CHAPTER 6

FOREIGN TRADE AND PAYMENTS IN THE EU-10, SOUTH-EAST EUROPE AND THE CIS

During 2004, the ECE emerging market economies (EME) continued to make significant progress in integrating themselves into the global trading and financial system. The further enlargement of the EU eastward was historic for both economic and political reasons. Although the EU-10 had already achieved high levels of trade and financial integration with the EU-15 prior to accession, the enlargement is likely to further intensify these trade and investment relations in the coming years. The difference in the commodity structure of the trade of the EME explains to a large degree the current account trends which developed during this period. The increase in the price of crude oil was particularly important for several of the CIS countries; the energy exporters and Ukraine had trade surpluses and were able to use their increased export earnings to further strengthen their economies and accumulate international reserves. Robust growth in all three regions – the EU-10, south-east Europe and the CIS – stimulated trade among themselves, as well as imports from the rest of the world. Exports from these economies benefited from strong global growth although exports to western Europe, their major market for manufactured goods, were dampened by the continued relatively slow growth there.

The continual integration of the ECE emerging market economies into the global financial market has eliminated the requirement that their national savings must limit their national investment. Low interest rates in the United States and western Europe increased the attractiveness of these regions to investors searching for higher yields. FDI inflows into the EU-10 declined slightly from last years' levels, while investment into south-east Europe and the CIS continued to increase.

6.1 The balance of payments and external financial flows

(i) The balance of payments in the EU-10, south-east Europe and the CIS

During the last 12 months to June 2004, net capital inflows into the EME totalled $53.4 billion, with $29.1 billion flowing in the first half of 2004; this amounted on average to about 3.3 per cent of the region's yearly GDP.[193] Over the same period, the international reserve assets of the EME increased by $45.2 billion, which is approximately 2.8 per cent of the region's GDP. On a net basis therefore, most of the capital inflow was channelled into international reserves. In the sense that a reserve accumulation can be considered as a capital outflow, the region was only a small net recipient of savings from the rest of the world. Excluding Turkey, the other emerging market economies accumulated more reserves than they imported capital and were thus net exporters of capital. The overall goods and services account balance for the EME in aggregate was just slightly in surplus over the last year, so the region produced slightly more than it consumed. There were significant differences among the subregions: the EU-10, south-east Europe and the energy-importing countries of the CIS[194] had large current account deficits while the energy-exporting CIS members[195] were in surplus. The fact that the majority of the economies of the region were large capital importers, while the region as a whole imported very little capital (when international reserves are included), reflects the economic weight of the CIS energy exporters that account for 38 per cent of the region's total GDP aggregated on the basis of current exchange rates.

The level of net foreign borrowing (excluding reserves) has remained relatively stable as a percentage of GDP for the last several years, both for the entire region and for the major subgroups – the EU-10, south-east Europe (excluding Turkey)[196] and the CIS; however there are considerable differences among these economies in their capital accounts and in the annual changes.

[193] The analysis of this section (table 6.1.1) primarily uses variables expressed as percentages of GDP. This allows for a more meaningful comparison across countries and also eliminates much of the distortion created by the relatively large fluctuations in the dollar and euro exchange rates.

[194] Armenia, Belarus, Georgia, Kyrgyzstan, the Republic of Moldova and Tajikistan.

[195] The CIS energy exporters include Azerbaijan, Kazakhstan, Russia, Turkmenistan, Ukraine and Uzbekistan. Ukraine is grouped with the energy exporters despite the fact that it is not a major oil exporter (although it exports significant amounts of coal) and actually imports significant amounts of energy. Ukraine's major export product is steel and the increase in the world price for steel has been as large as that for oil. Uzbekistan exports some energy (oil, gas, electricity) but cotton is its major export; by end of 2003, cotton prices were up significantly from mid-year or the beginning of the year but have since subsided. In this sense Ukraine and Uzbekistan are in a similar economic situation to that of the energy exporters and are therefore grouped with them.

[196] Turkey's current account has deteriorated over the last two years.

