecast of 2.9% GDP growth in 2004 and 2005.

Poland

1Q04 resulted in a rapid acceleration of growth to 6.9% yoy mainly on the back of an investment revival, where heavy stock building was probably motivated by forthcoming EU accession. The dynamics of private consumption were virtually unchanged from the previous quarters at 4% yoy. Exports continued to provide a boost, as was the case in 2003, manifesting itself in yet stronger expansion of value added in industry (14.5% yoy). The services sector expansion also accelerated somewhat (5.7%) and there was continued slump in construction (-3.9%). Exports increased by 16% yoy (in nominal euro terms) during January-May 2004, according to balance of payment data, though the results are difficult to interpret due to the one-off effect of EU accession. Thus, in March and April both export and import annual dynamics were around 30% in nominal euro terms, whereas in May both exports and imports actually declined yoy. We do not foresee any sizeable impact on foreign trade trends from the recent zloty appreciation.

Recent months also witnessed a rapid acceleration of inflation, which overshoot previously forecast levels. It increased from 1.7% yoy as of March to 4.4% yoy as of June, though largely due to one-off factors (mainly related to EU accession and oil price developments) and so far without stimulating any strong wage pressures. Accelerating output growth has not yet fed into the labour market. Employment edged up by only 0.9% yoy in 1Q04 according to LFS, helped by private sector hiring on fixed-term contracts. The standardised

unemployment rate declined from 19.1% in 1Q04 to 18.9% in April-May.

We have maintained our growth forecast for 2004 and slightly upgraded the forecast for 2005. We currently expect GDP expansion of 5.7% in 2004, followed by 4.8% in 2005¹. We have changed our CPI outlook and now expect it to reach its peak of around 5% yoy in 3Q04, before resuming to around 3% in mid-2005. There was mixed news concerning the adoption of public finance reform and in an environment of high political uncertainty these still constitute the major risk factor for the medium term outlook. <WP>

The Czech Republic

In 1Q04, the pace of economic growth was virtually unchanged from 1Q04, at 3.1% yoy. Unlike in 2003, growth was mainly supported by capital formation expenditures (+12.7%). Private consumption, which was the primary pillar of growth in the previous year, showed smaller gains (2.1% yoy) primarily driven by further real wage increases (6.3% yoy in 1Q04). The declining pace of private consumption growth may be down to the discouraging effect of fiscal reform measures. On the other hand, these had a dominant influence on gross fixed capital formation, which surged 9.5% yoy.

Around the date of the Czech Republic's accession to the EU foreign trade patterns were positive, with exports surging 19.2% yoy in January-May and imports increasing 18.5% yoy. It is expected that foreign trade and investments will continue benefiting from the advantages of the single market and improvements in institutions; and, probably, their joint positive impact on GDP will make up for the weakening contribution from private consumption.

Inflation accelerated to 2.9% yoy in June from 2.3% in 1Q04 and 0.1% in 2003 as a whole. However, its growth was slower than one would expect after tax changes and the country's accession to the EU. These changes primarily affected the structure of price movements. Together with VAT changes, the impact of which is still expected to reveal itself this summer, wage increases, high world prices of oil and metals and climbing

domestic agricultural producer prices should be listed as the other risks to an inflation upsurge.

The prospects for the economy are quite encouraging considering growing consumer and business confidence and positive developments in neighbouring countries.

Hungary

Economic growth strengthened to 4.2% yoy in 1Q04 up from 3.6% in 4Q03. Unlike in 2003 when GDP expansion was fuelled by domestic consumption, this year it was stimulated by a revival in investment (18.9% yoy increase) and favourable foreign trade conditions (exports increased 17.4% yoy, imports were up 16.6%). Export-oriented industrial production, driven by strong external demand increased 11% yoy (industrial exports were up 21%, while domestic sales declined 1%). A somewhat lower growth of retail trade turnover in 2Q04 compared to 1Q03 (6.0% yoy and 8.4% yoy, respectively) and considerable reduction of retail earnings expansion (about 1% compared to 14% in 1Q03) suggest a continuation of the weakening trend of private consumption, revealed in 4Q03.

Despite a strong export performance, March and April import growth rates again exceeded those of exports. The rise in imports was associated with the pick-up in investments and the one-off impact of Hungary's accession to the EU. CPI inflation was rose 7.5% yoy in June, up from 6.7% in March 2004. The rise in prices was related to the tax changes introduced at the beginning of the year, higher-than-expected wage inflation in the first four months, higher world oil prices and increased uncertainty related to domestic and external imbalances (which manifested themselves in rising risk premiums required on forint-denominated investments and long-term government securities yields in the second half of 2Q04).

