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# Global Economy

## Contents

<b>Global Outlook</b>	2
<b>Country Updates</b>	4
US	4
EU	5
<b>Emerging Europe</b>	11
CIS	12
Asia	14
Latin America	15
<b>Central Banks Watch</b>	16
<b>Exchange Rates</b>	17
<b>Commodity Prices</b>	17

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## Highlights

- **Global growth continues.** Although outlook for 2005 slightly lower (p. 2)
- **US expansion slowed.** Growth trend unbroken (p. 4)
- **Twin deficits in the US economy.** (p. 4)
- **Exports fuelling further euro-zone growth** (p. 5)
- **Growth and Stability Pact possibly violated in 2004.** By largest euro-zone members (p. 5)
- **Solid growth in new member states continues.** Boosted by increase in trade flows with old members (p. 7)
- **Good news from other emerging European economies.** Robust growth performance, favourable outlook (p. 11)
- **Turkey invited to open EU accession negotiations** (p. 11)
- **Strong CIS expansion.** Driven by high commodity prices (p. 12)
- **Cooling in China yet to come** (p. 14)
- **Japanese recovery continues.** 2004 growth to be the highest in 15 years (p. 14)
- **Regional upturn in Latin America.** Favourable outlook for 2005 (p. 15)
- **Gradual monetary tightening in the US.** ECB on hold (p. 17)
- **Dollar weakens after months of stability.** (p. 17)
- **Oil prices hit all-time nominal record.** Still far from highs of the 1970s and 1980s in real terms (p. 17)



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## Global Outlook

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- **Global growth continues, although outlook for 2005 slightly lower**
- **US expansion slowed, but growth trend unbroken**
- **Uninterrupted gradual recovery in the euro-zone**
- **Japanese upsurge highest in 15 years**
- **Emerging Asia leading the growth league**
- **Higher energy prices add to US inflation, gradual monetary tightening continues**
- **Dollar weakens in October after months of stability**
- **Fiscal challenges yet to be addressed**

Recent months have witnessed a continuation of the global economic upsurge, although at rates slightly slower than earlier expected. The main downward correction came from moderating US growth, as a result of high energy prices. In 3Q04, high oil prices were up by over 17% qoq and their upward course continued in early October, with Brent surpassing US\$50 per barrel, an all-time nominal record. In real terms, prices reached levels not seen since the 1990 Gulf War, though these were still well below the record-highs from the late 1970s and early 1980s. Oil prices are expected to stay high in the upcoming months, as Asian demand is anticipated to grow. The key, however, is the constraints it imposes on the US growth rate and we have as a consequence revised downward our forecast for global economic expansion in 2005. Still, the outlook remains optimistic, as both business and consumer confidence in the largest economies remain positive.

High energy prices constrained US consumer demand and exports. However, the annual rates of US GDP growth, although decelerating, were largely as expected and the growth trend was not broken. Exports have continued to fuel EU growth and the euro-zone annual growth figure of 2.2% in 2Q04 was a sign of a continuation of the recovery. Japanese annual growth in 2Q04 was the highest in almost 15 years and broadly based.

Still strong regional growth was observed in emerging Asia, especially in China and India. Although domestic demand weakened when compared with the previous quarter, exports remain

the regional driving force. Cooling in China has yet to come and this is driving up world commodity prices. Latin America maintained its strong expansion, based mainly on domestic demand, with exports largely dependent on fluctuations in demand for certain commodities. Russia and other CIS economies continue to benefit from high commodity prices and are growing at high rates.

The currencies of the world's largest economies were unusually stable in 3Q04. Both the euro-dollar and the euro-yen rates oscillated in narrow ranges. However, from mid-October the dollar lost ground against both the euro and the yen, depreciating by around 5%. US inflation remained above the euro-zone HICP annual changes throughout 3Q04, mainly as a result of recent energy price hikes. Oil prices jumped to an average of US\$41.39 per barrel of Brent in 3Q04 and continued to mount in October. However, US core yearly inflation remained broadly stable and inflation expectations have not changed. This was one of the arguments used by the Fed in support of its most recent interest rate increase. US rates were slightly raised in August, September and November. The policy of very gradual monetary tightening in the US is expected to continue, though there is little guidance as to the precise timing of the next policy moves. In contrast, the ECB has not decided to introduce any changes to its monetary policy stance. Given the current outlook, this will be probably ECB policy in the near future.

As in the previous quarter, there have not been many changes in the fiscal stance among the major economies. The US recorded the highest budget deficit in a single decade during the fiscal year 2004 (ending September 30), while the major euro-zone economies are expected to record fiscal deficits close to or over 3% of GDP by year-end, therefore again violating the Growth and Stability Pact.

Our projections have been changed slightly, principally by a lowering of the US growth forecast for 2005 on the basis of a lower contribution from net exports and consumer demand following energy price increases. The outlook for euro-zone growth remains cautiously optimistic and our forecast for growth in the UK in 2004 has been increased on the back of positive 1H04 news. The GDP of the OECD economies is set to rise by 3.4% in 2004 and

– slower than earlier expected – by 2.9% in 2005. In contrast, higher energy prices have improved the medium-term outlook for Russia. Recent oil price hikes prompted us to increase our 2004 inflation estimate for the US, with an unchanged figure for 2005. As before, we expect euro-zone HICP inflation to fall below 2% in 2005. Deflation in Japan will probably end in 2005. The Fed will also

probably continue its policy of gradual interest rate rises over the upcoming next months. Given the current outlook for the euro-zone, ECB rates are likely to stay unchanged well into 2005. The dollar is expected to remain weak against the euro in late 2004 and in 2005. <MJ>

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

	1999	2000	2001	2002	2003	2004f	2005f
OECD	3.3	3.9	1.0	1.7	2.2	3.4	2.9
USA	4.5	3.7	0.5	2.2	3.0	4.4	3.5
European Union	2.8	3.3	1.7	1.0	0.7	2.2	2.4
Euro zone	2.8	3.4	1.5	0.8	0.5	1.9	2.2
Germany	2.0	2.9	0.6	0.2	-0.1	1.5	1.7
France	3.2	3.8	2.1	1.2	0.5	2.2	2.4
Italy	1.6	2.9	1.8	0.4	0.3	1.3	1.9
United Kingdom	2.4	3.0	2.1	1.6	2.2	3.3	2.8
Czech Rep.	0.5	3.3	3.1	2.0	3.1	3.6	3.6
Hungary	4.2	5.2	3.8	3.5	2.9	3.3	3.4
Poland	4.1	4.0	1.0	1.4	3.8	5.5	3.9
Russia	5.4	8.3	5.0	4.7	7.3	6.5	5.0
Turkey	-6.1	6.3	-9.5	7.8	5.8	7.0	5.0
Japan	0.1	2.8	0.4	-0.4	3.2	3.5	2.1
China	7.1	8.0	7.2	8.0	9.1	8.8	7.5

Notes: f – forecast.

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

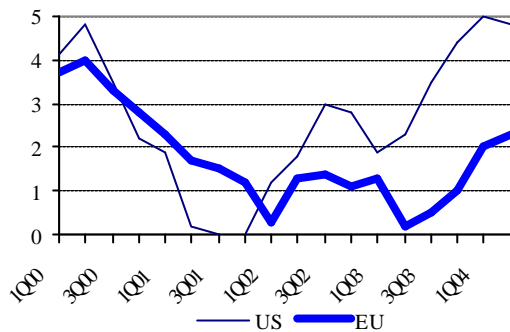
#### CPI in selected countries, 1999-2005 (% change, yoy)

	1999	2000	2001	2002	2003	2004f	2005f
USA	2.2	3.4	2.8	1.6	2.3	2.6	2.3
Japan	-0.3	-0.7	-0.7	-0.9	-0.2	-0.1	0.0
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	1.7
United Kingdom (HICP)	2.3	2.1	2.1	1.3	1.4	1.6	1.7
Czech Rep.	2.1	3.9	4.8	1.8	0.1	2.9	2.8
Hungary	10.0	9.8	9.2	5.3	4.7	6.5	4.3
Poland	7.3	10.1	5.5	1.9	0.8	4.3	3.1
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	9.5
China	-1.4	0.3	0.7	-0.8	0.8	4.0	3.3

Notes: f – forecast.

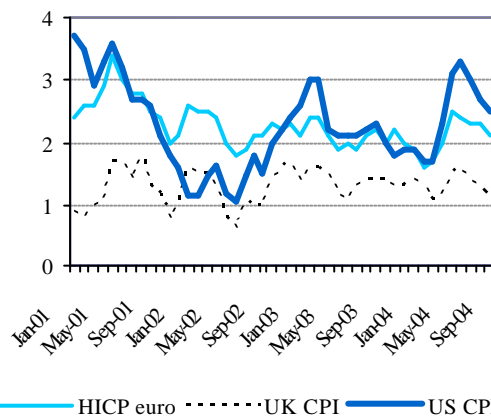
Source: OECD, ECB, IMF and statistical agencies (data); CASE and market consensus (forecast).

