



World Bank EU-8 Quarterly Economic Report January 2005¹ Part II

EU-8



POLAND

Political update

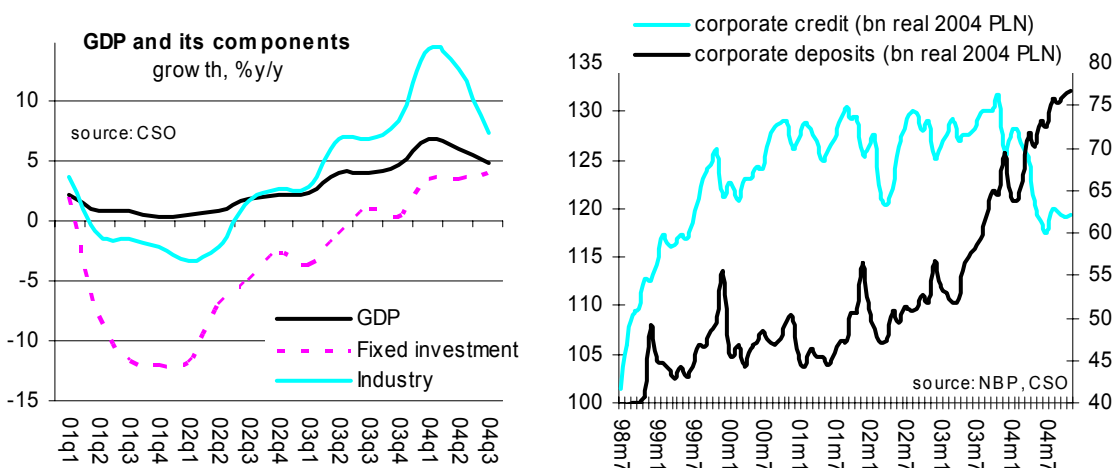
PM Belka obtained a confidence vote from parliament in October bringing needed stability onto Poland's political scene. The government has been able, although with difficulties, to secure parliamentary majority for important issues, including the 2005 budget. The government should work relatively undisturbed until the next elections, expected in mid-2005, while political parties will be preparing their campaigns.

On the left side of the political scene reshuffles are likely, reflecting an effort to form a unified election block, while center and right wing parties will try to defend their current holdings of popular political support. Political preferences will likely be shaped by two major factors: the improving economic conditions and the unfolding case before the parliamentary investigative commission on the privatization of the Polish oil sector.

The government in January submitted its draft National Development Plan for consultations. The plan will be finalized by the new government after elections and eventually form the basis for use of EU structural funds during 2007-13.

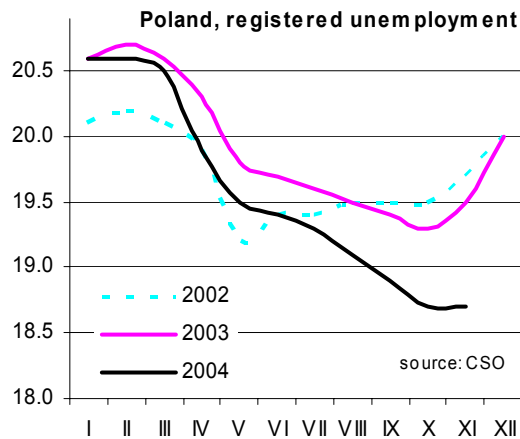
Macroeconomic developments

Output growth decelerated in the second half of 2004 as domestic demand growth slowed. Total consumption slowed to 2.9% and fixed investment inched up to 4.1% yoy, in the third quarter. A more sustained recovery in investment is still pending despite capacity utilization at the highest level ever (most recent estimates put it at 80.7% against a low of 73.3 in the first quarter of 2002) and high corporate profits and liquidity. Corporations should have enough resources and credit potential to sustain at least 10-15% fixed investment growth for the next couple of years. However, investors appear to be awaiting further stabilization of the business and political environment.

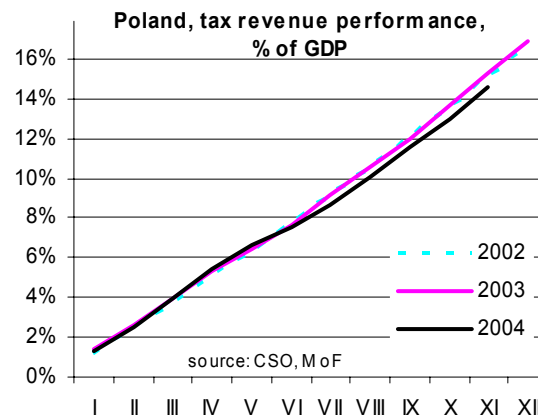
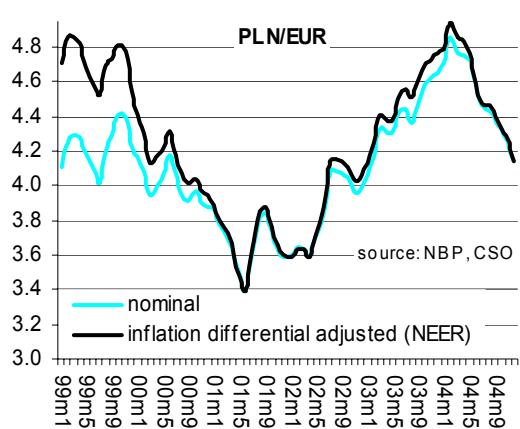


¹ This report is based on information available through end-December, 2004.

Unemployment is slowly coming down, visibly diverging from the pattern of the past two years. With the unemployment rate at 18-19%, estimates of structural unemployment of at least 10% and a natural rate possibly between 4-5%, the reservoir of a available labor could possibly have shrunk to as low as 3-4% of the labor force.



The recent sharp appreciation of the zloty helped stabilize inflation with no need for further interest rate hikes in the last quarter of the year. CPI inflation stabilized at 4.5% yoy toward the end of 2004, and should decline to below 3% in the second half of 2005. The appreciation of the zloty reflects stronger fundamentals and represents a change from very favorable to neutral conditions as the rate is now around the average of previous years. Wage growth remains slow at around 3% yoy, and export growth and the current account balance remain strong.



Fiscal performance in 2004 was better than budgeted on the back of strong revenues. The deficit is estimated to have undershot by 4 bn PLN. Revenues evolved more or less in line with stronger than expected output growth, while expenditures were held at budgeted levels. Nevertheless, the expansionary 2004 budget raised the deficit by 1.5% of GDP compared to the year before. The budget for 2005 initiates a much needed fiscal consolidation process, with the fiscal deficit targeted to decline by nearly 2% of GDP.

The good macroeconomic performance allowed Poland to place 3bn in Euro-denominated bonds in January 2005 with a maturity of 15 years and a spread of 27 bps. Poland plans to use the proceeds for early repayment of more expensive Paris-Club debt.

Reform efforts

Approval of further elements of the Hausner plan stalled in the last quarter of 2004. Most importantly, the reform of the farmers' pension system (KRUS) remains on the agenda. Also, plans to unify the VAT have apparently been put on hold. KRUS reform means higher social security contribution for farmers, and VAT rate unification means higher food prices, both highly sensitive political issues.