Despite steps taken by the government to reduce the budget deficit in 1Q04 (cuts in expenditures, reduction of subsidises for medication prices), the central government deficit in January-May was actually above its 2003 levels. Hence, in order to meet the deficit target this year further measures to reduce expenditures are required. Although the prospects for the economy are generally optimistic, the sizeable budget and current account deficits

¹ For an up-to-date forecast and detailed discussion consult Polish Economic Outlook.



may hinder investor confidence. Moreover, current fiscal policy has already postponed the introduction of the euro to 2009/2010.

Slovak Republic

The economy continues its impressive development, recording 5.5% yoy growth of GDP in 1Q04, fuelled by a continuing increase in external demand (up 15.8%) and a revival of domestic demand (up 2.5%, following a period of decline in 2003), particularly private consumption. Gross fixed capital was up 0.9% yoy compared to a 9.7% increase in 4Q03. The revival of consumption was in part stimulated by wage developments (average nominal monthly wages increased 11.2% yoy in 1Q04).

The external trade balance has continued to improve on an annual basis. The current account recorded a small surplus in 1Q04 and 2Q04 could see further reduction as the dividend payment abroad is expected to rise. Inflation has remained broadly stable, in recent months oscillating around 8% in annual terms. In June, it eased to 8.1%. At the end of April the legislation introducing health care reform was passed, while as recently as December 2003 a crucial law of the pension reform was adopted. However, given the unpopularity of the reforms there is a risk that some of these could be reversed following any changes to the governing coalition.

Baltic States

Baltic countries continue to show strong economic performance in 2004. In 1Q04, Estonian GDP grew 6.8% yoy, mainly driven by external demand. Domestic demand increased 2.7% yoy, with private and public consumption gains contrasting with declining investment. Despite very strong export dynamics, the current account deficits remains in double digit territory. Inflation accelerated to 4.4% in June 2004, driven by one-off increases of fuel, sugar and tobacco prices. Fiscal performance was strong, with a general government surplus of 2.4% of GDP in 1Q04, and contributed importantly to maintaining macroeconomic stability and joining the ERM II. Further prospects for the Estonian economy are favourable provided the government's prudent fiscal budgeting is not complicated by costly pension and health care reforms.

Latvian GDP expanded 8.8% yoy in 1Q04, fuelled by increasing domestic and external demand. With the dynamics of imports stronger than the growth of exports the trade deficit widened further in January-May. Annual inflation increased to 6.1% in June. Relatively high inflation, a widening trade balance and questions surrounding current account financing pose policy challenges to the authorities. On the fiscal front, the January-May consolidated budget was in surplus, though plan is for a 2.2% of GDP deficit at year's end.

In Lithuania, GDP grew 7.7% yoy in 1Q04, fuelled by buoyant domestic demand. Final consumption increased by 10% yoy and growth of investments in fixed capital formation was considerably higher at 17.4%. Household consumption was stimulated by the growing earnings of the population (over 8%). This also stimulated strong import growth and widening the trade and current account deficits. The current account deficit was at 8.9% of GDP in 1Q04. The CPI increased 1% yoy as of June 2004, among the lowest levels among EU countries.
<OP>

Emerging Europe

- **Robust growth performance, favourable outlook**
- **Turkey's inflation in single digits**

Turkey

According to preliminary data, 1Q04 saw a continuation of the growth pick-up trend underpinned by the government's economic program. Industrial production in March and April 2004 grew 16.5% yoy (up from 2.6% in 2003). According to the Central Bank of Turkey, 1Q04 growth was driven by private consumption, which, in turn, was affected by high consumer spending (especially of durable goods) and a rapid increase in investments on machinery equipment. Recent data on CPI inflation (8.9% yoy in June 2004, down from 18.4% in December 2003 and 29.8% in June 2003) strengthen the prospects of meeting the 12% year-end inflation target. However, continuation of the impressive accomplishments made in monetary policy (one-digit annual inflation rates) and attainment of macroeconomic stability requires governmental fiscal discipline and a further deepening of structural reforms.

In January-May 2004, exports increased 29.3% yoy. However, imports grew much faster, up 47.2%, driven by the recovery in private consumption for semi-durable and non-durable goods (the respective production sectors did not show a corresponding increase). Moreover, appreciation of the Turkish lira might have constrained exports. As a result, the foreign trade deficit widened substantially.

Romania

In 1Q04, GDP expanded 6.1% yoy, predominantly stimulated by domestic demand – both private consumption and investment. The trade deficit has continued to widen in 2004, with the growth rates of imports outpacing exports (respectively, 18.4% and 20.2% yoy in the first five months of 2004). However, given the large share of machinery and mechanical devices and other investment goods in total imports and the fast growth of these imports, it is expected that an increase in investments in the medium-term will outperform the negative impact of net exports on GDP growth.

In June, the CPI was up 12% yoy, continuing the gradual disinflation trend. Rising prices of services and non-food products (16.8% and 13.8% respectively) contributed most to inflation. Prospects for the economy remain quite good. By reaching consensus with the IMF to continue cooperation under the new stand-by agreement Romania sent a positive signal to the EU on facilitating important, but not very popular, structural reforms.