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



Source: FedStats, Eurostat

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



Source: Eurostat, Bureau of Labor Statistics, National Statistics

## Country Updates

### United States

- **Moderate deceleration in rates of growth, but still optimistic outlook**
- **Rising trade deficit**
- **Inflation fell in 3Q04**

Economic expansion continued in 2Q04, although at a slower pace than a quarter earlier. GDP grew by 4.8% yoy on the back of surging investment (up 16.8% yoy) and private consumption. As the growth of consumption slowed to 3.6% yoy in 2Q04, after 4.2% yoy in 1Q04, investment made the greatest contribution to the GDP increase. The trade deficit widened in 2Q04 to US\$591.3 billion, mainly as a result of the third consecutive quarter of strongly growing imports (10.7% yoy). Due to still

favourable external demand, exports expanded at a similar rate, up 10.8% yoy, accelerating in comparison to 1Q04.

Advance estimates suggest the pace of growth decreased in 3Q04 to 3.9% yoy. The rate of growth of household consumption probably fell to 3.5% yoy, as higher energy prices reduced household purchasing power. However, it is widely believed that the effects of higher energy prices have already been factored into household spending decisions in 2Q04 and that this may hold back the consumption growth trend in the upcoming quarters, although certainly not reversing it. Private investment was up 12.5%, while the contribution of net exports remained even more negative. It is estimated that the trade deficit widened in 3Q04 to US\$627.8 billion and that import growth accelerated to 12% yoy, against a fall in the rate of increase in exports to 9.2% yoy. Most probably, the US trade deficit will widen in nominal terms in 4Q04, reflecting the latest surge in oil prices. However, it is not clear how much of this will translate into volume terms. Positive news on the imports side is that volumes of imported capital goods were much stronger than consumer imports during the summer months of 2004. The trade deficit for the last 12 months accounted for approximately 5% of US GDP.

Industrial production grew 4.6% yoy in September 2004, after a 5.3% yoy rise in July and 5.1% yoy in August. Manufacturing output for the whole of 3Q04 was up 4.4% yoy and there was a notable slowdown in the production and export of high-tech goods throughout 3Q04 on an annual basis. However, capacity utilisation in overall industry remained at an unchanged level throughout 3Q04 and even increased in manufacturing – from 75.8% in July to 76.3% in September.

There was positive news from the labour market. Although the unemployment rate remained unchanged in 3Q04 at 5.4%, payroll employment have been increasing on average by over 100,000 jobs monthly. Employment in September 2004 was 1.4% higher than in September 2003.

Consumer prices increased 3.0% yoy in July, 2.7% yoy in August and 2.5% yoy in September 2004. Core consumer price inflation (excluding food and energy) remained at the relatively unchanged level of 1.8% yoy throughout 3Q04. Producer prices

were also falling in annual terms during 3Q04, with the exception of intermediate prices. Core intermediate prices went up from 6.4% yoy in July to 7.8% yoy in September 2004.

The US federal budget deficit during the fiscal year 2004 (ending September 30) is estimated at US\$412.5 billion, or about 3.6% of GDP. This is the highest figure in the last decade. Previously, deficits of comparable sizes were recorded in 1990-1993. Receipts of 19.8% of GDP were the lowest in three decades. However, there were signs in 3Q04 that towards the end of the 2004 fiscal year receipts were improving.

We have slightly revised downward our GDP growth forecast for 2004 to 4.4% as the negative pressure from net exports and weaker consumer spending did in fact materialise in 2Q04 and 3Q04. There are also forecasts of a continuation of slowing factory output. It is expected that consumer demand will continue to absorb higher energy prices in 2005 and that some energy-related services, as well as US manufacturing, will not grow as fast as it had been expected a quarter ago. We have therefore downgraded our forecast of US growth in 2005 from 4% to 3.5%. On the positive side, the medium-term outlook remains optimistic. There have been no sudden and high increases in market interest rates and inflation expectations connected with the recent oil price shock have stayed calm, suggesting that the current price surge is viewed as a temporary episode and that the domestic market remains supportive for continued growth. <MJ>

## European Union

- **Exports fuelling further euro-zone recovery in 2Q04**
- **Growth and Stability Pact possibly violated in 2004 by largest euro-zone members**
- **Solid growth in new member states continues**
- **Inflation stays high due to elevated oil prices**

### Euro-zone

GDP growth of 2.2% yoy in 2Q04 and 0.5% qoq indicates continuation of recovery in the euro-zone. Acceleration in 1H04 against 2003 was driven primarily by exports, fuelled by strong external

demand. In comparison to 1Q04, exports accelerated further in 2Q04. There were also signs of moderate growth in domestic demand, mainly from the side of consumers. Industrial production picked up in 2Q04, recording 3.7% yoy and 3.3% yoy growth in May and June 2004, respectively. However, industrial growth moderated in 3Q04, with annual changes of 2.2% yoy in July and 1.5% yoy in August.

During July-August 2004 labour market conditions in the euro-zone remained unchanged from the previous quarter, with the unemployment rate at 9% of the labour force. There were marginal moves in the rates of low-unemployment countries like Ireland, where the unemployment rate fell from 4.5% in 1Q04 to 4.4% in August, and in Luxembourg, where there was a slight increase in the unemployment rate from 4.2% in 1Q04 to 4.3% in the first two months of 2Q04. No significant moves in the unemployment rates of high-unemployment countries – Spain, Finland, France and Germany, which have unemployment at levels of 9% or higher – were observed in July-August 2004.

Oil prices pushed up consumer prices in the euro-area. The harmonised consumer price index was higher in 3Q04 than in the previous quarter, notwithstanding the effect of seasonal food price deflation on a quarterly basis. Food price deflation at an annual basis of -0.2% yoy was also recorded in September. However, due to the rise of prices of energy (up 6.4% yoy in September 2004), housing and transport, HICP inflation in annual terms fell from 2.4% yoy in June to only 2.1% yoy in September 2004.

The latest budgetary figures show that the euro-zone - in aggregate - is far from consolidating its fiscal finances. Some member countries, such as Germany, France, the Netherlands and Italy, are set to record fiscal deficits close to or above 3% of GDP. The aggregate fiscal deficit to GDP ratio for 2004 as a whole is thus expected to increase from 2.7% in 2003 to 2.8% in 2004; likewise the debt to GDP ratio, notwithstanding the acceleration of economic growth. The Growth and Stability Pact will therefore be violated again and proposals to allow more flexibility into the pact are on the agenda.

As the external demand is set to remain relatively strong in the second half of the year, we have slightly upgraded our near-term outlook, with euro-zone gross production expanding 1.9% during 2004 as a whole. Consumer demand is expected to pick up in 2005, hence the euro-zone is forecast to expand faster next year, by 2.2%. Inflation should ease a bit, assuming stabilisation of Brent crude prices at US\$40 per barrel. However, the harmonised consumer inflation is expected not to fall below 2% yoy until the end of 2004.

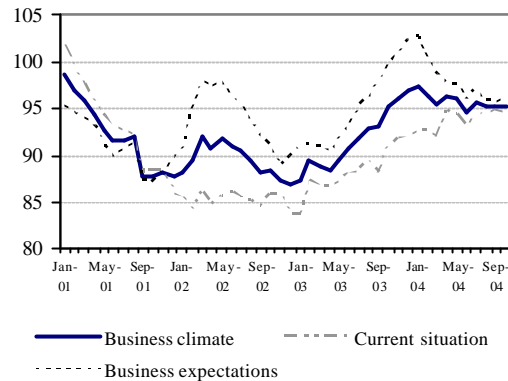
### Germany

The acceleration of growth in Germany, with GDP expanding 2.0% yoy in 2Q04, was possible exclusively due to strong external demand. A large trade surplus, with exports surging 14.3% yoy, provided a robust growth impulse unseen for years. Imports also grew at a high rate of 9.3% yoy. However, it seems that their growth to date has been exclusively connected with inputs for export-processing. Investment remained stagnant and consumption even decreased slightly on an annual basis. Booming exports have not influenced aggregate labour market figures. The unemployment rate of 10.2% (by national accounting) at the end of 2Q04 was lower than a quarter earlier, but then it went through its usual seasonal upturn to 10.5% in July-August and back to 10.3% in September 2004. However, all these were seasonal moves and the unemployment rate in 2Q04 and 3Q04 was a little higher than in the analogous periods of 2003. The primary reason for this was employment reductions in industry and construction on an annual basis. However, the number of people employed in financial, rental and business services, as well retail trade and transport, increased. Harmonised consumer price inflation went down from 2.0% yoy in July and 2.1% in August to 1.9% in September 2004, all the time slightly below the euro-zone average.