Table II. 1. Performance of Hauser program (general government, % of GDP)

	2004	2005	2006	2007
Savings in total expenditure	0.06	0.79	0.62	0.93
1. not requiring legislative changes (reduction in administrative costs)	0.01	0.05	0.07	0.07
2. requiring legislative changes	0.05	0.74	0.55	0.87
a) approved by the Parliament	0.00	0.60	0.39	0.67
<i>changes in defining the level and in indexation of retirement and disability pensions</i>	<i>0.00</i>	<i>0.42</i>	<i>0.12</i>	<i>0.33</i>
<i>changes in the rules of financing national defence requirements</i>	<i>0.00</i>	<i>0.14</i>	<i>0.15</i>	<i>0.16</i>
<i>changes in the rules of granting pre-retirement benefits</i>	<i>0.00</i>	<i>0.05</i>	<i>0.12</i>	<i>0.18</i>
b) in the legislative process	0.04	0.14	0.16	0.20
<i>changes in the system supporting employment of the disabled</i>	<i>0.04</i>	<i>0.05</i>	<i>0.03</i>	<i>0.02</i>
<i>other</i>	<i>0.00</i>	<i>0.08</i>	<i>0.14</i>	<i>0.17</i>
Total additional revenues	0.07	0.71	0.76	0.75
1. not requiring legislative changes:	0.00	0.40	0.39	0.38
a) restructuring of Polish State Railways	0.00	0.04	0.04	0.04
b) broadening of the tax base	0.00	0.35	0.35	0.34
2. requiring legislative changes:	0.07	0.31	0.37	0.36
a) approved by the Parliament	0.07	0.04	0.04	0.04
<i>restructuring of the hard coal mining</i>	<i>0.07</i>	<i>0.04</i>	<i>0.04</i>	<i>0.04</i>
b) in the legislative process	0.00	0.27	0.33	0.33
<i>additional actions</i>	<i>0.00</i>	<i>0.17</i>	<i>0.17</i>	<i>0.17</i>
<i>changes in the pension system for farmers including, inter alia, modified rules of social contribution payments by farmers</i>	<i>0.00</i>	<i>0.10</i>	<i>0.10</i>	<i>0.10</i>
<i>other</i>	<i>0.00</i>	<i>0.00</i>	<i>0.06</i>	<i>0.05</i>

Source: Convergence program, November 2004

At the same time, privatization efforts received a boost with the sale of a minority share in the largest state-owned bank (PKO) in November 2004 and the planned sale of the state insurance company PZU in 2005.

World Bank activities

The World Bank has been discussing a Country Partnership Strategy for Poland for the period 2005-2007, both with the government and other interested parties. It is also conducting an update of Accounting and Auditing as well as Corporate Governance Reports on Observance of Standards and Codes (ROSC). In its support for judicial reform in Poland, it has further initiated the analysis of contract and property rights enforcement.

Support of the coal mining sector reform continues with progress at a slower pace than anticipated, in particular in terms of labor retrenchment and privatization, largely due to a buyout market and prices. Following a successful implementation of its support for GDDKiA's road maintenance program in 2004, which saw an improvement of road in good condition from 40% to 46%, a follow-up EUR100M operation to support the 2005 maintenance program is in final stages of preparation with final approval expected at the end of March. An USD11m GEF grant was also signed in November to stimulate market-based investment in energy efficiency improvements.



HUNGARY

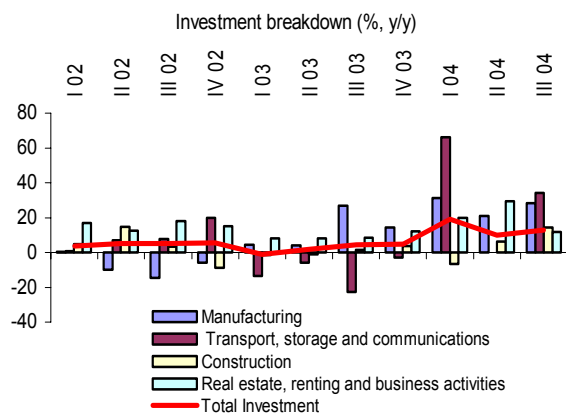
Political update

Opinion polls showed an increase in the support level of the ruling Socialist Party after the new PM Gyurcsany took office. The polls indicate that the government coalition has roughly the same support as the main opposition party Fidesz.

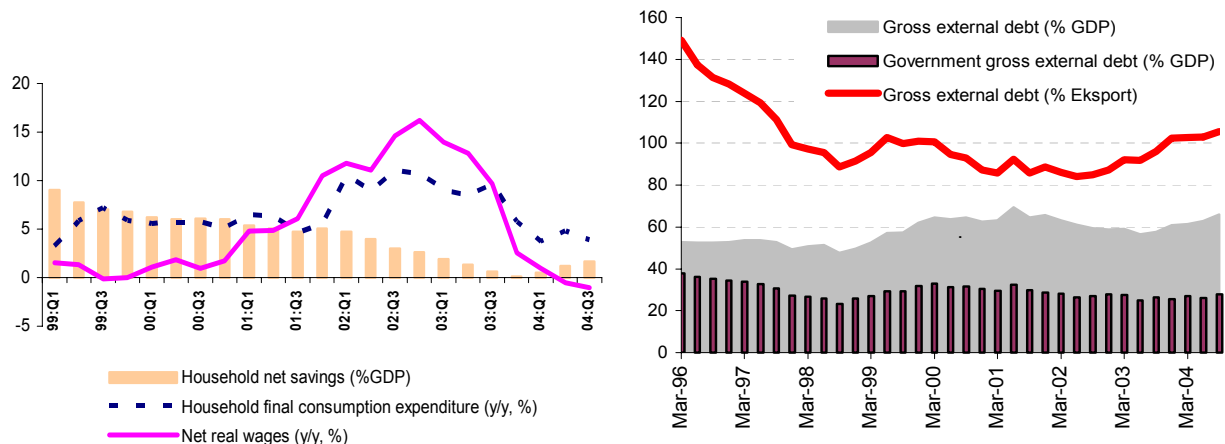
The Hungarian Parliament approved amendments to the Central Bank Law, which were prepared by the ruling coalition. According to the new law, the central bank's Monetary Council will be expanded to 13 by 2007, and the Prime Minister will have the right to nominate four persons to the rate-setting body. Based on an early version of the proposal, the European Central Bank had voiced concerns about what appeared to be an attack on the independence of the central bank and breach of the Acquis Communautaire, but the ECB seemed to accept the final somewhat modified version of the law.

Macroeconomic developments

Output growth slowed in the second half of 2004 mainly due to slower consumption and export growth. Output expanded by 3.7% in Q3-2004, down from 4.0% in Q2 2004 and with decelerating dynamics quarter by quarter during the year. Investment remains the key growth driver, up nearly 13% and contributing 3.25 pp to growth in Q3 (of which 3 pp gross fixed capital formation alone). A rebound of investments in machines and equipment supports future export growth. The sector breakdown of investment reveals strong expansion in transport, storage and communications as well as manufacturing investment (mainly electrical and optical equipment). Also, investments in construction retained its strong growth fuelled by the extensive motorway building program of the government. At the same time consumption growth slowed to less than 3% yoy due to slowing real wage growth, reductions of government preference schemes on home loans and a drop in government expenditure. Net export performance disappointed again, with export growth decelerating significantly to 10% yoy in Q3 from 18-19% in H1.



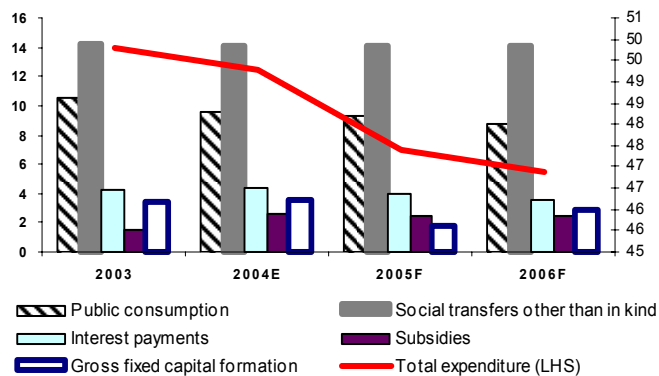
The current account continues to be the weakest part of the economy. The CA deficit for the first nine-months of 2004 amounted to over 9% of GDP. While the trade gap shrank in Q3, the income and tourism balance deteriorated. At the same time, however, non-debt generating financing increased to 80% of the current account gap in the third quarter triggered by higher FDI inflows which reached 3.4% GDP in the first nine months of the year. External debt is on the rise, but the state's share in it is increasing more slowly. A rough estimate of the debt stabilizing current account deficit is around 6% of GDP.