Bulgaria

Provisional data show that in 1Q04 GDP expanded by 5.3% yoy, driven primarily by domestic demand, with particularly strong performance of investment (a 21.4% yoy increase). Imports rose much faster than exports, resulting in a widening trade deficit. Annual inflation was on the rise (6.8% in May) mainly owing to oil price developments and the situation in the services sector. There are generally good prospects for economic growth. However, despite some narrowing in April, the level of the current account deficit remains alarming. Considering planned tax cuts in 2005, a tightening of fiscal policy will be needed. <OP>

CIS

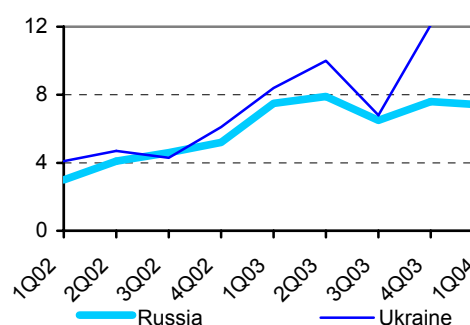
- **Russia and Ukraine booming**
- **Basic commodity prices important for growth trends**
- **PPI on the rise – will it feed into consumer prices?**

Russia

In 1H04, the Russian economy maintained its growth dynamics from the previous year. The boom in output was supported by high export prices and growing domestic demand. On one hand, high world prices of metal and mineral products impacted positively on the merchandise trade balance, while on the other they stimulated an acceleration of PPI. Consumer prices grew somewhat slower than in 2003, although inflation remains at a high level.

In 1Q04, GDP increased by 7.4% yoy, according to revised data. Investments, private consumption and high export prices continued to be the major sources of growth. For the first five months of the year investments in fixed assets expanded 12.8% yoy (interestingly, investments in the fuel sector are gradually reducing their share of the total volume of investments). As a consequence of powerful private consumption the volumes of retail trade increased by 11.0% yoy for January-May 2004. From the supply side, construction, stimulated by high investment activity, remained the most dynamic branch with 13.8% yoy growth in 1Q04. Industry and the services sector also grew robustly – 7.5% yoy and 7.0% yoy, respectively, in 1Q04.

GDP growth in Russia and Ukraine, 2002-2004
(% change, yoy)



Source: National Statistical Agencies

High world prices on mineral and metal products were the main driving forces behind the growth in industry. Export opportunities stimulated investment activities, which, in turn boosted industrial growth. In line with stimulation factors, the most dynamically expanding sectors include machinery and metallurgy (14.2% yoy for January-May 2004), chemical and petrochemical industry (10.0% yoy), construction materials production (9.8% yoy) and the fuel industry (8.3% yoy).

In 2Q04, the merchandise trade balance continued to improve. The CBR has provisionally estimated the merchandise trade balance for the first half of 2004 at US\$34.7 billion – a 20.0% improvement in annual nominal terms. On the side of exports, increasing dynamics was strongly influenced by high world prices for oil and metals. The expansion of merchandise imports was stimulated by the rouble's real appreciation and real growth in household incomes. Current dynamics allow one to expect further improvements in the trade balance, strongly contributing to GDP expansion.

The rouble's real effective exchange rate stubbornly appreciated (+7.4% yoy in 1H04). In 2Q04, the monetary authorities attempted nominal devaluation, but due to persistently high inflation, the rouble continued to appreciate in real terms. In order to support the nominal exchange rate the CBR continued to intervene heavily on the foreign currency market – in 1H04 monetary reserves increased by US\$11.3 billion.

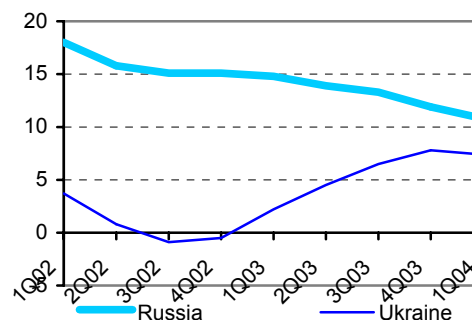
Inflation continued a slow downward trend – in January-May the CPI increased 10.6% yoy (14.4% yoy in the same period of 2003). The slowdown in the growth of consumer prices was impacted by a lower increase in the prices of services and rouble appreciation. In contrast to the CPI, the PPI markedly accelerated from the beginning of the year due to higher world prices of mineral and metal products. The first five months of 2004 brought a 20.6% yoy increase in the PPI (18.8% yoy for the same period in 2003). For the time being any pass-on to the CPI has remained very limited, but may over the longer horizon eventually feed into consumer prices.