The recovery is continuing, with export expectations picking up. This, despite export earnings not yet visible in higher investment and the employment outlook still unfavourable, made most forecasting institutions withheld optimistic forecasts of the German economy for 2004. We have followed in their footsteps here. German GDP should expand in 2004 as a whole by 1.5% and 1.7% in 2005. The forecast for 2005 is slightly

lowered to reflect deceleration in the growth of global demand next year.

### Ifo business climate index, 2001-2004



Source: Ifo Institute for Economic Research.

### France

2Q04 figures brought positive news of a strengthening of the recovery. After 1.6% yoy growth in 1Q04, French GDP expanded 2.8% yoy in 2Q04. The leading force was domestic demand, with household consumption up 2.8% yoy and investment up 3.6% yoy. Net exports continued to exert a negative impact on GDP. On the supply side, value added in manufacturing grew 3.4% yoy. Retail trade and other services increased by over 2% yoy in 2Q04. Increased economic activity in 2Q04 led to slight reduction in unemployment and standardised unemployment fell to 9.5%. However, it did move back later to 9.6% and stayed at this level during July-August 2004 as more young job-seekers appeared on the market in August. Consumer price inflation was 2.1% yoy at the end of 3Q04, down from 2.4% yoy at the end of 2Q03. We have raised slightly our full year growth forecast for France to 2.2% in 2004 and left unchanged the 2.4% growth projection for 2005, as the outlook remains optimistic.

### Other EU economies

The difference in annual growth rates between the euro-zone and other EU countries narrowed again in 2Q04. However, it remained significant, as almost all new member states and Sweden recorded GDP expansion of above 4% in 2Q04, with the Baltic countries' growth rates close to or above 6% yoy.

## UK

Moderate growth acceleration in the UK was observed in 2Q04, when GDP rose 3.6% yoy from 3.4% yoy in 1Q04. The expansion was broadly based, with consumption up 3.2% yoy change providing the strongest growth impulse. Investment in fixed assets continued to increase strongly, by over 6% yoy, while net exports remained negative due to the strong expansion of imports. On the production side, manufacturing grew 2.2% yoy in 2Q04, after a 1.2% yoy change at the beginning of 2004 and very small gains in 2003. However, the strongest growth in output was in construction (5.5% yoy) and services (4.1% yoy). The labour market stabilised in 2Q04 and during the subsequent two months, with unemployment at an unchanged 4.7% level alongside a flattening trend in working age employment. CPI 12-month inflation, which rose in 2Q04 to 1.6% yoy (June), fell in 3Q04 to 1.1% yoy in September 2004. The downward inflation trend was driven mainly by the fall in food, transport and communication prices. The UK inflation rates are among the lowest in the EU. On the back of recent growth acceleration we have increased our growth forecast to 3.3% in 2004 and left the 2005 figure practically unchanged at 2.8%.

## Poland

Strong growth continued in 2Q04 and GDP increased by 6.1% yoy, nearly as much as in 1Q04. Investment in fixed assets and individual consumption remained as strong as at the beginning of the year, increasing by 3.3% yoy and 3.8% yoy, respectively. Consumption was boosted by the growth of household disposable incomes, which continued to accelerate further during 3Q04. Exports continued to drive up industrial production and manufacturing value added increased 12.8% yoy in 2Q04, while construction declined by nearly 3% yoy (a follow on from its 4-year recession). As in the previous quarter, export volumes expanded strongly in 2Q04, up 11.1% yoy, and exports of machinery, transport equipment and various manufacturing products to EU countries provided the strongest boost. In nominal euro terms, merchandise exports rose 20% in the following quarter. Imports, by contrast, were losing speed in 2Q04 compared to the 2003 average figure, with volumes up 8% yoy. Merchandise imports increased 13% yoy in nominal euro terms in 3Q04. However, trade volumes for 3Q04 may come out

somewhat different, as part of the nominal dynamics is due to the appreciation of the zloty.

Inflation stayed above 4% yoy, as earlier expected, again stimulated by higher oil prices and EU accession developments. Consumer prices were up 4.4% yoy in September and 4.3% yoy up at the end of 2Q04. World energy and metal price hikes drove producer prices up 8% yoy at the end of 3Q04. There is still no positive news from the labour market. Although the unemployment rate continues to fall there was almost no change in the number of registered employed in 2Q04 or 3Q04 yoy. If any move was observable it was the slight reduction in the number of people in work. The falling registered unemployment rate (from 19.5% in 2Q04 to 18.9% in 3Q04, having been over 20% at the beginning of the year) mainly reflects people exiting the labour force.

We have slightly decreased our growth forecast for 2005, mainly due to a slowing growth of export volumes, which is impacting industrial production and incomes. Polish GDP is expected to expand in 2004 by 5.5% and 4.0% in 2005. As a result of a higher than expected CPI rise in 3Q04 our estimate for year-end inflation has been adjusted upwards to 4.4% yoy. As before, we see consumer price inflation returning to 3% yoy in mid-2005. Public finances remain a major risk factor in the medium-term outlook. Maintaining a high rate of growth will also depend on structural reforms aimed at developing small businesses in Poland. <MJ>

## The Czech Republic

In 1H04, especially 2Q04, output growth accelerated compared to annual average GDP expansion over the last five years. GDP growth of 4.1% yoy in 2Q04 and 3.8% yoy in 1H04 was primarily driven by a significant increase in gross fixed capital formation (12.8% yoy and 11.3% yoy, respectively). Affected by slow growth in real disposable incomes (a mere 1.8% yoy in 2Q04), growing unemployment (9.3% in August, according to ILO) and increasing inflation (CPI grew 3.4% yoy in August, but producer prices increased even faster - by 9% yoy in 2Q04 and continue rising), private consumption recorded a 3.4% yoy increase in 2Q04, down from 3.7% yoy in 1Q04. On the supply side, the robust increase in industrial output (10.8% yoy in 1H04 and 12.6% yoy in 2Q04) was particularly affected by fast growing labour



productivity (12.4% yoy and 14.4% yoy, respectively), intensified structural changes in the country and increased foreign demand due to the global and EU recovery. The best-performing industries in the second quarter were manufacturing, quarrying and mining, trade, transport and construction. Agriculture was below the previous year's level; however, it is expected to contribute positively to 2H04 GDP growth.

Czech exporters started to benefit from EU membership from day 1. Czech exports have also been stimulated by the EU's economic growth and favourable exchange rate developments (the crown depreciated against the euro by 2.7% yoy in 1H04 and against the USD by 8.2% yoy). As a result, exports accelerated to 29.9% yoy in 2Q04 (up from 11.2% yoy in 1Q04) and continue growing. Foreign trade advanced strongly after EU entry: in May-June 2004 alone exports and imports grew 33.7% yoy and 30.5% yoy, respectively, against 15.5% yoy and 15.1% yoy in January-April. The biggest improvement was registered in trade with other EU members (the EU25 states account for 86.8% of total exports and 73.9% of total imports). Since imports grew at a slightly lower pace (28.2% yoy in 2Q04 and 20.2% in 1H04 yoy vs. 21.6% yoy for exports in 1H04) the overall trade deficit improved in 1H04 (CKZ 11.3 billion, about CZK 3 billion less than in 1H03).

Despite the narrowing of the external trade deficit and surplus in trade in services, a CA deficit of CZK41 billion (EUR 1.3 billion) was recorded in 2Q04. The CA deficit rose from 5.5% of GDP in 2Q03 to a high of 6.4% in 2Q04. The widening of the CA deficit was mainly the result of a deficit on the income account. A considerable increase in debits on the income account was associated with transfers of investment income abroad. At the same time, the financial position of the country in 2Q04 was reasonably favourable. The net inflow of capital was CZK 38.5 billion in Q2 (5.8% of GDP), which is almost twice as much as the corresponding figure last year. The increase was due to issues of Czech T-bills abroad and a slight increase in foreign direct investment.

Unlike climbing producer prices, which recorded a 8.1% yoy increase in August, their highest rate of growth since 1993, consumer price inflation was much more modest, registering 3.4% yoy in

August. Moreover, in September, the CPI unexpectedly fell to 3% yoy. Nevertheless, the major inflation risks, such as a strong increase in wages in the public sector, accelerating producer prices, increases in oil prices on world markets and so on have spurred inflationary expectations.

### **Hungary**

Economic recovery continued in 2Q04, although at a slightly lower pace than in the preceding quarter (4.0% yoy vs. 4.2% yoy in 1Q04). As in the preceding quarter, growth was mainly stimulated by the strong performance of investments and the expansion of private consumption. Although investment in fixed capital continued growing at a high 10.0% yoy in 2Q04, its rate of increase decelerated from 18.9% yoy in 1Q04. In contrast, private consumption (with a share in Hungarian GDP of about 70%) accelerated from 3.8% yoy in 1Q04 to 5.1% yoy in 2Q04. On the back of strong domestic demand, the import growth rate (18.5% yoy in 2Q04) outpaced that of exports (16.9% yoy). Thus net exports negatively contributed to GDP growth. On the supply side, the economy was boosted by the recovery in agriculture (after 2 year of decreases and a modest 0.5% yoy increase in 1Q04, it recorded 2.9% yoy growth in 2Q04), manufacturing (8.2% yoy) and services (3.7% yoy).