Inflation is slowing. After fluctuating just above 7% in the second quarter, CPI inflation fell to 5.5% in December. Meanwhile, the “constant tax inflation rate” dropped to 3.5% and core inflation to 5.0%. Monetary easing continued, with further cuts in interest rates of 150bps in the last quarter (for a total of 300 bps in 2004). The decline in inflation reflects currency appreciation, slowing household consumption and wage growth, and tighter government spending.

Fiscal policy remains a key credibility issue. During 2004 the government revised upwards the fiscal target twice to 5.3% of GDP from an initial level of 3.8% of GDP (or 3.1% of GDP adjusting for the effect of pension reform). Even this higher fiscal target is estimated to have been met only through additional measures of around 1.8% of GDP in 2004 and arbitrary postponement of expenditures into 2005. This notwithstanding, expenditures (as a share of GDP) are estimated to overrun the budgeted level by nearly 2% of GDP, while revenues—despite greater than expected VAT losses after accession and greater uses of tax credits in PIT—will be higher than projected in the budget by 0.4% of GDP. On the positive side, the fiscal position improved by roughly 1.2% of GDP in comparison to 2003, reflecting equally stronger revenues and lower expenditures (each by 0.5% of GDP). The budget for 2005 targets a further reduction in the deficit to 4.7% of GDP (3.8% of GDP adjusting for pension reform). Expenditure would be curtailed by 1.9% of GDP through more effective staff management within the public sector, a 5.5% nominal reduction in expenditure appropriations of central budgetary institutions, introduction of zero-base budgeting for chapter managed appropriations (0% growth in nominal terms), and implementation of infrastructure projects under PPP schemes (both capital and current spending will decline by 1% of GDP).

General government expenditure % GDP



source: CP, December 2004

Additional safeguards have been built into the 2005 budget, but risks remain. A special reserve amounting to 0.5% of GDP has been created and new procedural safeguards will be introduced (e.g. imposing a ceiling on appropriation of normative subsidies for social and public education purposes, introduction of possibilities for blocking, reducing or canceling appropriations by government, introduction of obligation for maintaining balance for extra-budgetary funds, and stricter control on appropriations for pharmaceutical subsidies). By modifying the regulatory system the government intends to limit the risk of reallocation of appropriations to operational costs within the public administration. Despite these safeguards, there are risks that the deficit target will again be exceeded, on the basis of optimistic assumptions on GDP, consumption growth, the effect of tax changes, PPP schemes and the effectiveness of tightening measures that were introduced. Further planned tax cuts may also weaken revenues.

Reform efforts

Changes on the political scene and approaching elections have continued to hamper a greater push on the reform side. Nevertheless, some progress was made on privatization and fiscal management. On the other hand, there was little progress on other essential structural reforms, especially in health care and public administration.

Some progress was made in advancing the remaining privatization agenda. Privatization revenues in 2004 amounted to 1.8% of GDP, the third highest annual revenue ever. The State Privatization and Holding Company placed bonds convertible into Richter shares for the 25% state owned stake in the pharmaceutical company and sold part of its stake in leading oil and gas company MOL.

Some elements of fiscal reform were introduced and are planned for 2005. In 2004, the government adopted specific measures to enhance effective financial management of central budgetary institutions' expenditures and introduced a zero-base planning system for chapter-managed appropriations. For 2005, the government plans to implement new measures in order to strengthen fiscal discipline (e.g. tighter control on unused appropriations, financial processing during the year, and reduction in the number of automatically fulfilled expenditure appropriations).

The government also plans a new labor program. Parliament started debating the latest proposal to help invigorate Hungary's labor market, offering subsidies to employers that hire fresh graduates, mothers returning from maternity leave or unemployed over 50. The program offers special tax relief for employers who choose their staff from the specified groups. The government reimburses half of the employers' social security payments on gross wages up to HUF 90,000 a month, which translates into a maximum of HUF 13,050 monthly savings per employee.

In healthcare, limits were introduced for pharmaceutical subsidies, and system of risk allocation between producers and the government will be initiated. Further, performance volume limits were introduced to control expenditure on patient care. The government may submit its plans concerning the future of state-owned healthcare facilities to Parliament in the near future (a referendum to halt hospital privatization failed in December).

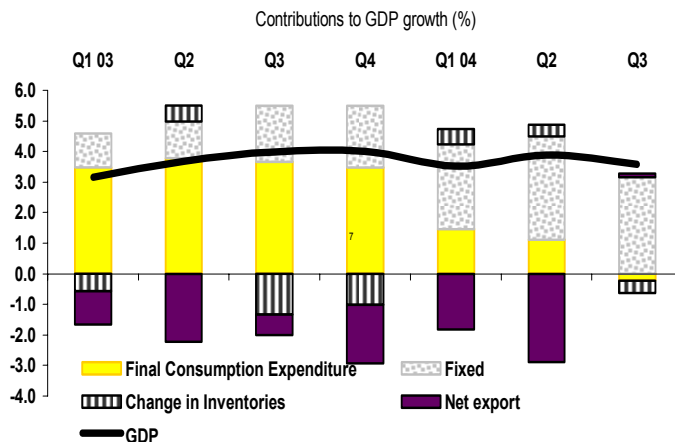


Political update

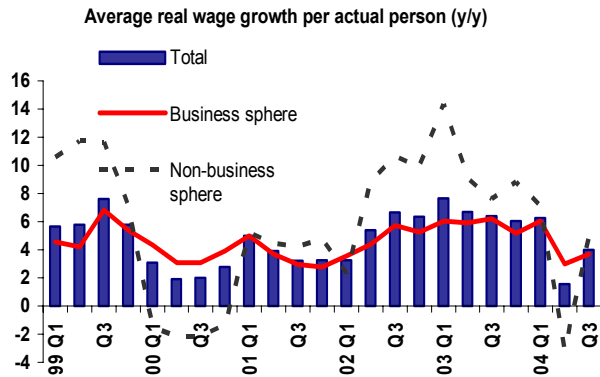
The government seems to have shifted its emphasis to structural reforms due *inter alia* to the perceived unpopularity of fiscal reforms proposed by the preceding government. Thus, recent efforts have concentrated on improving the business environment to attract FDI and active employment policy. Nevertheless, the ruling coalition fared poorly in regional and Senate elections in November, with the latter being won by the main opposition party Civic Democrats (ODS).

Macroeconomic developments

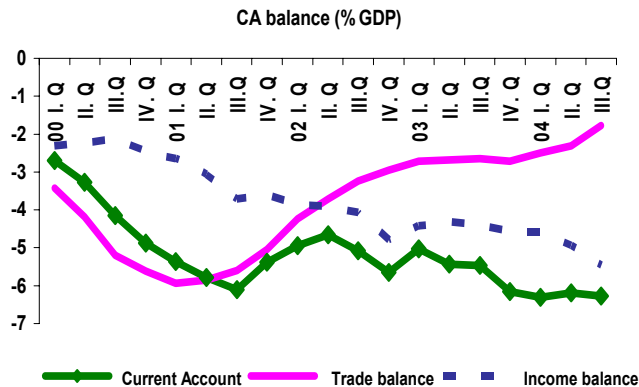
Output growth slowed in the third quarter of the year, and for 2004 is likely to be similar to 2003. For the first nine months of the year, output growth amounted to 3.7% yoy, the same pace as in 2003. In Q3-2004, real GDP growth slowed to 3.6% yoy (from 4.0% in the previous quarter) as a result of weaker consumption (mainly government). Meanwhile, fixed-asset investment and exports remained strong (up by 10% yoy and 23% yoy, respectively, in Q3), and net exports for the first time since 2001 contributed positively to GDP growth. On the supply side, industry made the largest contribution to growth, but agriculture also grew rapidly. The robust growth of new export orders and vigorous growth of capital investment in manufacturing bode well for continued export-oriented growth.