Federal budget results for the five months of the year were quite positive, especially in the context of the tax reform that started at the beginning of the

year. Losses from the cancellation of sales tax and reduction of the VAT rate from 20% to 18% were partially offset by growing earnings related to mineral product exports. At the end of May 2004 the federal budget was in surplus by 1.8% of GDP. The significant surplus of the federal budget created favourable conditions for the setting up of a stabilisation fund, which is expected to cumulate some US\$13-14 billion by the end of 2004. Given the budgetary situation, the authorities do not intend to borrow more on external markets. Moreover, it is expected that some of the stabilisation fund's resources will be used for external debt repayment.

2Q04 witnessed the continuation of the Yukos saga. It now appears increasingly likely that the company will be allowed to go bankrupt and its assets divided up and most taken over by state controlled entities. This would send a negative signal to potential investors and might impact on the long-term growth potential of the economy. As illustrated by the recent OECD Survey, private oil companies have been responsible for at least a quarter of GDP growth in recent years. Another worrying factor was a strange string of announcements made by high-ranking government officials mixing good and bad news on the company. These announcements caused major swings in Yukos stock prices. A similar problem can be identified with the authorities' handling of runs on local banks resulting from leakages of unconfirmed information on liquidity problems and the very delayed reaction by the authorities. As a result, some important banks associated with opponents of the current presidential administration incurred losses, lost their reputation and are likely to be taken over by state controlled institutions.

Inflation in Russia and Ukraine, 2002-2004 (% change, yoy)



Source: National Statistical Agencies

Ukraine

In 1H04, Ukraine's GDP soared 12.7% yoy on the back of factors identical to those operating in Russia: high export prices, robust private consumption (+15.5% yoy in 1Q04) and booming investments in fixed assets (+52.1% yoy in 1Q04). In 1H04, industrial output surged 15.9% yoy, led by external demand and domestic investment activities. Machinery (+33.9% yoy), metallurgy and metal working (+17.5% yoy) and the chemical industry (+18.4% yoy) remain the most dynamic branches of the industry.

For the first five months of 2004 the merchandise trade balance improved impressively due to favourable external market conditions. Merchandise exports increased 50.5% yoy in this period (in US dollars terms), led by metallurgy, machinery and chemical industry products. Merchandise imports grew 32.5% yoy for the same period. The trade balance on services also improved due to growing transportation services. Despite upcoming presidential elections, the inflow of foreign direct investments to Ukraine has been gradually increasing. 1Q04 inflows were 30% higher than a year earlier.

The National Bank of Ukraine has maintained the hryvnia's nominal exchange rate at a stable level, allowing a minimal appreciation of the national currency. Current account developments and sizeable interventions by the NBU on the forex market fuelled an accumulation of foreign reserves in 2Q04 to US\$9.8 billion (provisional calculations).

Consumer price inflation was on the rise, coming in at 7.4% yoy in 1H04. Similarly to Russia, high world prices for mineral and metal products triggered significant growth in the PPI index – in 1H04 up 17.3% yoy – which will eventually spur further growth in the CPI. Acceleration of economic growth and unprecedented privatisation revenues stimulated an upward revision of the revenues and expenditures sides in the 2004 budget. In 1H04, revenues from privatisation equalled about US\$1 billion.

Other CIS economies

Powerful economic rebound is a common feature of all FSU countries. Foreign trade and investments are also acting as stimulating factors in most

countries. For the first five months of 2004 growth rates in the countries were in the range of 5-10% yoy. This was generally accompanied by rising inflation in the range of 6-8% yoy in January-May 2004. Only in Belarus and Moldova was inflation above 10%. <DB>

Asia

- **Strong regional growth, good prospects for 2H04**
- **Cooling down in China yet to come**
- **Japanese recovery accelerates, deflation end in sight**

Regional growth in Asia has remained strong in recent months, with very good prospects at least for the remainder of 2004. Thailand recorded 5.8% yoy GDP growth in 2Q04, on the back of strong consumption, investments and exports. Malaysia expanded 7.6% yoy in 1Q04, driven by private consumption. Malaysian investment has been recovering and exports accelerating. Indonesia grew 4.5% yoy in 1Q04, although the 2Q04 growth of domestic demand has been probably constrained by high oil prices. Vietnam's expansion has been continuing, fuelled by the strong growth of exports and consumption. The economy is expected to grow 7% in 2004 as a whole. Following strong domestic demand-led growth, consumer prices in some Asian economies are also on the rise.

China continued its high-speed expansion in 1H04. GDP grew 9.8% yoy in 1Q04, after a similar increase in 4Q03. This high figure was the result of escalating investment, which grew an astounding 47.8% yoy in 1Q04. Booming imports (merchandise imports surged by over 40% yoy in January-May 2004) resulted in the largest trade deficit since 1984. 2Q04 growth came in at 9.6% yoy, slightly below expectations, though this cannot be interpreted as a sign of cooling. Forecasts for 2004 growth are above 9%, making it clear that any cooling of the economy is yet to materialise. Prices are definitely on the rise, with the CPI growing 3.8% yoy in April and 4.4% yoy in May 2004. However, inflationary pressures remain modest. The Chinese government has been trying to dampen demand, but to date administrative tightening has been more targeted than broad-based.