As export growth in 2Q04 decelerated (from 17.4% yoy in 1Q04) while imports accelerated (from 16.6% yoy), the trade deficit widened by EUR 795 mln in 2Q04 compared to the previous quarter, reaching EUR 1.19 billion. However, since exports grew faster than in the corresponding period of last year, the trade deficit was about 23% less. The widening trade deficit and to a greater extent the worsening of the balance of incomes and current transfers (dividend payments on portfolio investments and contributions to the EU budget) resulted in a 13.4% yoy increase in the CA deficit in 1H04; to 9.3% of GDP in 2Q04). Risks related to CA deficit financing increased with the deterioration in FDI, whose outflow in 2Q04 amounted to EUR 100 mln. However, even more alarming is that fact that the deficit is almost entirely financed by portfolio investments, which almost doubled in 2Q04 stimulated by the central bank's high key interest rate of 11.5%. Subsequent rate cuts in August and October probably put downward pressure on short-term capital inflows in 2H04.

Due to seasonal factors, the CPI declined 0.3% mom in August, putting year-to-date inflation at 7.1%. The increase in taxes at the beginning of the year made the largest contribution to CPI developments. The upcoming performance of inflation will be affected by the on-going forint appreciation trend, high base effects and world oil prices.

Fiscal prospects for this year are rather pessimistic, with the January-August consolidated budget deficit 7% over target for 2004. According to the new prime minister, there will be no concerted attempts to improve the situation. Given that usually substantial deficits are recorded at the end of the year, the fiscal deficit is expected to be around 5.2% of GDP in 2004 (up from 4.6% of the previous target). Uncertainty about the state of public finances has already caused an increase in yields on government securities and a reduction in the Budapest Stock Exchange index. In the budget proposal for 2005 the fiscal deficit is set at 4.7% of GDP. However, this may turn out to be too optimistic as in 2005 a number of tax changes (tax cuts for middle income earners and a reduction in lump-sum contributions to health care) will be introduced, which might negatively affect budget revenues. At the same time, to offset the fall in revenues, capital gains tax will be reintroduced, the dividend and withholding taxes increased and a 6% tax on the net interest revenues of financial institutions launched. Moreover, reforms of the army and public administration starting in 2005 will also reduce expenditures in this sectors.

### **Slovak Republic**

In 2Q04, the Slovak economy expanded 5.4% yoy, just 0.1 percentage points less than in the previous quarter. Unlike 1Q04, when growth was fuelled by strong external demand, it was driven by both external and domestic demand. The latter, after stagnation in 2003, recovered in 1H04 to 4.2% yoy. The considerable, 5.8% yoy, increase in 2Q04 was mainly achieved due to accelerating gross capital formation and improving private consumption. The 2.8% yoy increase in consumption in 2Q04 (slightly down from 3% yoy in 1Q04) was connected with the growth of real wages, changes in income taxation and a reduction in lending interest rates. Gross capital formation increased by an impressive 13.8% yoy in 2Q04, stimulated by

higher fixed investments (3.5% yoy, up from 0.9% yoy in 1Q04) and an increase in inventories. On the supply side, GDP growth in the second quarter was primarily driven by the growing value added in public services (by 26% yoy), agriculture (11.4% yoy), financial intermediation (9.5% yoy) and industry (7.4% yoy).

Unlike the previous quarter, net exports contributed negatively to GDP growth (-2.1% yoy in 2Q04 against 0.5% yoy in 1Q04). Two-digit growth rates in exports were recorded again and in 2Q04 exports slightly accelerated to 16.4% yoy (up from 15.4% yoy in 1Q04). However, since the Slovak economy is mainly export-oriented, recovered domestic demand stimulated the increase in imports (17% yoy in 2Q04 against 12% yoy in 1Q04). Despite a future recovery in exports, it is expected that imports will grow faster, thus widening the external trade balance further.

The BoP current account in 1H04 recorded a deficit of SKK 16.8 billion (about EUR 414 million) mainly due to a widening of the income deficit (dividend payments to foreign investors) and a decrease in the surplus of current transfers (transfers to the EU budget). The inflow of funds in the capital and financial accounts to a large extent offset the CA deficit. In 1H04, FDI reached SKK 19.9 billion (around EUR 490 million), which was slightly less than SKK 20.8 billion in 1H03. However, excluding privatisation, the level of FDI was higher than in the previous year (SKK 17 billion against SKK 11.4 billion, respectively). The issuance of government bonds on foreign markets and purchase of government bonds and bills by non-residents stimulated the inflow of funds in the form of portfolio investments (the net capital inflow amounted to SKK 20.1 billion). The CA deficit will gradually deteriorate due to a worsening of the foreign trade deficit and deteriorating balances on the income and current transfers accounts. However, the CA deficit is not expected to exceed 3% of GDP by the end of 2004.

Affected by seasonal factors, the CPI declined 0.1% mom in August, bringing yoy inflation to below 8% – to 7.2% yoy (down from 8.5% yoy in July). The slowdown in inflation can be also explained by a high base effect due to the increase in excises in August 2003. The increase in regulated prices



(15.4% yoy in August) made the largest contribution to CPI growth.

In the second half of September, Slovakia adopted key laws for health system reform. The reform of the health care sector is necessary to restructure the country's heavily indebted and mismanaged hospitals, in turn reducing the "last resort" role of the budget. Slovakia's budget deficit in 2003 was 3.7% of GDP. As such, bringing it below the 3% level helps in the direction of meeting the Maastricht criteria by 2006 and in adopting the euro in January 2009. Slovakia has also progressed in public administration reform, in September approving new rules of financing local governments. For the first time the government has proposed a multi-annual budget for 2005-2007. According to this proposal, the fiscal deficit will be gradually decreased from an expected 3.9% of GDP in 2004 to 3% in 2007. Observing Slovakia's robust economic growth and progress in reforms, in September Fitch rating agency has upgraded the country's foreign currency position from BBB- to A- and its domestic currency position from A to A+.

### **Baltic States**

The Baltic countries have continued their strong economic expansion throughout 2004. In July, Fitch rating agency upgraded the long-term foreign currency positions of Estonia from A- to A, and Latvia and Lithuania from BBB+ to A-.

Latvia recorded the second highest inflation rate of 7.8% yoy in August (just 0.1 pps lower than in September) among the EU countries. In contrast, Lithuania's and Estonia's inflation rates are among the lowest among their peer countries, with 2.2% yoy and 4.0% yoy in August, respectively. The current level of inflation in Latvia, combined with a rapidly growing CA deficit, may dangerously increase the vulnerability of the Latvian economy to external shocks.

Estonia continued its strong economic performance, growing 5.9% yoy in 2Q04. The slight weakening of GDP growth (from 6.8% yoy in 1Q04) was the result of smaller changes in inventories (the share of changes in inventories declined 6.8% of GDP in 1Q04 to 3.4% of GDP in 2Q04) and seasonal factors (seasonally adjusted, GDP in constant prices in 2Q04 was 1.3% higher than in 1Q04). Growth

was primarily driven by recovered investments (from +8.5% yoy in 1Q04 to +20.2% yoy in 2Q04) and private and public consumption (6.6% and 5.3% yoy in 2Q04, respectively). The economy will probably slowdown slightly in the second half of the year due to the high base effect and decelerating private consumption (as a result of expected slower growth of real wages). The major concern for the country remains the accelerating CA deficit: it expanded from a high of 10.9% of GDP in 1Q04 to a dangerous 21% of GDP in 2Q04, reaching EUR 690 million. However, it is expected to decrease in 2H04, since import growth, the major reason for the widening CA deficit, surged in the pre-accession months and is not expected to accelerate. At the same time, the export performance remains relatively strong. FDI inflows are the highest among the Baltic countries (EUR 390 million in 1H04).

Although growth in Latvia slightly decelerated in 2Q04 (7.7% yoy against an impressive 8.8% yoy in 1Q04), it remains the fastest growing economy in the European Union, registering 8.2% yoy for 1H04. This expansion was driven by domestic demand for goods and services and external demand for investment goods and services. On the supply side, in 2Q04 GDP growth was stimulated by expanding transportation and communication industry (by 10.9% yoy), construction (by 12% yoy), wholesale and retail trade (which expanded by 8% yoy). However, almost 73% of Latvia's GDP is produced by service industries. The leading branches in 2Q04 were financial and banking services (9% yoy growth) and hotel and restaurant business (7% yoy). Although slightly slowing, the country's economy is not expected to record growth of less than 7% over the next two years. In 2Q04, the CA balance exhibited dangerous dynamics, jumping from -9.5% of GDP in 1Q04 to almost -14% of GDP in 2Q04. The financing of the CA deficit would also appear problematic given the rather modest inflows of FDI (since the beginning of the year inflow of FDI have amounted to EUR 270 million, the lowest level among the Baltic states).