Inflation remained muted. CPI inflation slipped below 3% yoy in November, with underlying inflation hovering around 2%. The strengthening crown and falling inflation have served to tighten monetary conditions thus postponing potential further interest rate hikes. Wage growth remains moderate under pressure from rising unemployment. Real wage growth in Q3 was running at around 4% yoy, with civil servant salaries the most buoyant. Modest real wage growth should continue in 2005 year as the planned large increase in wages for the security forces was delayed and the government plans to freeze politicians' pay. Further, minimum wage growth will slow in 2005.



The current account deficit is stuck at a relatively high level. The current account deficit is running at just over 6% of GDP, with an improving trade balance offset by deterioration of the income balance reflecting higher transfers of dividends on direct and portfolio investment and rise in the volume of reinvested earnings. FDI inflows recovered to 4.5% of GDP in Q1-Q3 from less than 3% of GDP in 2003 manifesting both active government investment promotion and renewed privatization efforts.



Fiscal policy remains on track for slow, but gradual consolidation. The general government deficit in 2004 is estimated at 5.2% of GDP, similar to the outcome for the year before when adjusting for special factors that year. Tax reforms raised revenues by about 0.5% GDP in 2004. The budget for 2005 targets a further reduction in the deficit in 2005 4.7% of GDP, with expenditures set to decline by 1.8% of GDP and revenues projected to decline by 1.3% of GDP reflecting mainly tax changes (reduction in effective taxation of corporate profits, and tax relief for families with children). On the expenditure side, a number of discretionary measures were introduced to curb expenditure growth (limited wage growth, global reduction in all expenditure categories). As a result almost all expenditure items were impacted, with social subsidies, transfers, and government consumption declining the most. The main risks relate to potential costs of contingent liabilities (e.g. lease of 14 Gripen fighters).

The updated convergence program confirms the deficit reduction strategy from May 2004. According to this, the general government deficit would be contained to 3.8% of GDP in 2006 and decline to below the reference value in 2008.

Table II. 2 Additional Savings Measures Suggested by the Ministry of Finance

	2005	2006	2007
Reduction of social benefits expenditures	0.03	0.06	0.06
Reduction of state social support benefits	0.02	0.03	0.03
Reduction of expenditures on passive employment policy	0.03	0.06	0.06
Reduction of sickness benefits expenditures	0.07	0.06	0.06
Deferral of State Employees' Service Act	0.00	0.00	0.25
Elimination of the valorization mechanism and reduction of severance pay and retirement pay for members of army and police forces	0.00	0.13	0.17
Prolongation of freezing the salaries of constitutional officials, MP's, judges and state attorneys beyond the year 2006	0.00	0.00	0.04
Reduction of expenditure categories implemented in the state budget for 2005	0.09	0.08	0.07
Reduction of selected expenditure categories and global cut of 4 % in the state budget for 2006	0.00	0.49	0.43
Total	0.24	0.92	1.19

Source: staff calculations based on updated CP, November 2004.

Reform efforts

Fiscal reforms approved in late 2003 were implemented in 2004. The main changes were on the tax side, but there were also adjustments on the expenditure side (increasing efficiency of pension and health insurance systems, controlling wage growth, improving management of other expenditure categories). The medium-term expenditure framework for 2005 - 2007 includes additional policy plans for meeting medium-term fiscal targets. However, these remain largely of an administrative nature.

A new Act on Employment came into effect from October 1, 2004. This allows for the creation of private profit-oriented employment agencies, which may contract-out and enhance flexibility in the labor market. Also, the new Act focuses on extension of active employment policies (including a new possibility for employees to join the re-qualification process when they are assumed to lose their jobs soon). Amendments to the acts on material poverty and subsistence minimum are under preparation and their planned adoption with effect from 1 January 2006 should align the structure and construction of social benefits better with job-seeking incentives.

Further efforts to improve business conditions consisted of revamping cumbersome business registration procedures, reform of the judiciary system (the goal of which is to improve the functioning of courts, ensure faster and smoother court proceedings and the punish judges who neglect their duties), and tax changes (accelerated depreciation and increased R&D allowances).

The bulk of **privatization** proceeds in 2004 came from sale of a 63% stake in the oil company Unipetrol. Also, the government is going ahead with the long-planned privatization of the last national telecommunications operator in Central Europe (Cesky Telecom) and metallurgical firm Vitkovice Steel in 2005. At the same, however, the privatization plans for electricity conglomerate CEZ, Czech Airlines and the Czech Airport Authority appear to have been pushed back to beyond 2006.

An **amendment to the Act on Energy** in line with EU regulations became effective from January 1, 2005. This will further open up the electricity market and free up electricity prices. The Act introduces greater competition in the selection of the universal service provider and stipulate legal separation of distribution activities from production and/or trade by the end of 2006. In the gas sector, implementation of the amended Energy Act looks set to bring welcome increase in market access.



Political update

General support for the ruling coalition strengthened. In December, the ruling coalition received 38.8% in a poll organized by the Statistical Office, which is close to the maximum of 40.6% when it took over. The minority government (with 69 out of 150 MPs) has been able to secure approval in Parliament for major reforms and foreign policy issues, including EU negotiations with Turkey and the presence of Slovak soldiers abroad.

The budget for 2005 was also approved in December by 82 out of 150 MPs, even though only 69 MPs formally belong to the ruling coalition.

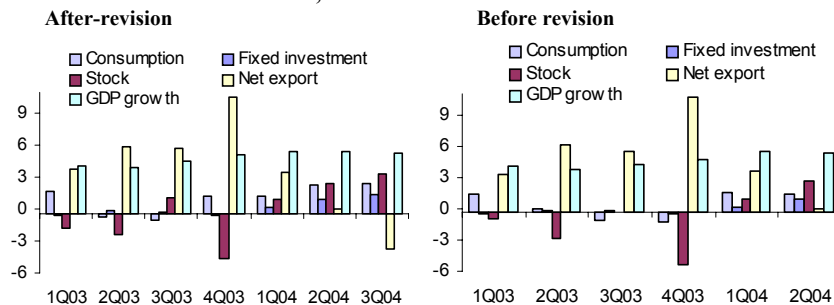
Ivan Šramko took over as Governor of the NBS in January. The decision-making Board of the Central Bank became more stable as it now consists of seven people of whom five will remain in their position until 2010 (one position remains vacant).

Macroeconomic developments

Macroeconomic developments remain favorable. In November 2004, the OECD published a positive Economic Outlook on Slovakia. In December, S&P upgraded Slovakia's rating from BBB+ to A-, the same level as Hungary and the Czech Republic.

Growth eased to a still robust 5.3% in the third quarter of 2004. While net exports contributed negatively by 3.7%, stocks and consumption continued to rise. Export growth at 15.3% was the weakest of the last four quarters. Real GDP revisions for the period since 2002 in December 2004 revealed higher output growth in 2003 and stronger contribution from consumption.

Panel. Contribution to GDP, December 2004 revision

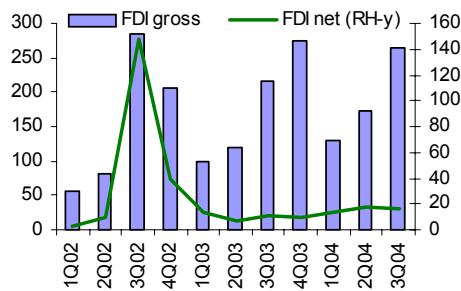


Source: Statistical Office of Slovak Republic and staff calculation.