TABLE 6.1.1

The balance of payments and external financing for ECE emerging market economies, 2003QIII-2004QII

(Per cent of GDP)

	Balance of flows by accounts						*External financial indicators*		
	Merchandise trade	*Trade in services*	*Income and transfers*	*FDI inflows*	*Other capital* [a]	*Reserve changes* [b]	*Cumulative FDI inflows* [cd]	*Gross debt* [d]	*Total reserves* [d]
New EU members	-4.3	1.4	-1.7	2.7	2.9	0.9	33.1	52.4	19.8
Cyprus [e]	-25.7	21.3	-0.9	8.6	0.1	3.3	52.4	38.1	22.6
Czech Republic	-2.3	0.5	-4.5	3.1	3.6	0.3	43.8	35.8	26.9
Estonia	-18.7	9.8	-6.1	8.9	7.8	1.7	45.7	81.6	13.5
Hungary	-3.3	-0.9	-5.1	3.0	5.9	-0.4	43.4	68.9	14.2
Latvia	-20.0	4.7	3.8	3.5	9.6	1.6	28.8	87.1	12.4
Lithuania	-10.1	3.1	-1.6	1.7	8.5	1.7	21.2	45.6	16.0
Malta	-13.5	8.8	-1.6	7.6	-2.4	-1.1	56.9	33.7	49.4
Poland	-2.6	0.5	0.4	2.0	1.1	1.3	26.1	51.2	16.0
Slovakia	-2.1	0.8	-0.6	2.1	3.2	3.4	31.0	50.7	32.3
Slovenia	-2.6	2.2	–	0.9	-1.8	-1.1	13.4	58.1	26.2
South-east Europe	-11.4	4.3	1.1	2.6	6.1	2.6	12.7	53.3	15.5
Albania [f]	-20.0	-1.1	14.5	4.3	4.7	2.4	18.7	20.0	15.4
Bosnia and Herzegovina [f]	-56.7	4.2	22.7	6.0	31.2	7.3	18.9	50.6	26.5
Bulgaria	-13.9	3.2	2.2	8.7	6.9	7.0	35.0	66.6	32.2
Croatia	-26.8	17.4	2.1	4.9	4.5	2.1	32.2	80.5	24.7
Romania	-8.5	–	2.3	3.8	7.0	4.7	19.6	33.4	16.7
Serbia and Montenegro [g]	-28.3	1.5	15.6	7.3	8.3	4.3	15.6	57.1	15.3
The former Yugoslav Republic of Macedonia	-19.6	-0.6	10.6	3.2	6.9	0.4	22.2	36.4	16.7
Turkey	-7.2	4.3	-1.7	1.0	5.1	1.6	6.3	54.6	12.5
CIS [h]	11.1	-2.4	-2.3	2.5	-4.5	4.5	13.0	40.1	16.4
Armenia	-14.3	-2.7	10.9	6.4	0.6	0.9	31.5	59.4	16.3
Azerbaijan [f]	-2.0	-25.2	-4.4	50.4	-16.3	2.4	132.9	18.4	10.6
Belarus	-7.6	3.1	0.9	1.1	2.3	-0.2	9.5	19.1	3.5
Georgia	..	..	..	..	..	..	..	43.6	6.1
Kazakhstan [i]	13.7	-7.9	-6.8	8.5	-1.1	6.4	50.4	68.2	17.0
Kyrgyzstan	-4.7	-0.3	3.2	..	..	..	..	110.8	17.8
Republic of Moldova	-31.1	-3.3	26.0	3.2	6.3	1.2	38.0	85.2	13.3
Russian Federation [i]	13.6	-2.5	-3.2	1.3	-4.8	4.5	8.2	38.2	16.8
Tajikistan	..	..	..	..	..	..	..	60.0	7.8
Turkmenistan	..	..	..	..	..	..	..	..	..
Ukraine	3.1	2.9	3.2	2.9	-6.3	5.8	13.7	47.1	17.0
Uzbekistan	..	..	..	..	..	..	..	..	..
Total emerging market economies [h]	0.1	0.6	-1.2	2.6	0.7	2.8	19.6	47.6	17.3
Memorandum items:									
EU-8	-3.7	0.8	-1.7	2.5	3.0	0.9	32.3	53.0	19.4
South-east Europe without Turkey	-18.8	4.3	5.8	5.3	7.7	4.3	23.7	51.1	20.7
CIS without Russian Federation [h]	3.0	-2.0	0.4	6.4	-3.5	4.4	28.9	46.4	15.1
CIS energy exporters [h]	12.3	-2.6	-2.7	2.5	-4.9	4.7	12.8	40.2	16.9
CIS energy importers [h]	-11.3	1.5	4.7	3.1	2.7	0.7	18.2	38.3	6.8