Lithuanian GDP accelerated from 7.1% yoy in 1Q04 to 7.3% yoy in 2Q04. This growth was fuelled by domestic consumption. Final consumption increased by 8% yoy, less than the 12.2% in the previous quarter. The economy

benefited from accelerating gross capital formation, which reported 27.6% yoy growth in 2Q04 (up from 20.3% yoy in 1Q04). The household consumption increase of 8% yoy was stimulated by the growing earnings of the population (5%) and average pensions (9%). However, high domestic demand also drew in imports, which in 2Q04 increased 14.6% yoy, while exports grew a modest 6.6% yoy. However, a slight acceleration in export growth (in 1Q04 exports grew only 3.8% yoy) and deceleration of import growth (15% yoy in 1Q04) resulted in a narrowing of the CA deficit, although it remains at a very high level (10% of GDP in 2Q04, down from 10.9% of GDP in 1Q04). The good news is that FDI inflows to the country rebounded in 1H04. <OP>

## Emerging Europe

- **Robust growth performance, favourable outlook**
- **Turkey to start EU accession negotiations**

On October 6 2004, the European Commission released a report on candidate countries' progress in the adherence process. By granting "functioning market economy" status to Romania, the report confirmed the agreed schedule for the beginning of 2007 for Bulgaria and Romania joining the EU. By doing so it thus resolved recently raised concerns about a possible separation of Romania from Bulgaria in the accession process. Although positively assessing the progress in structural reforms made by these countries and their commitments to meet membership criteria, the report emphasised the need for further improvements in public administration and judiciary reforms and additional efforts to reduce corruption. The EC also defined the pre-accession strategy for Croatia, whose accession negotiations will start in early 2005. The Commission also recognized Turkey's substantial progress in overall structural and political reforms. It concluded that Turkey had fulfilled the political criteria and recommended opening accession negotiations.

### Turkey

The Turkish economy continued to accelerate in 2Q04: GDP grew 13.4% yoy (up from 10.1% yoy in 1Q04), driven by domestic demand, with the greatest contributions made by investment and

private consumption. Private consumption climbed to 16.4% yoy in 2Q04 (up from 10.6% yoy in 1Q04). The surge in consumption in 1H04 was the result of a decline in the cost of borrowing (due to decreasing credit rates and easier access to credits and appreciation of the Turkish lira against foreign currencies). However, the tightening of the credit supply and increasing interest rates in May-June may result in decelerating private consumption in 2H04. The most important GDP drive factor remains investment. Despite a slight deceleration in 2Q04, the pace of increase in gross fixed capital formation was above 50% yoy (51.7% yoy in 2Q04, down from 52.6% yoy in 1Q04). The investment boom can be attributed to robust economic growth, the decline in the cost of borrowing, greater domestic and external finance opportunities and growing investor confidence.

Net exports made a negative contribution to GDP growth in 2Q04. Although the export performance improved (in 2Q04, the export growth rate accelerated to 15.7% yoy, against 10.3% yoy in 1Q04), while import growth rates were more than twice as high (32.7% yoy in 2Q04, up from 31.2% yoy in 1Q04). This considerable import growth resulted from recovered domestic demand, expanded industrial production and the appreciative trend of the Turkish lira. The widening trade deficit was the key factor underpinning the increased CA deficit in 1H04. The CA deficit reached US\$9.4 billion in 1H04, although narrowed during the summer months (in August it registered a surplus of US\$118 million) due to a considerable surplus in trade in services. At the same time, financing of the CA deficit is favourable given the significant inflows of FDI into the country: during January-August FDI reached almost US\$2 billion, 2.3-times higher than in the corresponding period of last year. Consumer prices in 3Q04 exhibited similar tendencies to June 2004, growing 9-10% yoy each month. Thus, a strong disinflation trend prevailed during the first three quarters of 2004 and CPI inflation finally fell below 10% in annual terms. The declining inflation trend will be probably maintained.

### Romania

Romania's economic growth accelerated to 7.0% yoy in 2Q04 (up from 6.1% yoy in 1Q04), bringing the half-year 2004 figure to 6.6% yoy. This growth was primarily stimulated by strong domestic

demand and fast growing investment. Boosted by the population's growing revenues (8.9% yoy in 1H04) and considerable domestic credit growth (40.4% yoy in June), private consumption recorded a 9.0% yoy increase in 1H04 (9.5% yoy in 2Q04, up from 8.4% yoy in 1Q04). Gross fixed capital formation expanded by an impressive 12.9% yoy in the second quarter, increasing its share in GDP from 16.7% in 1Q04 to 24.1% in 2Q04. Despite upcoming elections this winter the government has pursued a prudent fiscal policy. Robust economic growth and improved tax collection made it possible to bring the fiscal deficit down to 0.65% of the GDP forecast for 2004 in 1H04 and to 0.1% of GDP in July. Although, according to an agreement signed with the IMF in July, the year-end target was set at 2.1% of GDP, positive fiscal developments induced the government to reduce the deficit projections to 1.6%.

After inflation fell to 12% yoy in June 2004, it accelerated in the next two months to 12.4% yoy in August. Such a CPI dynamic makes a 9% year-end target somewhat unrealistic, although at the end of August the central bank reduced its intervention rate to 18.75% (for the fourth time this year) to show its confidence in achieving the target. Despite fast growing exports, import growth rates have strongly outpaced those of exports (20.2% yoy and 22.0% in 1H04, respectively). As a result, the trade deficit continued to widen (by 27.8% yoy in 1H04), contributing to a worsening of the CA deficit (3% of GDP in 1H04, 25.3% higher than in 1H03). The government expects to cover up to 70% of the deficit by growing FDI inflows. In 1H04, FDI inflows reached EUR 1.16 billion (more than 45% higher than in 1H03) and will continue expanding given the large privatisation deals taking place in the second half of the year.

### **Bulgaria**

Bulgarian GDP accelerated to 6% yoy in 2Q04 (up from 5.3% yoy in 1Q04 and 4.3% in 2003), mainly fuelled by strong external demand. Exports and investments had the largest impact on GDP growth this quarter. Although the latter slowed from 21.4% in 1Q04 to a modest 6.3% in 2Q04 it is expected to rebound in the third quarter on the back of large FDI inflows. Foreign demand stimulated the two-digit growth rate of exports (10.9% yoy in 2Q04 compared with 8% yoy in 1Q04). Consumption

continues to slow at 4.2% yoy in 2Q04 (down from 5.2% yoy in 1Q04 and 6.6% yoy in 2003).

In 2Q04, the trade deficit narrowed due to an improved export performance and decelerating imports (11.3% yoy in 2Q04, down from 17.7% yoy in 1Q04). Positive developments in foreign trade and an improvement in the current transfers surplus in 2Q04 and at the beginning of 3Q04 resulted in an 18.4% yoy reduction in the CA deficit during January-July, equivalent to 3.7% of forecast full-year GDP (5% of GDP in the corresponding period last year). The current strong performance and expected balanced growth rates of both exports and imports (high oil price risk to foreign trade development should be offset by strong external demand for metals) may result in an almost one percentage point reduction of the previously estimated full-year CA deficit at 8-8.5% of GDP. Worries about the still considerable CA deficit have been somewhat lessened by the expansion of FDI inflows. The net inflow of FDI reached EUR 1.3 billion in January-July 2004, up 68% yoy. <OP>

## **CIS**

- **Russia still strong**
- **Record high growth in Ukraine**
- **CPI inflation on the rise**

### **Russia**

The Russian economy continues to develop strongly. A banking crisis and government pressure on Yukos created some turmoil on financial markets, but with no effect on the real economy so far. In the second quarter of 2004 the Russian economy recorded 7.4% yoy GDP growth. External demand for oil and gas, increasing household consumption and strong investment are the main growth factors on the demand side. The outstanding upswing in world commodity prices appears to be extremely beneficial for the resource-exporting Russian economy. Household consumption was maintained following the expansion of household income – for April-June 2004, real income grew by 7.2% yoy. Increasing external and internal demand stimulated investments (gross capital accumulation surged by 15.6% yoy), which provided an additional growth impulse.

On the supply side, construction and communication appeared to be the most

dynamically developing sectors, with 14.6% yoy and 23.6% yoy growth in 2Q04, respectively. Industry hit 7.1% yoy in the second quarter of the year. The fuel industry (7.8% yoy for April-June 2004), chemical industry (8.6%) and machinery and metal-working (12.3%) were the driving forces of industrial development in 2Q04. Dynamics in these sectors were determined by world commodity prices and strong investment demand.