India recorded 8.2% yoy growth in 1Q04, mainly on the back of strong results in agriculture and retail trade. Manufacturing production and construction also remained strong, both expanding 7.6% yoy in 1Q04. Consumer price inflation slowed from the beginning of the year, to 2.2% yoy in April and 2.8% yoy in May 2004. Economic projections for India for 2005 as a whole are in the range of 6-7%. The outcome of the May 2004 national elections has clearly been positive, as the current prime minister has a strong reputation on the back of his authorship of financial sector reforms in the early 1990s.

Japan

After over 3% yoy growth in the last quarter of 2003, expansion accelerated to 5.6% yoy in 1Q04. The highest contributors have been private consumption, inventories, non-residential investments and exports. If the economy was to continue at this pace for the rest of the year the growth figure for 2004 as a whole would likely be the highest since 1990.

Personal consumption in 2Q04 was seen as growing at a similar rate as in the previous quarter, as suggested by the annual growth in disposable incomes and living expenditures, as well as the significant increase in the propensity to consume during April-May 2004. Individual consumers started to spend more on durables and overseas travel.

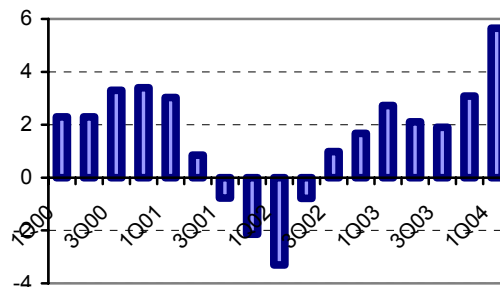
Business fixed investment probably accelerated in 2Q04, as indicated by faster growing machinery orders in manufacturing during April-May 2004 than at the beginning at the year. Large firms continued to register higher sales and unemployment continued its downward trend, while labour productivity increased during 2Q04.

Exports to other Asian economies remained strong. Customs data for April-May 2004 show that while the overall value of exports increased 10.3% yoy during this time (11% in 1Q04), exports to Asia rose 23% yoy. Overall, data for the first two months of 2Q04 suggests that the growth figure for 2Q04 should be no lower than 5-6% yoy.

Although the CPI recorded negative changes in April (-0.4 yoy) and in May (-0.5 yoy), prices for domestic corporate goods increased 0.6% yoy in

April, 0.9% yoy in May and 1.4% yoy in June 2004. This, together with rising incomes, creates an upward pressure on consumer prices and should result in a higher CPI soon. <MJ>

GDP growth in Japan, 2000-2004
(% change, yoy)



Source: Bank of Japan.

Latin America

- **Regional upturn based on domestic demand**
- **Good prospects for 2H04**
- **Argentina remains regional growth leader**

The region overall exhibits good prospects for 2004-2005 and average growth in Latin America this year is expected to be above 3%. Expansion is fuelled by growing investment and consumer demand, which are both forecast to continue in 2004-2005. Consumer spending in some of the larger regional countries has been depressed for a long time and institutional investors are now showing stronger sentiment towards emerging markets as the global recovery takes off. The Chilean and Peruvian economies accelerated in 1Q04 and both are expected to grow by more than 4% in 2004 as a whole. Although political tensions are unlikely to disappear in Venezuela, high oil prices and the very low base from 2003 will support positive growth there.

The Brazilian economy started to recover in 1Q04 after registering a small decline in 2003. The decline in interest rates and improvement in investor confidence will further stimulate investment, while high commodity prices will continue to support exports. Therefore, growth in the range of 3-5% is expected in 2004. Inflation rose to 5.2% in May, but should slow towards the end of the year. The exchange rate should be

broadly stable and there shouldn't be any problems meeting fiscal targets for 2004 agreed with the IMF.

Argentina has continued its strong recovery, expanding 11.2% yoy in 1Q04. Such high growth resulted from a surge in domestic demand. Private consumption rose 11.7% yoy, following growth in real wages. Investment was up 51% yoy and with imports also up 57% yoy in 1Q04. Prospects for the whole of 2004 are positive, with expected growth at over 6%. However, it is anticipated that as soon as potential on the demand side is exhausted, supply side constraints will start playing a role and growth will slow. The fiscal targets for 1Q04 were safely met and the public sector recorded a primary surplus. Growth of the monetary base also remains under control and the exchange rate is stable. Consumer price inflation has been modest at around 2.5% yoy in 1Q04.