Unemployment declined further. While the registered rate seemed to stabilize just below 13% in November, the LFS shows a reduction from 19.3% in Q1-2004 to 17.5% in Q3. However, unemployment is still slightly above its level one year ago. Meanwhile, the duration of unemployment continues to rise.

The current account deficit remains within comfortable margins, despite an increase in the third quarter to 2.4% of GDP. Estimates for 2004 deficit are in the 2.2-3.5% of GDP range. FDI picked up in 2004 to an estimated Euro 1.8 billion, although it was still lower than in 2002. Several new projects were contracted in the automotive sector, electronics and engineering.

Foreign Direct Investment, SKbn

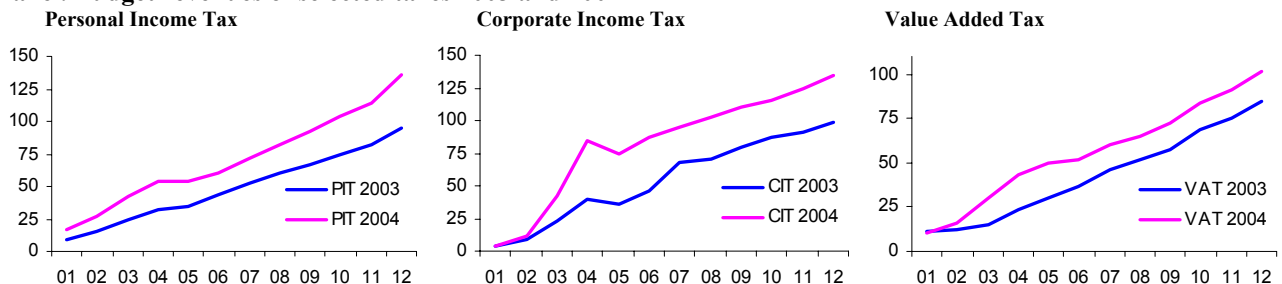


Quarterly. Source: NBS and staff calculation.

Inflation eased. CPI inflation in December declined to 5.9% yoy from a peak of 8.5 % in July. Core inflation remained at around 2. In December, the NBS announced its new monetary program for 2005-08 focused on “inflation targeting under ERM conditions”. While inflation targets for 2006-08 did not change (below 2.5% in 2006 and then below 2%), the target for 2005 increased from 2.4-3.3% to 3-4%. Despite further cuts in interest rates, several rounds of market intervention and relatively high inflation, the koruna continues to appreciate (5.5% yoy at end-December 2004).

The fiscal outcome for 2004 was better than expected on the back of strong revenue performance. State budget revenues exceed plans by 4.5% (while expenditures were raised only by 0.7%), reflecting better than expected personal income tax collections (36%), corporate income tax collections (35%) and value added tax (2%). The fiscal deficit in 2004 is estimated at 3.9% of GDP compared to 3.6% of GDP in 2003. The budget for 2005 targets a broadly unchanged fiscal balance with a fiscal deficit of 3.8% of GDP, but adjusted for pension reform the deficit would decline to 3.4% of GDP (the pay-as-you-go pillar revenue shortfall is projected at 0.4% of GDP in 2005, 1.0% of GDP in 2006 and 1.1% of GDP in 2007).

Panel. Budget revenues of selected taxes 2003 and 2004



Source: Ministry of Finance and staff calculation.

In December the International Center for Settlement of Investment Disputes ruled against the government in a long pending case with the Czech Bank, CSOB. The ruling obliges Slovakia to compensate CSOB with Sk25 billion by end-January 2005, which is about 1.9% of the Slovak GDP. The debt stems from a guarantee issued by the Slovak government in the early 1990s for bad assets taken over from CSOB by the Slovak consolidation agency. In 1996, the then government in Slovakia refused to acknowledge this debt. The plan is to use a combination of state financial assets, privatization revenues and 2005 state budget resources to pay the debt.

Reform efforts

Major changes in the operation of pension and health care systems started in January 2005. While the impact of the introduction of the 2nd pillar of the pension system will be a long run affair, implementation of the health care legislation is expected to bring improvements quickly.

The pension reform goes a long way toward improving the sustainability, adequacy, affordability, and robustness of the pension system. The long run deficit of the pension system is estimated to be reduced by more than 80 percent, although some further reform measures are needed in the future to ensure long-term viability. Pensions in the new system seem reasonably adequate with individuals who contribute receiving reasonable pensions. However, many people with incomplete work histories and widows who previously had access to the pension system will get small or no pensions from the new system. Adequate resources for a well designed social assistance system are critical to ensure that significant portions of the elderly population do not fall into poverty. The new funded pillar will receive 9% of the total 14% employer contributions, while employee contributions of 4% will continue to be directed to the PAYG system. Any current worker may choose to join the mixed system, but participation will be mandatory for all new entrants to the labor market.

Box II 1. Characteristics of Pension Reforms in the EU8

Nine other Eastern European countries have undertaken multi-pillar reforms to their pension systems: Bulgaria, Croatia, Estonia, Hungary, Kazakhstan, Kosovo, Latvia, Poland, and Russia. The design of each of the systems is different. Like many of the other countries, Slovakia has chosen to retain a first pillar which closely links contributions and benefits through the point system. In the case of Latvia, Poland, and Russia, the link between contributions and benefits is provided through a system of notional accounts. In Bulgaria, Croatia, Estonia and Hungary, a traditional defined benefit PAYG system is retained. Kazakhstan and Kosovo eliminated their first pillars. Slovakia is almost unique in having eliminated a minimum pension (Kazakhstan also does not provide a minimum pension to new entrants). The Slovak approach has been to use social assistance to address all re-distributional requirements while the pension system becomes a contribution-based instrument only.

Slovakia has one of the largest second pillars among the Central European countries. In every case but Hungary, the contribution collections are centralized (central collections and transfer of contributions to the private funds) as opposed to decentralized (direct collections of contributions by private funds). However, centralized collection has not been sufficient to lower costs in countries like Croatia.

Characteristic of Pension Reforms in EU8

Country	Starting Date	First Pillar	Target Retirement Age	Benefit Indexation	Size of second pillar as percent of payroll	Providers of Funded Pillar	Switching strategy to new system
Hungary Operating	January 1998	PAYG DB	62/62	50% prices-50% wages	6 percent	Private	Mandatory new entrants Voluntary others
Poland Operating	January 1999	NDC1/	60/65	80% prices-20% wages	7.2 percent	Private	Mandatory <30, Voluntary 30-50
Latvia Operating	July 2001 (NDC January 1996)	NDC	62/62	Mixed price/wage indexation	2 percent growing to 9 percent	Private and Public	Mandatory <30, Voluntary 30-50
Estonia Operating	July 2002	PAYG DB	63/63	50% prices-50% wages	6 percent	Private	Voluntary (opt-out +2 percent)
Slovakia Operating	January 2005	PAYG	62/62	50% prices - 50% wages	9 percent	Private	Mandatory new entrants Voluntary others

Source: The World Bank, Slovak Republic: Pension Policy Reform Note. September 13, 2004

1/ NDC is notional defined contribution, a system that has the same features as DC but is not funded.

The success of health care reform depends crucially on how effectively the new legislation will be implemented. The Slovak Parliament passed the six pieces of legislation that form the basis for Slovakia's far-reaching health system reform, which should result in better care, more satisfied patients and lower arrears. Secondary legislation is now needed to manage a smooth transition to the new system of care. Promoting competition wherever it is possible will be a major challenge.