Thanks to a growing world economy and increasing oil and metal prices, Russian external trade is flourishing. In 2Q04, foreign trade volumes surged 29.7% yoy. Continuing upward dynamics of oil prices are fuelling Russia's export development, although also increase the risks of sharp slumps in the future. For April-June 2004, exports increased 31.4% yoy. Imports were stimulated by strong household consumption due to growing incomes – in 2Q04 imports grew 26.7% yoy. As a result the trade balance improved 37.6% yoy in 2Q04 and estimates of the first nine months of the year indicate a 30.9% yoy increase in the balance of trade to US\$58.1 billion. Russia has been trading most actively with other CIS countries: exports to these countries rose 39.7% yoy in 2Q04. However, trade relations with non-CIS countries are also booming – exports volumes grew 29.8% yoy.

Turmoil in the banking sector and conflict between the government and big business stimulated an outflow of capital from Russia. This was the main reason behind nominal rouble devaluation. The Russian rouble fell 0.9% qoq in 3Q04. The nominal devaluation trend mitigated, to some extent, real effective exchange rate appreciation to 6.6% yoy for eight months of 2004 (+7.4% yoy in 1H04). Capital outflow broke the accumulation of monetary reserves trend. From June to August 2004 reserves stock remained almost unchanged (around US\$88 billion), before strong upward dynamics of foreign reserves accumulation recommenced in September. At the beginning of October reserves had reached US\$95 billion.

The contraction in monetary aggregates appeared to be another consequence of the summer 2004 banking crisis. For July and August 2004 reserve money fell 5% compared to June 2004, the result of a decrease of reserve requirements. Subsequently, at the end of August a slight reduction (-0.7%) in the money supply (M2) was observed compared to June 2004.

Despite some decrease in the monetary base, inflation continues to accelerate, dampening otherwise bright prospects. The CPI, led by rising

prices of petrol and agriculture products, accelerated to 11.3% yoy in August 2004. Nominal rouble devaluation also contributed to the upward price dynamics. Producer prices continue to grow in line with world prices for oil, gas and metals – in August PPI increasing 25.5% yoy.

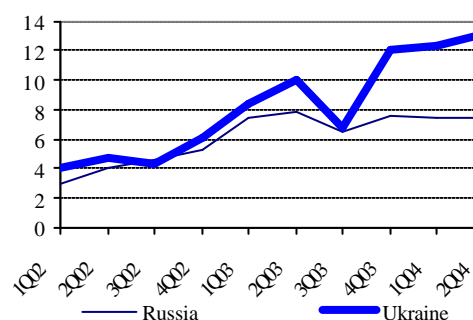
High export prices also positively influenced the federal budget. At the end of July 2004 the federal budget surplus was 5.8% of GDP. A so-called "Stabilisation Fund" will be created by the end of 2004 at the expense of the budget surplus. Provisionally, it is expected that the fund will accumulate about RUR 500 billion (~US\$17 billion) by the end of the year. Some of the resources from the fund will be allocated for external debt repayment and Pension Fund deficit financing. It is also believed that the fund could be used in the case of a slump in oil prices, thus protecting economic stability in the longer-term.

#### Ukraine

The Ukrainian economy continues to accelerate. GDP expanded 13.2% yoy in 2Q04 and provisional estimates show a record level of GDP growth of 13.6% yoy for January-August 2004. A good grain harvest and high prices of base metals are the main factors driving the accelerating growth rate.

On the demand side, private consumption (+15.3% yoy in 2Q04) and foreign trade - with a five-fold improvement in the trade balance in 2Q04 compared to 2Q03 – have been the main source of GDP growth. Investments and government consumption lagged behind. Gross capital accumulation dynamics decelerated to 4.3% yoy in 2Q04 (+23.3% yoy in 1Q04). The change in government consumption in 2Q04 was still negative (-0.2% yoy in 2Q04), as the government prepared for heavy expenses in 2H04 in the run-up to the presidential elections.

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



Source: National Statistical Agencies



On the supply side, construction (+30.6% yoy for April-June 2004), manufacturing industry (+15.5%) and trade services (35.1%) were the most dynamically growing sectors. Thanks to a strong grain harvest, agricultural production reversed the negative growth registered in 1H04 and hit 29.5% of yearly growth at the end of August – however, this high figure was simply the effect of a low statistical base in the summer of 2003.

The Ukrainian economy continues to benefit from favourable external market conditions. Strong demand for base metals and machinery products spurred growth of merchandise exports to 54.4% yoy in 2Q04 in US dollar terms. Investment demand and increasing household incomes in turn stimulated 27.0% yoy growth in merchandise imports in 2Q04. Russia and the EU remain the main markets for Ukrainian products. As a result of the first half of 2004, the trade balance of goods and services improved three-fold compared to 1H03.

An outstanding improvement in the trade balance and subsequent inflow of foreign currency stimulated a further appreciation of the hryvnia. In 3Q04, the national currency strengthened 0.28%, which appeared to be a significant fluctuation in the context of NBU policy of exchange rate stability. Inflow of foreign currency, coupled with NBU interventions on the forex market, guaranteed further strong accumulation of foreign reserves. Gross reserves amounted to US\$12 billion (equivalent to about four months of import) at the end of 3Q04.

The monetary base continued to grow (+37.2% yoy in 2Q04), mainly at the expense of NBU interventions on the forex market, while money supply developments were somewhat restricted by the monetary authorities – the M3 growth rate decelerated to 45.7% yoy in 2Q04. Accelerating inflation inclined the NBU to sterilise interventions - following a hryvnia issue the discount rate was raised and refinancing restrictions introduced.

World oil prices and undersupply of meat products, due to a decrease in the cattle stock, fuelled further inflationary growth. In 3Q04, the CPI hit 9.6% yoy, mainly due to an increase in food prices. Producer prices have been growing thanks to high world prices of minerals and metal products – the PPI surged to 22.2% yoy in 3Q04.

Impressive economic growth and upcoming presidential elections (autumn 2004) influenced budget figures during the preceding summer. High

GDP growth allowed for a revision of the state budget. A new, higher, state budget deficit (2.3% of GDP) is to be financed from privatisation revenues, which by August had already amounted to 2.7% of GDP. It is expected that revenues from privatisation will be about 3.0% of GDP for the year as a whole.

#### Other CIS economies

FSU countries continue to grow robustly, with 9-10% yoy of GDP growth on average in 1H04. Growth in Russia, led by high commodity prices, acts as the major factor underpinning the regional upturn. CIS growth is broadly based with strong private consumption, investments and external demand. Inflation continues to accelerate with the exception of Belarus and Tajikistan. In 1H04, CPI growth rates were in a range of 4-8% yoy. Belarus and Moldova continue to experience two-digit inflation. <DB>

#### Asia

- **Still strong regional growth, although domestic demand weakens**
- **Cooling in China still to come**
- **Japanese recovery continues**

Some cooling of the Asian economies was visible throughout 3Q04, although regional annual rates of growth remain at high levels, especially in China and India. Export growth remains the regional driving force and the Asian share of global exports increased in 1Q04. The highest gains were recorded by China, followed by Korea, India, Thailand and Singapore.

The high-speed expansion of the Chinese economy was still visible in 2Q04, when gross domestic product grew 9.6% yoy. Preliminary estimates suggest that there was no sign of cooling in 3Q04 either, with GDP annual dynamics close to 9%. Gross fixed investment was up 32% yoy in July and 26% yoy in August. Investment is gradually decelerating – from over 40% yoy dynamics in 1Q04 – although a high base effect is in place in 3Q03, which means deceleration will not be as significant as in 2Q04. The trade balance moved into surplus in 3Q04 on the back of strong exports. Merchandise exports grew 33%-37% yoy in all three months of 3Q04, while the growth in merchandise imports fell to 22% yoy in September 2004. Imports of steel and petroleum in July-

August 2004 averaged 20% below their average 1H04 level. CPI inflation reached 5.3% yoy in July and August.

Indian GDP in 2Q04 expanded 7.4% yoy, after over 8% yoy growth a quarter earlier. Manufacturing production strengthened, growing 8% yoy. The growth in some service sectors, such as trade, transport and communications, was above 11% yoy. However, growth in agricultural output slowed down during the monsoon season in 2Q04 to 3.4% yoy. Consumer prices were on the rise, with September CPI annual inflation of 4%, as earlier expected.

### Japan

The growth figure of 4.2% yoy in 2Q04 confirms earlier hopes for the highest economic expansion in almost 15 years in 2004 as a whole. As in the previous quarter, when Japanese GDP expanded nearly 6% yoy, growth stemmed from private consumption, non-residential investment, exports and government consumption.