Source: UNECE secretariat calculations, based on national statistics; IMF statistics.

a Includes errors and omissions.

b A negative sign indicates a decrease in reserves.

c From 1988.

d As of 30 June 2004 unless otherwise noted.

e Debt only to December 2003.

f Debt not reported using standard IMF definitions.

g Serbia only.

h Totals include UNECE secretariat estimates for missing values.

i Debt only to March 2004.

Current account surpluses for the energy exporters

Over the last 12 months to June 2004 and especially in the first half of 2004, the EME current account balances, and their merchandise trade component, were affected by the rise in commodity prices. This was most noticeable for the major oil exporters (Kazakhstan and Russia), which accumulated large trade surpluses exceeding 10 per cent of GDP. Due to large increases in the price of steel, Ukraine was in a similar position with a trade surplus of 3.1 per cent of GDP. Turkmenistan and Uzbekistan also had large trade surpluses based on price increases for their exports of fuels and in addition, cotton for Uzbekistan. Exceptionally, the oil exporter Azerbaijan had a trade deficit and the largest current account deficit (as a per cent of GDP) of any EME. This largely reflected Azerbaijan's large imports of capital equipment for pipeline infrastructure and oil and gas exploration. All of the CIS energy exporters (except Ukraine) were in deficit on their service accounts; these imported services are often directly related to the development of the their energy industries.

Since the energy exporters have gained an essentially temporary boost in income (historically, previous oil price increases have been followed by declines) it should be expected that they would attempt to save a portion of this to iron out fluctuations in their consumption and investment patterns, and thus the expectation of improvements in their current accounts. An additional factor in explaining the increased external surpluses of the energy exporters is their specialized export structure. Generally, countries with highly concentrated commodity exports tend to have more volatile terms of trade, and many of them attempt to minimize this effect by increasing precautionary savings and thereby running more positive current accounts than more diversified economies.[197]

The CIS energy exporters have used their oil revenues to accumulate significant amounts of official reserve assets.[198] In absolute terms, Russia dominates with a net increase of $22.5 billion over the last year (or 4.5 per cent of its GDP), and its total reserve assets in October 2004 were in excess of $100 billion.[199] Although large as an absolute amount, as a per cent of its GDP (16.8 per cent) its official reserves are not particularly large compared with the other ECE emerging market economies. In terms of their proportion to GDP, several other CIS energy exporters including Kazakhstan (with reserve accumulation equalling 6.4 per cent of its GDP), Ukraine (5.8 per cent), and possibly Turkmenistan had even higher rates of reserve growth than Russia. Although such accumulation provides some insurance against future currency instability and allows some smoothing of consumption over time, a major motivation over the last year has been to check currency appreciation in order to limit possible "Dutch Disease" effects.

Current account deficits for east Europe and CIS energy importers

All of the EU-10, south-east Europe and the energy-importing CIS countries are primarily energy importers and all had both current account and merchandise trade deficits during 2003QIII-2004QII (table 6.1.1). The current account deficit of the south-east European region was the largest at 6 per cent of GDP (8.7 per cent excluding Turkey), while the EU-10 had a slightly smaller deficit of 4.7 per cent and the CIS energy importers one of 5.1 per cent. There was more variation in their trade deficits, which varied from 4.3 per cent of GDP for the EU-10 to 11.4 per cent for south-east Europe (18.8 per cent without Turkey); the CIS energy importers fell in between with a trade deficit of 11.3 per cent of GDP. Each of these three subregions has a current account deficit that has been increasing over the last two and a half years (table 6.1.2).