Mexico's growth of 3.7% yoy in 1Q04 was supported by the dynamism of the US economy, with the increase led by exports. Given the expected strength of the US economy, investments should continue to pick up and GDP growth for the whole year should be in the range of 4-5%. However, it is expected that domestic demand growth will remain subdued due to the tight fiscal and monetary policies in place and the lack of structural reforms. The exchange rate depreciated somewhat during the first months of 2004, but remained strong in real terms. Inflation was at 4.3% yoy as of May and may increase moderately over the year. <MJ>

Central Banks Watch

- **Fed starts increasing rates**
- **ECB on hold**
- **Monetary tightening in the UK and some CEE economies**

The most important event of the last few months was the 25 basis point increase in US official interest rates decided upon at the June meeting of the Federal Open Market Committee. This decision was widely anticipated although came somewhat earlier than we forecast a quarter ago. Rates nevertheless remain at a very low level and, given developments in the US and global economy, one

should expect a series of interest rate hikes over the coming quarters. Indeed, Alan Greenspan's July address to the Senate Banking Committee suggested that rates might rise at fair clip.

The ECB has not introduced any changes in its monetary policy and recent news suggests that rates might not rise before late 2004 or early 2005. Euro-zone inflation developments (well above the 2% ceiling) and the somewhat better performance of the real sector most likely preclude any monetary easing. Following its February decision, the Bank of England increased its rates twice in 2Q04, by 25 basis points each time, bringing the repo rate to 4.5%, on the grounds of strong output performance and rising cost pressures despite inflation remaining below target.

The CEE region also witnessed a move towards monetary tightening, with the Czech National Bank increasing its rates by 25 basis point in late June and the Polish MPC deciding on a larger increase, of 50 basis points, followed by another 25 points hike in late July bringing rates to 6%. In Hungary, after a 50 basis point cut in May, the Monetary Council decided to keep rates at a high level (11.5%), citing rising inflationary uncertainty and increased perception of risks. The National Bank of Slovakia Board was the only rate setting body to opt for a cut in late June. This decision appears to be largely motivated by a desire to prevent koruna appreciation. <WP>

Central Bank	Official interest rate	Current	Last change
US	Federal funds	1.25	30 Jun 04
Japan	Overnight call	0.00	19 Mar 01
ECB	Refi	2.00	5 Jun 03
England	Repo	4.50	10 Jun 04
Czech Rep.	2-week repo	2.25	25 Jun 04
Hungary	2-week repo	11.50	5 May 04
Poland	2-week repo	6.00	29 Jul 04

Source: Central banks.

Exchange Rates

- **Small rate changes among major currencies**
- **CEE currencies appreciating**
- **3 new EU member states enter ERM II**



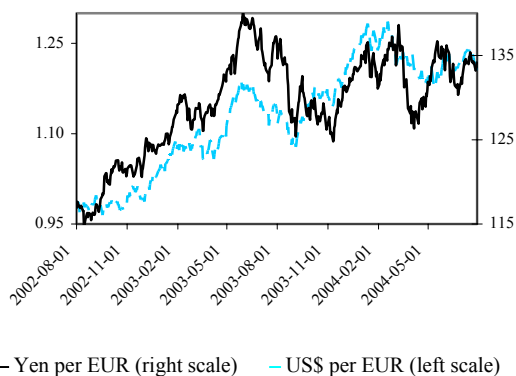
There were no major swings in the exchange rates of the major currencies in the recent months. The euro-dollar exchange rate oscillated in the 1.2-1.25 dollars per euro range throughout most of the period from March to July. The Japanese yen was slightly more volatile, though no clear trend can be identified. The exchange rate against the euro has oscillated between 126 and 136 over the last four months. In real effective terms the euro was nearly flat in May-June 2004 compared to a year ago. We foresee the euro-dollar exchange rate remaining broadly stable reaching US\$1.24 at the end of 2004 and US\$1.20 at the end of 2005.

There were some changes in trends in the exchange rates of Central European currencies. The zloty underwent a sizeable appreciation against the euro, strengthening by nearly 10% in nominal terms between April and July. This was partly explained by changing expectations concerning monetary policy actions. Similarly, the Czech koruna and the Slovak koruna appreciated somewhat against the euro, though the magnitude of the changes was smaller than in the case of the zloty. The forint remained very stable against the euro in April-July, following strengthening in 1Q04.

From 28 June 2004 the currencies of three EU countries (Estonia, Lithuania and Slovenia) entered the Exchange Rate Mechanism II (ERM II).

Standard fluctuation bands of +/-15% were agreed, though in the cases of Estonia and Lithuania their currency board arrangements were accepted as unilateral commitments on the side of these countries. In Slovenia the central parity was set at the rate prevailing on June 25th. Previously, the Slovenian authorities had followed a managed float exchange rate with the tolar undergoing a steady, albeit slow, nominal depreciation against the euro. Provided the three countries meet the appropriate criteria they can be expected to adopt the euro in summer 2006. <WP >

US\$ and yen exchange rates against euro, Aug 2002-Jul 2004



Source: ECB.

US\$ and yen exchange rates against euro, 1999-2005

	1999	2000	2001	2002	2003	2004 ^f	2005 ^f
Dollar	1.066	0.924	0.896	0.945	1.131	1.23	1.22
Yen	121.3	99.5	108.7	118.1	131.0	133.1	128.7

Note: f – forecasts.