In December 2004, the government announced its plan for the development of a competitive national economy in line with the EU's "Lisbon Strategy". The government strategy explicitly recognizes that structural reforms to promote a knowledge-based economy can only succeed if there is a strong macroeconomic foundation and structural reforms which focus on: (i) shared responsibility of an individual for his/her social situation, social policy that does not distort incentives of individuals to be active and creative, reduces absolute poverty, and maintains an effective social security network; (iii) maintenance of minimal health care and pension security for all while ensuring sustainable health care and pension systems. Specific development priorities consist of: (i) modern education policy, high employment rate and coping with demographic trends; (ii) IT literacy, e-government, and wide access to internet; (iii) improvement in the quality of research and development and public support of private innovation; (iv) enforcement of law, infrastructure and services in network industries, quality of public service, and effective access to capital market for all enterprises.

A new framework for bankruptcies was approved in December. Creditors' rights were enhanced and trustees became licensed. The goal is to shorten the duration of cases (currently 3-7 years), and increase the volume of revenues recovered (currently only 5-10%). The law should secure active behavior of related parties and make proceedings faster, increase responsibility and accountability, allow better restructuring of assets, make creditors' right coherent with other legislation, maximize the recovery rate and reduce corruption. The law on trustees deals with the large number of trustees in Slovakia (above 1,000 compared to 2,500 in Great Britain) and their professional skills. Trustees will be licensed by the Ministry of Justice, educated by licensed private companies, and monitored by the ministry and bankruptcy courts. The new framework will be financed both by the state budget and fees.

World Bank activities

A human capital technical assistance loan for Euro 5 million was negotiated in November. The Government intends to consolidate reforms undertaken to date and to couple them with forward-looking and mutually consistent employment and social cohesion policies in order to achieve a lasting decline in poverty and social exclusion. The loan will contribute to these objectives by developing the human resources involved in policy-making, strengthening the management systems and processes governing policy preparation and ensuring the capacity for evidence-based policy monitoring.

The World Bank, in cooperation with the Liberal Institute Foundation, organized on November 9 an international conference on Enterprise and Financial Sector Restructuring in Slovakia. The conference was organized under the auspices of the Slovak Ministry of Finance. Finance Minister Ivan Miklos and Roger Grawe, Country Director for Slovakia, were among the speakers at the conference. The conference was attended by around hundred people, representing the Slovak Government, financial market institutions, commercial banks, academics, international organizations, think tanks, and media.

Other

The IMF concluded its 2004 Article IV mission to Slovakia on November 10. The main recommendations were for the central bank to focus more on reducing inflation and to target a somewhat tighter fiscal stance in 2005 (adjusting for net transfers from the EU and pension reform costs, it is estimated that the budget implies a fiscal expansion of about ¼ percent of GDP in 2005).



SLOVENIA

Political update

Following parliamentary elections in October, which brought a victory to the centre-right Slovenian Democratic Party (SDS), a new coalition government (formed with New Slovenia - NSi) headed by Prime Minister Janez Jansa took office in December. The new government controls 49 seats in the 90-seat parliament. The main policy plans for 2005 include prudent conduct of macro policies in the ERM2, tax reform, and easier business conditions for SMEs.

Macroeconomic developments

Output growth slowed in the third quarter of 2004, but was high for the year as a whole. Real GDP growth decelerated to 3.9% yoy in Q3-2004 (from 4.6% yoy in the previous quarter) as investment growth weakened. The first nine months of the year resulted in output growth of 5.8% yoy. Employment is rising and the unemployment rate stabilized at 6.0% in the third quarter. Inflation, after falling for several months, rose to 3.6% yoy in November reflecting seasonal price increase of food, clothes, and shoes as well as the higher prices of oil, refined petroleum products and gas. There were downward pressures on the exchange rate through October, but this has since been reversed. Real wage growth is running at around 2% yoy, well behind productivity growth at around twice this rate. The current account deficit remained low at 0.3% of GDP in the first nine months of 2004. Meanwhile, the net financial outflow amounted to 2.5% of GDP. The fiscal deficit in 2004 is estimated at around 2.1% of GDP, slightly higher than envisaged in the May 2004 Convergence Program, due to the inclusion of the activities of two extra-budgetary funds within the general government and the change in the composition of expenditures and revenues in 2004. For the years 2005 and 2006, the general government's deficit figures will be 2.1% of GDP and 1.8% of GDP, respectively. The gradual decrease in the general government deficit will come from both cyclical factors and continuing expenditure restructuring. (Revenues are expected to decline by 0.5% of GDP by 2006, as a result of tax reform and impact of EU accession).

Reform efforts

Tax reform has become a hot political issue. The tax reform proposals submitted by the previous government—aimed at reducing taxes on labor and increasing taxes on capital—were criticized for risking to reduce fiscal revenues and endanger meeting the nominal convergence criteria, as well as providing an unclear and inconsistent legislative framework. While the tax reform has not yet been approved, it will reportedly be difficult to pull back. The government will monitor revenue developments closely.

A December 2004 **amendment to the Company Act** introduced international accounting standards for companies from January 2005 and for banks and insurance companies from 2007.



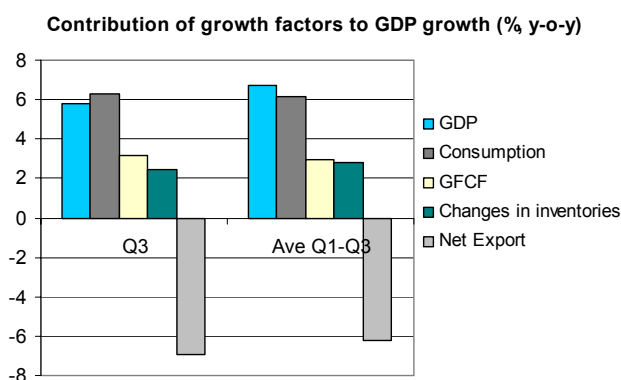
LITHUANIA

Political update

Following parliamentary elections in October 2004, a new government was formed in December through a four party alliance of the Labor Party, Social Democrats (LSDP), New Union/Social Liberals (NU/SL), and New Democracy Union. Algirdas Brazauskas (LSDP) remained Prime Minister in the new government. The current government will naturally face more challenges both political and economic. Contrary to the previous cadence, which was working within the narrow frames of accession to the EU and NATO road, the current will need to deal with meeting Maastricht criteria, and maintaining sustainable growth in order to diminish income gap between new and senior EU members.

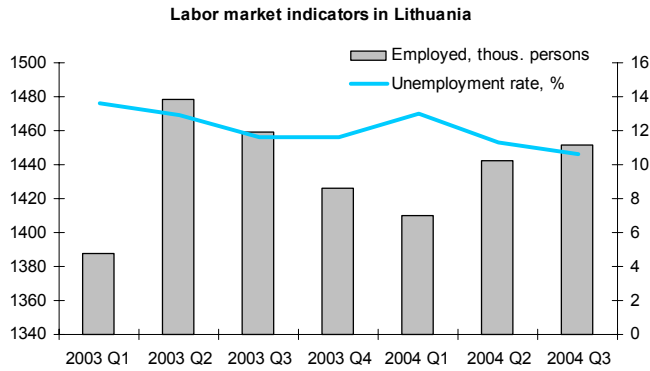
Macroeconomic developments

Output growth remains robust despite slowing in the third quarter of 2004. Though Lithuania's economic growth slowed somewhat in 2004, it remained well above the EU-8 average. In Q3 2004 real GDP increased by 5.8% yoy, resulting in 6.7% growth yoy over the first 9 months. Output growth continues to be led by consumption and to a lesser extent investment, while net exports continue to contribute negatively. On the supply side, all sectors are showing good dynamics with the exception of primary producers.