These increasing current account deficits seem consistent with the more general pattern of how a spurt in income growth affects current accounts in emerging markets. The response of the current account to an increase in income above the past trend differs between small open advanced economies and emerging markets.[200] When an advanced economy experiences growth, agents tend to view it as a positive transitory income shock, and they therefore increase savings as a way to smooth consumption and this generally offsets any increase in investment. The current account therefore follows a procyclical pattern (i.e. surpluses during periods of rapid growth). In emerging markets, however, there is a tendency to interpret a period of high growth not as a transitory shock (likely to be reversed) but as an increase in the likely long-run growth rate.[201] Since an expected increase in the growth rate implies that future income will increase by more than current income, consumption increases relative to income, and the current account deteriorates. The recent rapid increases in the GDP of the ECE emerging market economies are translating into growing expectations that their per capita income levels will tend to converge toward those of western Europe. The previous experiences of

[197] Empirical evidence for this is provided by A. Ghosh and J. Ostry, "Export instability and the external balance in developing countries", *IMF Staff Papers*, Vol. 41 (Washington, D.C.), June 1994, pp. 214-235.

[198] Official external debt has also been retired. Russian foreign debt has declined from 90 per cent of GDP at the time of the 1998 crisis to about 28 per cent by mid 2004; significant amounts of oil profits have also been diverted into a stabilization fund.

[199] This gives Russia the eighth largest amount of official reserves of any country in the world economy, larger even than those of the United States.

[200] M. Aguiar and G. Gopinath, *Emerging Market Business Cycles: The Cycle Is the Trend*, NBER Working Paper, No. 10734 (Cambridge, MA), September 2004.

[201] It is this basic tendency of adjusting expectations about the long-run prospects of an economy based upon short-run developments that contributes to the underlying volatility in emerging markets.

TABLE 6.1.2

Trends in trade and external balances of the ECE emerging market economies, 2002-2004
(Per cent)

	Trade and services balance (per cent of GDP)			Current account (per cent of GDP)			FDI inflows (per cent of GDP)			Total reserves to gross debt (per cent)		
	2002	2003	2004 Jan.-June	2002	2003	2004 Jan.-June	2002	2003	2004 Jan.-June	2002	2003	2004 June
New EU members	-3.1	-3.0	-3.0	-4.3	-4.4	-5.0	5.5	2.5	3.1	44	39	38
Cyprus [a]	-1.0	-1.5	-12.8	-4.4	-3.4	-12.5	10.4	7.8	6.6	70	60	59
Czech Republic	-2.0	-2.2	-0.2	-5.6	-6.2	-4.2	11.5	2.9	4.4	87	77	75
Estonia	-7.1	-8.0	-9.9	-10.2	-13.2	-16.4	4.0	9.8	9.2	21	19	17
Hungary	-2.5	-4.7	-4.1	-7.3	-9.0	-10.1	4.7	2.8	2.5	26	22	21
Latvia	-10.2	-12.9	-15.8	-6.8	-8.3	-13.6	2.8	2.7	5.3	18	15	14
Lithuania	-5.6	-5.6	-7.0	-5.2	-6.6	-9.9	5.2	1.0	4.6	38	39	35
Malta	1.2	-5.3	-7.2	0.3	-5.6	-8.9	-10.2	6.2	3.9	162	166	147
Poland	-3.3	-2.5	-2.2	-2.6	-2.2	-2.1	2.2	2.0	2.1	34	31	31
Slovakia	-6.9	-1.2	-1.4	-8.0	-0.9	-3.2	16.6	1.7	3.7	67	65	64
Slovenia	1.5	-0.1	-0.4	1.4	-0.4	-0.5	7.4	1.2	0.9	58	52	45
South-east Europe	-4.8	-5.9	-10.3	-3.4	-5.2	-9.4	1.7	2.3	2.7	26	29	29
Albania [b]	-25.8	-23.4	-18.1	-9.3	-6.7	-5.4	3.0	2.9	5.5	71	72	77
Bosnia and Herzegovina [b]	-57.7	-53.5	-48.2	-31.0	-29.6	-27.1	4.9	5.5	6.4	52	70	53
Bulgaria	-7.2	-9.5	-13.0	-5.3	-8.4	-11.1	5.8	7.1	11.3	39	48	48
Croatia	-10.9	-7.9	-18.1	-8.4	-7.2	-17.2	4.9	6.9	3.4	38	35	31
Romania	-5.7	-7.7	-9.5	-3.4	-5.7	-7.2	2.5	3.2	5.2	46	44	50
Serbia and Montenegro [c]	-23.2	-23.3	-28.5	-11.0	-9.8	-13.7	3.0	6.9	2.8	18	24	27
The former Yugoslav Republic of Macedonia	-22.0	-18.3	-22.6	-9.5	-6.0	-14.4	2.1	2.0	3.3	45	49	46
Turkey	0.3	-1.5	-6.0	-0.8	-3.4	-7.8	0.6	0.7	1.2	21	23	23
CIS [d]	7.9	8.7	10.1	6.6	6.5	8.0	1.9	2.8	3.2	28	36	41
Armenia [e]	-17.2	-17.9	-22.9	-6.2	-6.8	-10.3	4.7	4.3	8.7	41	29	28
Azerbaijan [b]	-7.3	-24.0	-25.8	-12.3	-28.3	-31.0	22.3	46.0	50.2	52	57	58
Belarus	-3.3	-3.9	-3.1	-2.1	-3.0	-2.3	1.7	1.0	0.7	20	17	18
Georgia [b]	-12.5	-14.6	..	-6.8	-10.0	..	4.9	8.5	..	11	10	14
Kazakhstan [f]	0.7	6.1	8.1	-3.4	-0.1	0.5	10.5	6.8	9.9	14	19	25
Kyrgyzstan [e]	-3.7	-4.0	-8.7	-1.6	-1.2	-5.1	0.3	2.4	..	16	16	16
Republic of Moldova [e]	-24.7	-33.8	-32.7	-3.1	-7.3	-3.7	7.0	3.0	3.7	16	15	16
Russian Federation [f]	10.5	11.4	11.9	8.4	8.3	9.1	1.0	1.8	2.0	29	39	44
Tajikistan	-13.1	-9.8	..	-1.2	-0.3	..	3.0	2.0	..	9	11	13
Turkmenistan	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine [e]	4.4	2.6	11.5	7.5	5.8	15.0	1.6	2.9	3.3	33	28	36
Uzbekistan	..	..	..	..	..	..	..	..	..	..	..	..
Total emerging market economies [d]	0.8	0.8	0.6	0.2	-0.3	-0.7	3.2	2.6	3.0	33	35	36
Memorandum items:												
EU-8	-3.2	-3.0	-2.6	-4.3	-4.4	-4.8	5.5	2.4	3.0	42	38	37
South-east Europe without Turkey	-13.2	-13.4	-17.6	-7.5	-8.2	-12.0	3.6	5.1	5.3	38	40	40
CIS without Russian Federation [d]	0.2	0.3	3.9	1.1	0.8	4.1	4.7	5.6	7.1	26	27	32
CIS energy exporters [d]	8.8	9.7	11.1	7.1	7.1	8.7	1.9	2.8	3.2	29	37	42
CIS energy importers [d]	-7.8	-9.0	-10.0	-3.1	-4.3	-5.2	2.7	2.6	3.1	18	17	18