Personal consumption probably increased in 3Q04, as indicated by the annual growth in disposable income, propensity to consume and consumer confidence index for the period July-August 2004. However, it is possible that its growth on a yoy basis will be lower than in 2Q04. Individuals continued to spend more on durables (including cars) and on overseas travel in 3Q04. Business fixed investment should show similar dynamics to 2Q04, as indicated by the yoy growth in private sector machinery orders, strong expansion of capital goods shipments and orders received for construction during July-August.

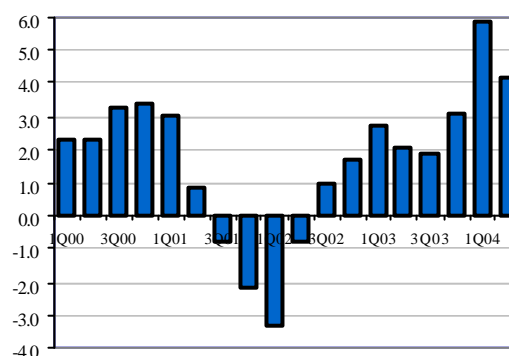
The growth of output in 3Q04 is also confirmed by the 5.9% yoy growth of industrial production in July and 9.7% yoy industrial output growth in August. In 2Q04, industrial production increased 7.4% yoy. There are also cautiously optimistic signals from the labour market. New job openings increased 10.5% yoy in July and 13.5% yoy in August and the number of employed increased in July and August by the same amount as during the whole of 2Q04. However, the unemployment rate in August was 4.8%, up on 2Q04 (4.6%).

Trade figures currently available give a mixed picture. Real exports fell -2.4% yoy in July and rose

0.8% yoy in August. Imports also fell in July, by -4.5% yoy, but rose much higher in August, by 2.3% yoy, probably reflecting industrial production growth. As a result, the trade surplus was reduced to yen 5.7 billion in August - it had been at a level of about yen 10 billion every month in the first half of the year.

Deflation continued in July-August 2004. Consumer prices decreased 0.1% yoy in July and 0.2% yoy in August. However, prices for domestic corporate goods indicated higher dynamics in 3Q04 than a quarter earlier. The domestic corporate goods price index was up 1.8% yoy in September 2004 (1.6-1.7% yoy in July-August), compared with 1.5% yoy growth at the end of 2Q04. We have maintained our view that deflation should come to an end relatively soon. <MJ>

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



Source: Bank of Japan.

### Latin America

- **Regional upturn based on domestic demand**
- **Prospects for 2005 weaker, although still favourable**
- **Argentina growing strongly, so far**

Prospects for Latin America remain favourable, although regional growth deceleration in 2005 is expected, mainly as a result of a downward revision to the US outlook. However, this year's average growth is expected to be 5-6%, with oil-exporting Venezuela scoring the highest. Domestic demand continues to underpin regional growth, with previously long-depressed personal consumption



now rebounding. Prospects for exports for countries such as Chile, Argentina and Mexico may be constrained by lower demand for metals and agricultural commodities, as well as by slower growth in US demand.

Brazilian GDP expanded 5.8% yoy in 2Q04. The growth looks broadly based, with not only strong exports (up 16.5% yoy), but also intensive investment and rebounding consumption. Industrial production grew 13% yoy in August. Annual inflation is decreasing gradually from over 10% at its peak in 2002, but at a rather slow rate. Consumer prices grew 7% yoy in September 2004.

Domestic demand grew 7% yoy in Argentina in 2Q04. While exports remained almost stagnant compared to the previous year, consumption was up 8.1% yoy and fixed investment increased 38.3% yoy. There has been fiscal adjustment both at the central and at provincial levels and a primary surplus of over 4% of GDP was reached in 1H04. In August 2004, the government decided to suspend its agreement with the IMF. Up to then Argentina had passed two IMF reviews and had been in the position to meet quantitative targets rather easily. The reason for the delay was lack of movement on legislation encouraging local governments to collect tax revenues. The next negotiations with the IMF on new targets will take place in early 2005.

Mexico's economy continued its upward path, growing 3.9% yoy in 2Q04. Manufacturing production remained strong, with output expansion in the range of 4-5% yoy in each month of 2Q04. CPI inflation was on an upward trend throughout 2Q04, reaching 5.2% yoy in September. Inflation rates are expected to fall in the coming months. <MJ>

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## Central Banks Watch

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- Gradual monetary tightening in the US
- ECB on hold
- Rates rising in some CEE economies

US rates were increased in August, September and November, by 25 points each time, bringing the funds rate to 2.00%. The Fed justified its decisions

with reference to signs that the economy was growing at a firm pace and on improving labour market conditions. Given the moderate inflation and contained inflationary expectations, a policy of very gradual monetary tightening is expected to continue, though there is little guidance as to the precise timing of next policy moves.

In line with expectations, the ECB has not decided to introduce any changes to its monetary policy stance. The bank appears confident that interest rates at their present low level are appropriate given the prevailing economic conditions. Euro-zone inflation has remained above the 2% ceiling mostly on the back of rising oil prices, but the risks of this feeding into wages and thus threatening the medium-term inflation outlook appear so far to be limited. Given the current outlook, interest rates can be expected to stay unchanged well into 2005.

The Bank of England opted for a 25 point rate increase in August. The market appears to think rates have now peaked, though bank comments in mid-October suggest there may be more to come.

Central Bank	Official interest rate	Current	Last change
US	Federal funds	2.00	10 Nov 04
Japan	Overnight call	0.00	19 Mar 01
ECB	Refi	2.00	5 Jun 03
England	Repo	4.75	5 Aug 04
Czech Rep.	2-week repo	2.50	27 Aug 04
Hungary	2-week repo	10.50	19 Oct 04
Poland	2-week repo	6.50	26 Aug 04

Source: Central banks.

Mixed tendencies were observed in the CEE region. Rates were gradually increased in the Czech Republic (a 25 point increase in late August) and Poland (a 25 point increase in late July). The National Bank of Slovakia has kept rates constant. The situation in Hungary is distinct in that rates remain at very high levels following drastic increases in 2H03. The trend is thus towards rate cuts, although even after the 50 point cuts in August and October the base rate remains very high at 10.5%. <WP>

## Exchange Rates

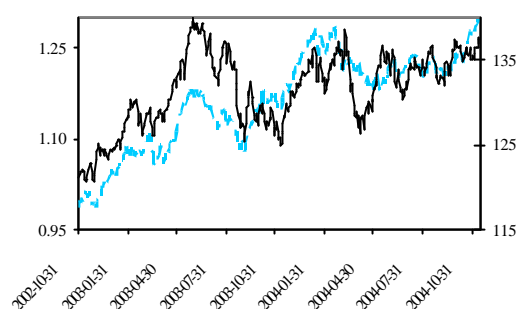
- **Stabilisation of major currencies' exchange rates...**
- **... followed by weakening of the dollar**
- **Zloty appreciation**

The period from mid-June to mid-October was characterised by a stabilisation of the major currencies' exchange rates. The euro-dollar rate oscillated in a narrow range of 1.2-1.24 dollars per euro. The Japanese yen followed a horizontal trend, with most oscillations not exceeding 2% above or below the 134 yen per euro average over the last 4 months. Such stability and low volatility of exchange rates is somewhat unusual compared to what had been the case over the last few years. However, from mid-October the dollar lost ground against both the euro and the yen, depreciating some 5%. We foresee the dollar remaining weak against the euro in late 2004 and next year with a 2005 average of around 1.27 dollars per euro.

The zloty continued its appreciative trend, reaching its strongest levels against the euro since mid-2003 in late October and early November. A stronger

economic upturn, gradual interest rate rises, reduced political risk and market preparations for large-scale privatisation offers in early November all contributed to this. The Hungarian forint's exchange rate, after some strengthening in August, has remained broadly stable ever since. The Czech and Slovak korunas have both remained very stable against the euro for the last few months, although the Slovak currency strengthened somewhat in early November, hitting an all-time low against the euro. <WP>

**US\$ and yen exchange rates against euro, Nov 2002-Nov 2004**



— Yen per EUR (right scale) — US\$ per EUR (left scale)  
Source: ECB.

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

	1999	2000	2001	2002	2003	2004 <sup>f</sup>	2005 <sup>f</sup>
Dollar	1.066	0.924	0.896	0.945	1.131	1.24	1.27
Yen	121.3	99.5	108.7	118.1	131.0	131.4	133.4

Note: f – forecasts.