Source: data – ECB, forecast – CASE and market consensus.

Commodity Prices

- Oil prices rising further
- Oil supply uncertainty
- Metal prices easing from recent highs but will not fall significantly

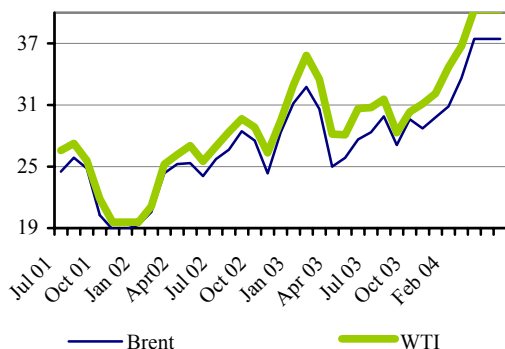
Oil

In 2Q04, oil prices continued to climb with Brent averaging US\$35.45 per barrel, 11% above its 1Q04 level and a major rise in annual terms (35%)

resulting from the low base effect (a temporary easing of prices after initially positive developments in Iraq in 2Q03). There was much volatility in the market, with news impacting in large price swings. This situation results from a combination of factors that are now expected to remain in place for some time, thus making significant easing of prices unlikely in 2H04. Global demand is steadily increasing alongside solid economic growth and stocks remain in the low territory. This is coupled with global production close to capacity and risks to production capacity in

several major suppliers. For example, an early July price surge was mainly driven by news of further terrorist attacks targeting Iraqi oil infrastructure and uncertainty about production in Russia stemming from the authorities action against Yukos.

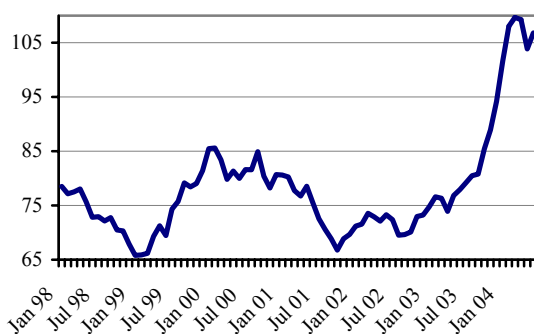
World oil prices, 2001-2004 (US\$ per barrel)



Source: US Energy Information Administration.

The International Energy Agency has continued to revise upward its demand growth forecasts and currently sees global demand rising 2.3 mb/d (compared to 1.7% forecast in April). On the supply side, the outlook for Former Soviet Union production development in 2004 -2005 deteriorated. The region has accounted for much of global production increase over the last few years. <WP>

Metal prices, 1998-2004 (index in nominal terms)



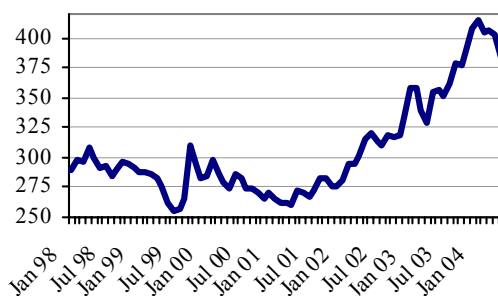
Source: IMF Research Department.

Metals

After hitting a peak in 1Q04, metal prices stabilised and started gradually easing. In 2Q04, the IMF metals price index decreased 2.6% qoq. This was to a large extent the result of developments in China, where the government restricted the introduction of new metal-consuming production. Still, the market consensus does not expect any significant decrease in metal prices in the coming months. According to the International Iron and Steel Institute, world consumption of steel products will grow 6.2% in 2004 and 4.5% in 2005. China is expected to increase its share in the world's steel consumption from 26.8% in 2003 to 28.7% in 2004 and to 30.2% in 2005.

After falling for four months, gold prices started to grow again in June and by mid-July had achieved their level from April 2004. Price fluctuations on the world gold market were tightly correlated with US dollar exchange rate dynamics. Although it is difficult to predict the US dollar exchange rate trend, experts expect gold prices to remain at a high level due to geopolitical instability. <DB>

Gold prices, 1998-2004 (US\$ per troy ounce)



Source: Pacific FX Database.