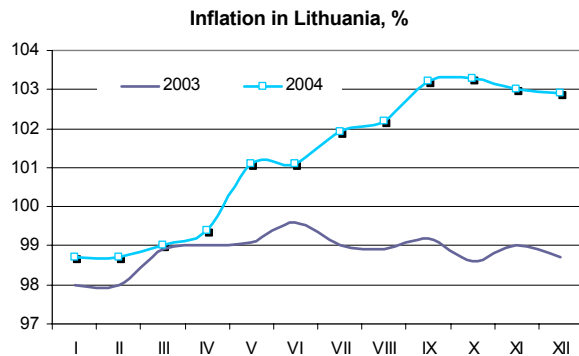
Source: CSO, staff calculations

Unemployment is receding rapidly and labor shortages emerging. The unemployment rate declined to 10.6% in Q3, the lowest rate since independence. Only agriculture and forestry are experiencing declining employment. In addition to rapid output growth, labor migration is playing a role. The migration boom, including of highly qualified labor, has unveiled the structural imbalances of the labor market, showing that there is not much room left for further declines in unemployment and potentially undermining medium-term growth prospects. A shortage of qualified labor has already imposed upward pressure on wages that over time may impact inflation.



Source: CSO of Lithuania

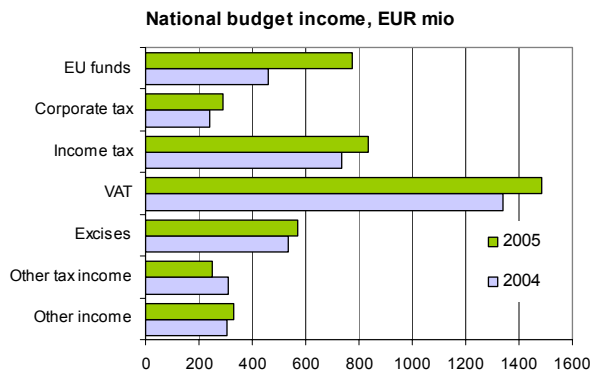
Inflation appears to have stabilized for the time being. The CPI index went up 2.9% yoy in December after spiking to 3.3% in October. The highest inflation was in health care and transportation. At the same time, record high world oil prices have put upward pressures on PPI (6.8% yoy in December).



Source: CSO

The current account deficit remains large despite strong exports. The current account deficit declined to 7.7% of GDP in Q3 (compared to 11.0% of GDP in Q2). While exports are growing rapidly, this reflects partly higher prices for mineral products. FDI inflow rebounded strongly in 2004, but remained relatively low compared to other EU8 countries (in per capita terms). On the positive side, the share of green-field investment has shot up with privatization-related FDI amounting to only 6.6% of total FDI

In 2004 the fiscal deficit is balancing on the edge of 3% of GDP. The budget for 2005 targets a deficit of 2.7% of GDP, but there are risks of slippage, bearing in mind co financial projects postponed for 2005 and repeal of the tax on roads in the second half of 2005.



Source: MF, staff calculations

Reform efforts

Reforms in recent years have focused on EU accession while less attention was given to sectors which were not that much covered by *Acquis* - mainly education and health.

The main reform initiative involved changes in the pension system. A small second pension pillar with mandatory private savings was introduced in 2004, and a third pillar with voluntary private savings was started from January 1, 2005. People have until July 1, 2005 to decide on whether they want to shift to the new, first and second pillar mixed system. The share of contributions redirected from the social security fund to the second pillar was 2.5% in 2004, rising by 1 pp every year to reach 5.5% in 2007.

Some important steps have also been taken to improve social protection. Unemployment benefits will become more generous from 2005, mainly through shortening of the necessary insurance periods, prolonging the duration of benefits, and linking benefits to the previous salary. Also, the lump sum birth allowance has been increased by 1/3, and the Government intends to gradually increase the maternity/paternity allowance from 70% to 100% of the salary received. Other plans include a gradual rise in the minimum monthly wage (from LTL 500 to LTL 600 in 2006), increasing the tax-exempt income minimum (in 2006 supposed to reach LTL 390, against current LTL 290), and base pension.

World Bank activities

Accession to the EU means a new stage in the relationship between the Bank and Lithuania, with a transition from a borrower-lender relationship to a partnership based more on analytic work and technical advice targeted at the key challenges Lithuania faces.

The ongoing lending program includes five active projects dealing with social policy community services, municipal development, Klaipeda Port and health and education reforms. Commitments for these projects total about US\$ 120, projects are performing well and are scheduled for completion by June 2006.

The Bank's non-lending work program includes a recent Education Financing Policy Note, Rural Finance Note, Trade and Transport Facilitation Audit as well as telecommunications/rural internet access, health, civil service and municipal strategic planning TA.

Lithuania's Investment Climate Assessment is to be launched soon, a study on Growth in the Baltic States is on its way, the key findings might be found in the special issue of the quarterly report and an international seminar on Transport Sector Restructuring in the Baltic States is scheduled in February in Vilnius.

Political update

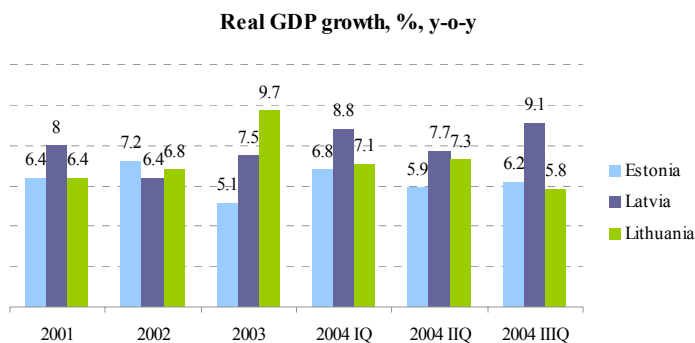
The minority government headed by of Indulis Emsis of the Union of Greens and Farmers collapsed after its coalition partner People's Party rejected the draft 2005 national budget. After an extended period of inter-party consultations, the President appointed the twelfth Government since restoration of Latvia's independence in 1991. Government is headed by Aigars Kalvitis, who succeeded in bringing together a broad four party right-wing coalition (People's Party (TP), New Era (JL), Latvia's First Party, and the alliance of the Green and Farmers' Parties) and covers 70 seats out of 100 in the Saeima. Moreover, the grand coalition was supported by Fatherland and Freedom Party, and three independent MPs. While one half of the cabinet remained unchanged, tensions may emerge between the People's Party and New Era (with controversial former Prime Minister Einars Repse getting the portfolio of Defence Minister).

The new government's broad reform plans include (in order of priority):

1. Solving the health care crisis and developing a well-functional healthcare system.
2. Establishing a balanced medium-term state budget and curbing inflation.
3. Enhancing competitiveness and developing a knowledge-based economy.
4. Ratifying the Constitutional Treaty of the European Union.
5. Finalizing the privatization process.