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

## Commodity Prices

- **Oil and metal prices hitting record highs**
- **Gold prices again on upward path**

### Oil

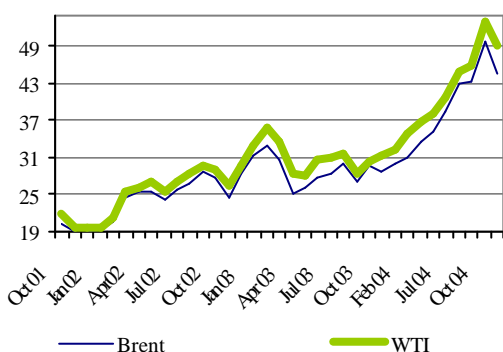
In 3Q04, oil prices jumped to an average of US\$41.39 per barrel of Brent. This is nearly 17% above the 2Q04 level and a 45% increase from a year ago. The upward surge continued in early October, with Brent surpassing US\$50 per barrel, an all-time nominal record. In real terms, prices

reached levels from the period of the 1990 Gulf war, though this was still well below record-highs from the late 1970s and early 1980s. In late October and early November, prices eased visibly with Brent trading below US\$45. Market developments are driven by a combination of fundamental factors: a strong demand rise in an environment of very limited spare supply capacity and a series of short-term disruptions and/or news on possible disruptions to production and refining due to tense political situations in Nigeria, Russia and Venezuela, sabotage in Iraq and hurricanes in the Gulf of Mexico and in the US. Such a situation creates perfect conditions for speculative actions on

the market and, indeed, part of the price surge can only be explained by such speculative activity of market participants.

The International Energy Agency has continued to revise upward its 2004 demand growth forecasts and currently sees global demand rising 2.8 mb/d from last year to 82.4 mb/d. This is the fastest consumption increase in 28 years and it comes totally unanticipated. Nearly one third of this demand rise is expected to come from China, with also strong increases from the US, other Asian economies and EU countries. At the same time, the IEA trimmed its 2005 forecast, as high prices should finally feed to demand. In particular, it is expected that the dynamics of Chinese demand will be more moderate. On the supply side it is now apparent that refining capacity will remain a bottleneck for some time to come. <WP>

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



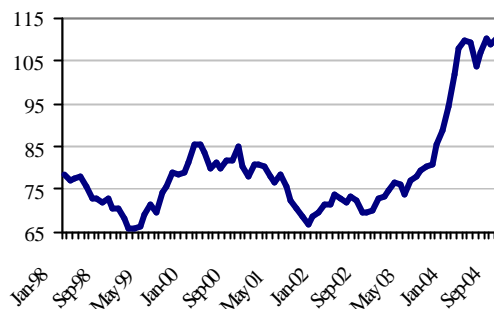
Note: November prices are from the first half of the month  
Source: US Energy Information Administration

### Metals

In 3Q04, the IMF metal price index was at a stable level. It seems that world metal prices reached their ceiling, although there are no evident reasons for a slump in prices in the immediate future. Demand is strong and supply tight. Global recovery continues to stimulate domestic consumption of the main metal product exporters. A further increase in world

demand for metals in 2005 is expected, though growth in metal consumption will be not as strong as in 2004. Experts anticipate a decline in prices as soon as new Chinese mills start operating.

**Composite metal price index, 1998-2004**

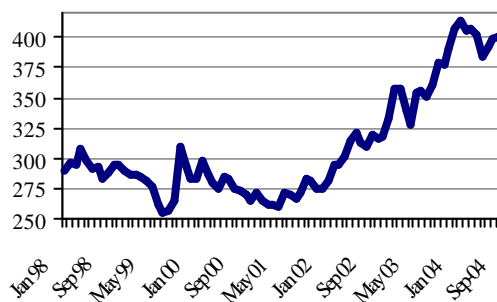


Source: IMF

### Gold

Gold prices continue to move upwards. In September gold prices returned to their level from February 2004. Upward dynamics of prices are mainly stimulated by the weakening of the US dollar after Fed chief Alan Greenspan's statement on prospects for the US economy. Increasing prices of oil, hampering US growth, and continuing geopolitical instability will not allow gold prices to decline in the immediate future. <DB>

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



Source: Pacific FX Database.

### Statistical Appendix

	2001	2002	2003	3Q03	4Q03	1Q04	2Q04	July	August	September
<b>GDP, % yoy change</b>										
US	0.8	1.9	3.0	3.5	4.4	5.0	4.8	..	..	..
Japan	0.4	-0.4	2.7	1.9	3.1	5.9	4.2	..	..	..
EU	1.7	1.0	0.7	0.5	1.0	2.0	2.3	..	..	..
UK	2.1	1.6	2.2	2.2	2.9	3.4	3.6	..	..	..
Euro-zone	1.5	0.9	0.4	0.3	0.7	1.7	2.2	..	..	..
Germany	0.8	0.2	-0.1	-0.3	0.2	1.5	2.0	..	..	..
France	2.1	1.2	0.5	0.4	1.0	1.6	2.8	..	..	..
Czech Rep.	3.1	2.0	3.1	3.3	3.3	3.5	4.1	..	..	..
Hungary	3.8	3.5	2.9	2.9	3.5	4.2	4.0	..	..	..
Poland	1.0	1.4	3.7	4.0	4.7	6.9	6.0	..	..	..
Russia	5.1	4.7	7.3	6.5	7.6	7.5	7.4	..	..	..
Turkey (GNP)	-9.5	7.8	5.8	5.5	6.1	10.1	13.4	..	..	..
<b>CPI, % change yoy</b>										
US	2.8	1.6	2.3	2.2	1.9	1.8	2.9	3.0	2.7	2.5
Japan	-0.7	-0.9	-0.3	-0.2	-0.3	-0.1	-0.3	-0.1	-0.2	..
EU15	2.5	2.0	2.0	1.9	1.9	1.6	2.1	2.1	2.1	..
UK (HICP)	1.2	1.3	1.4	1.4	1.3	1.3	1.4	1.4	1.3	1.1
Euro-zone (HICP)	2.3	2.3	2.1	2.1	2.1	1.7	2.3	2.3	2.3	2.1
Germany (HICP)	1.9	1.3	1.0	1.0	1.2	1.0	1.9	2.0	2.1	1.9
France (HICP)	1.8	1.9	2.2	2.1	2.4	2.0	2.6	2.6	2.5	2.2
Czech Rep.	4.8	1.8	0.1	-0.1	0.8	2.4	2.6	3.2	3.4	3.0
Hungary	9.2	5.3	4.7	4.7	5.4	6.8	7.3	7.2	7.2	6.6
Poland	5.5	1.9	0.8	0.8	1.5	1.6	3.3	4.6	4.6	4.4
Russia	21.6	16.0	13.5	13.3	11.9	10.8	10.2	10.5	11.3	11.4
Turkey	54.4	45.0	25.3	25.1	19.5	14.1	9.3	9.57	10.04	9.0
<b>Short-term interest rate, %</b>										
US	3.69	1.73	1.15	1.07	1.10	1.05	1.25	1.57	1.68	1.86
Japan	0.12	0.06	0.04	0.04	0.03	0.03	0.03	0.03	0.03	..
UK	4.97	3.99	3.67	3.50	3.86	4.11	4.51	4.79	4.89	4.87
Euro-zone	4.26	3.32	2.34	2.14	2.15	2.06	2.08	2.12	2.11	2.12
Czech Rep.	5.17	3.55	2.28	2.12	2.07	2.06	2.18	2.47	2.57	2.72
Hungary	10.80	8.91	8.22	9.48	10.38	12.44	11.49	11.46	11.22	11.00
Poland	14.85	8.71	5.38	5.01	5.21	5.27	5.51	5.85	6.58	..
Russia	10.00	12.40	5.40	4.30	4.70	3.00	3.10	4.10	2.20	..
Turkey	59.00	44.00	26.50	33.20	26.50	24.49	22.00	22.00	22.00	20.53
<b>Unemployment rate, %</b>										
OECD	6.5	7.0	7.1	7.2	7.1	7.0	6.9	6.9	6.9	..
US	4.7	5.8	6.0	6.1	5.9	5.6	5.6	5.5	5.4	..
Japan	5.0	5.4	5.3	5.2	5.1	4.9	4.6	4.9	4.8	..
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	4.9	4.9	4.7	4.7	4.7	4.7	..
Euro-zone	8.0	8.4	8.8	8.9	8.9	8.9	9.0	9.0	9.0	..
Germany	7.8	8.6	9.3	9.7	9.6	9.7	9.8	9.9	9.9	..
France	8.5	8.8	9.4	9.5	9.6	9.5	9.5	9.6	9.6	..
Czech Rep.	8.0	7.3	7.8	8.0	8.2	8.5	8.5	8.5	8.5	..
Hungary	5.6	5.6	5.8	5.7	5.8	5.9	5.9	5.9	5.9	..
Poland	18.5	19.8	19.2	19.2	19.1	19.1	18.9	18.8	18.7	..
Russia	8.7	7.1	8.6	7.9	8.6	8.0	8.1	7.1	7.4	..
Turkey	8.4	10.3	10.5	9.4	10.3	12.4	9.3	..	..	..

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 11 November 2004. Additional information is available upon request. Please contact CASE at [global.economy@case.com.pl](mailto:global.economy@case.com.pl).

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