Statistical Appendix

	2001	2002	2003	2Q03	3Q03	4Q03	1Q04	Apr	May	June
GDP, % yoy change										
US	0.5	2.2	3.1	2.4	3.6	4.3	4.8	..	..	..
Japan	0.4	-0.4	2.7	2.2	2.0	3.2	5.4	..	..	..
EU	1.7	1.0	0.7	0.3	0.6	0.9	2.3	..	..	..
UK	2.1	1.6	2.2	2.2	2.2	2.7	3.0	..	..	..
Euro-zone	1.5	0.9	0.4	-0.1	0.3	0.7	2.0	..	..	..
Germany	0.8	0.2	-0.1	-0.7	-0.2	0.1	1.5	..	..	..
France	2.1	1.2	0.5	-0.1	0.4	1.1	1.7	..	..	..
Czech Rep.	3.1	2.0	2.9	2.9	3.4	3.3	3.1	..	..	..
Hungary	3.8	3.5	2.9	2.4	2.9	3.5	4.2	..	..	..
Poland	1.0	1.4	3.7	3.9	4.0	4.7	6.9	..	..	..
Russia	5.1	4.7	7.3	7.9	6.5	7.6	7.4	..	..	..
Turkey (GNP)	-9.5	7.8	5.9	3.6	5.6	7.2	12.4	..	..	..
CPI, % change yoy										
US	2.8	1.6	2.3	2.1	2.2	1.9	1.8	2.3	3.1	3.3
Japan	-0.7	-0.9	-0.3	-0.2	-0.2	-0.3	-0.1	-0.4	-0.5	..
EU15	2.5	2.0	2.0	1.8	1.9	1.9	1.6	1.8	2.3	2.2
UK (HICP)	1.2	1.3	1.4	1.3	1.4	1.3	1.3	1.2	1.5	1.6
Euro-zone (HICP)	2.3	2.3	2.1	1.9	2.1	2.1	1.7	2.0	2.5	2.4
Germany (HICP)	1.9	1.3	1.0	0.8	1.0	1.2	1.0	1.7	2.1	1.9
France (HICP)	1.8	1.9	2.2	1.9	2.1	2.4	2.0	2.4	2.8	2.7
Czech Rep.	4.8	1.8	0.1	0.0	-0.1	0.8	2.4	2.3	2.7	2.9
Hungary	9.2	5.3	4.7	3.9	4.7	5.4	6.8	6.9	7.6	7.5
Poland	5.5	1.9	0.8	0.5	0.8	1.5	1.6	2.2	3.4	4.4
Russia	21.6	16.0	13.5	13.9	13.3	11.9	10.8	10.3	10.2	..
Turkey	54.4	45.0	25.3	30.0	25.1	19.5	14.1	10.2	8.9	8.9
Short-term interest rate, %										
US	3.69	1.73	1.15	1.17	1.07	1.10	1.05	1.08	1.20	1.46
Japan	0.12	0.06	0.04	0.04	0.04	0.03	0.03	0.02	0.02	..
UK	4.97	3.99	3.67	3.57	3.50	3.86	4.11	4.33	4.46	..
Euro-zone	4.26	3.32	2.34	2.37	2.14	2.15	2.06	2.05	2.09	2.11
Czech Rep.	5.17	3.55	2.28	2.40	2.12	2.07	2.06	2.06	2.16	2.33
Hungary	10.80	8.91	8.22	6.60	9.48	10.38	12.44	11.62	11.40	..
Poland	14.85	8.71	5.38	5.41	5.01	5.20	5.27	5.38	..	5.64
Russia	10.00	12.40	5.40	4.70	4.30	4.70	3.00	2.30	2.70	..
Turkey	59.00	44.00	26.50	38.00	33.20	26.50	24.49	22.00	22.00	22.00
Unemployment rate, %										
OECD	6.5	7.0	7.1	7.2	7.2	7.1	6.9	6.9	6.9	..
US	4.7	5.8	6.0	6.1	6.1	5.9	5.6	5.6	5.6	5.6
Japan	5.0	5.4	5.3	5.4	5.2	5.1	4.9	4.7	4.6	..
EU	7.4	7.7	8.0	8.1	8.1	8.1	8.1	8.1	8.1	..
UK	5.0	5.1	5.0	5.0	4.9	4.9	4.7	..	..	..
Euro-zone	8.0	8.4	8.8	8.9	8.9	8.9	8.9	9.0	9.0	..
Germany	7.8	8.6	9.3	9.7	9.7	9.6	9.7	9.8	9.8	..
France	8.5	8.8	9.4	9.4	9.4	9.5	9.4	9.4	9.4	..
Czech Rep.	8.0	7.3	7.8	7.8	8.0	8.1	8.3	8.4	8.4	..
Hungary	5.6	5.6	5.8	5.8	5.7	5.8	5.9	5.9	..	..
Poland	18.5	19.8	19.2	19.2	19.2	19.1	19.1	18.9	18.9	..
Russia	8.7	7.1	8.6	8.2	7.9	8.6	8.0	8.3	8.1	..
Turkey	8.4	10.3	10.5	10.0	9.4	10.3	..	..	..	..

Notes: 1. Short term interest rates generally refer to 3-month interbank rates or Treasury rates (overnight rate for Turkey).

2. Standardised unemployment rate is presented with exceptions of Russia and Turkey.

Sources: OECD, Eurostat, countries' statistical agencies and central banks. <DB>

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All analyses are based on data and information available until 24 July 2004. Additional information is available upon request. Please contact CASE at global.economy@case.com.pl.

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