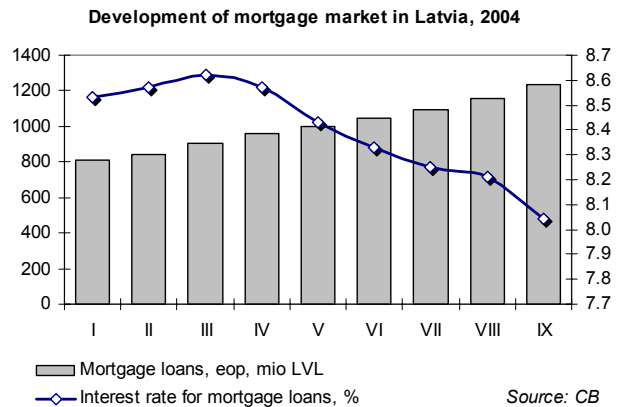
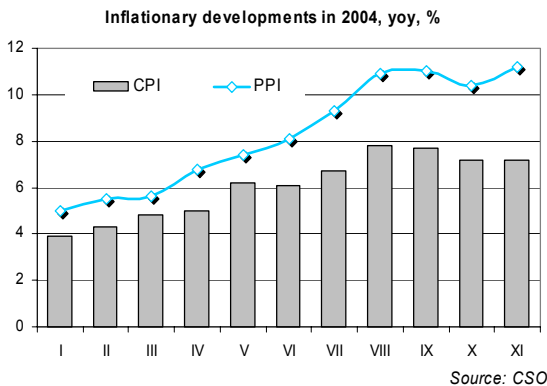
Macroeconomic developments

Strong output growth continued. Latvia continues to maintain leadership in the EU in terms of GDP growth. Real GDP growth in Q3 accelerated to 9.1% yoy, pushing the nine month rate to 8.5%. Latvia's spectacular growth was underpinned by booming domestic demand. On the supply side, the shift towards the service sector continues: with transport and communication, construction, real estate, renting and business activities, wholesale and retail trade, and financial intermediation leading the way. Despite the remarkable growth rates, unemployment has remained fairly stable during 2004 indicating that the benefits of growth may not be shared equally among all groups of the population. Higher labor market flexibility remains a key challenge in improving the situation.



Inflation has shot up. CPI inflation in December hit 7.3% yoy, affected also by higher fuel and energy prices. The biggest rise in prices in 2004 was recorded in the healthcare sector (over 14%). Inflation is also fueled by a credit boom that shows no signs of abating. Mortgage lending continues to be the key driver of credit expansion. As of November, loans to residents were up by 47% yoy, but the share of credits-to-GDP remains fairly low. The Bank of Latvia raised the refinancing rate from 3.5% to 4% in November. Also, from January 24, 2005, banks' liabilities to foreign banks will be included in the compulsory reserves. On December 30, 2004, the lat was re-pegged from the SDR to the Euro at an exchange rate of 1 EUR = 0.702804 LVL. The Bank of

Latvia will unilaterally keep the bound of $\pm 1\%$ around the central rate. Prime Minister Kalvitis has stated that the Government is not planning to carry out any specific anti-inflation measures.



The current account deficit has increased throughout 2004. EU accession and growing income have been the key contributing factors to the increasing current account deficit, which is expected to exceed 12% of GDP in 2004. Only about one third of the deficit was financed by inflows of foreign direct investment in 2004. The increase has mainly been financed by private borrowing abroad, while public sector debt still remains at low levels by international standards. The outlook for 2005 is more optimistic with the current account deficit expected to decrease by several percentage points.

Fiscal policy was strong in the first nine months of the year. The general government recorded a surplus for the first eleven months of 2004, and the deficit for the year stood at only 1.1% of GDP (or 79 million LVL) - the result has been better than expected due to strong revenues throughout 2004, and represents an improvement from the 1.8% deficit in 2003. The budget for 2005 that brought down the Emsis government was smoothly passed several weeks later, with only minor changes. In line with the intention of the Latvian government to solve the escalating problems of the health care sector, a substantial increase in health care funding was included in the budget.

Reform efforts

The recent focus has been on addressing the crisis in the health care system. However, it is unlikely that increasing spending on health care is sufficient to overhaul the existing system, even taking into account continuously increasing funding in coming years (according to the Ministry of Health, full implementation of health care reform would require at least twice as much as is planned). The situation has not stabilized yet, and anesthetists and intensive-care staff may continue striking for higher wages and reduced working hours. According to the World Health Organization, Latvia spends the lowest percentage of GDP on health and also sits at the bottom of the EU8.

World Bank activities

The activities in Latvia are currently limited to non-lending services and maintaining policy dialogue. The World Bank initiated a discussion on Programmatic Structural Adjustment loan (PSAL) progress with the Government. It has also finalized a report on Tertiary Education and Innovation Systems in Latvia. Further, the World Bank announced a Development Marketplace competition in October and organized a workshop on Cities' Alliance project in November. Finally, a study on Growth in the Baltic countries is under way.

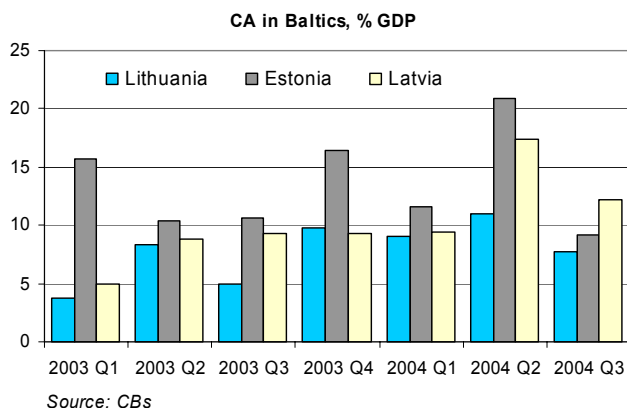
Political update

The latest polls suggest that public sentiment may be shifting to the left, from the ruling center-right, pro-liberal parties towards socially orientated political parties. Municipal elections are scheduled for October 2005, and the political climate is already heating up.

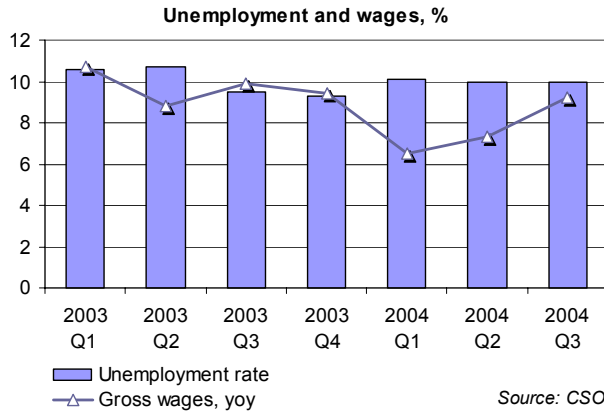
Macroeconomic developments

GDP growth remains solid. In Q3-2004 real GDP expanded by 6.1% yoy, led by strong domestic demand. The most rapid growth was recorded in domestically oriented sectors, i.e. financial intermediation, hotels and restaurants, and utilities. The unemployment rate in Q3 remained at 10%, but emerging bottlenecks in the labor market has pushed up wage growth to over 9% yoy in Q3. However, strong productivity growth is still holding down unit labor costs.

The current account deficit declined somewhat as exports swelled. In Q3-2004 the CAD declined to just over 9% of GDP. Exports accelerated substantially, reaching the same annual growth rate as imports of 24%.



Inflation and interest rates edged up. Despite the increase in CPI inflation from 1.3% in 2003 to 3.0% in 2004 (annual averages), price stability has not become a significant concern in Estonia. Some of the 2004 price increases are linked to EU accession and are not expected to be repeated in 2005. The most significant price increases were observed in transport (+5.4%, mainly due to significant increases in fuel prices) and health sectors (+4.7%). Despite rising interest rates (6.0% in December compared to 5.4% at the beginning of 2004), credit growth remains rapid. However, the peak of the mortgage boom appears to have been passed.



Reform efforts

Estonia was upgraded to fourth place (after Hong Kong, Singapore and Luxembourg) on the 2005 global index of freedom (Heritage Foundation). It was the only EU8 country ranked as “free.”

Despite one of the lowest tax burden in Europe, the government has plans for further tax cuts in 2006. The intention is to reduce the flat income tax rate from 26% percent to 20% in order to diminish the gap between corporate and individual taxation levels. At the same time, there are strong pressures to improve social policies.

Other

The IMF concluded its 2004 Article IV consultation in November. The Fund points out that the high and continued current account deficits may not be sustainable during the medium term, and that adequate fiscal policy will play an important role in concerns about the current account deficit and inflation. The report also points out the importance of labor market flexibility in maintaining external competitiveness and supporting the currency board.