Source: UNECE secretariat calculations, based on national statistics and direct communications from national statistical offices; IMF statistics.

a Debt only to December 2003.

b Debt not reported using standard IMF definitions.

c Serbia only from 2003.

d Totals include UNECE secretariat estimates for missing values.

e Debt not reported using standard IMF definitions prior to 2003.

f Debt only to March 2004.

Portugal, Spain and to a lesser extent Greece further contribute to this expectation. Generally it is thought that countries that have expectations of future growth rates of income above the world level (or that of the regions in which they are highly integrated) are likely to run current account deficits, while slower growing countries are likely to run surpluses.[202] An additional possible explanation for the increasing deficits is that the higher fuel prices and

[202] O. Blanchard and F. Giavazzi, "Current account deficits in the euro area: the end of the Feldstein-Horioka puzzle?", *Brookings Papers on Economic Activity*, 2 (Washington, D.C.), 2002, pp. 147-209.

higher domestic GDP growth increased imports, while the monetary authorities attempted to partially or fully maintain exchange rates.

In the EU-8, the three Baltic countries had the largest merchandise trade deficits – all above 10 per cent of GDP. These three economies also had the largest surpluses in their services accounts, but these were much smaller than their trade deficits. These service surpluses are primarily due to the shipment of freight coming from and going to Russia through Baltic ports. Estonia also receives extensive revenue from tourism. The Czech Republic, Estonia, and Hungary had sizeable deficits of over 4 per cent of GDP in their income and transfers account. Cyprus and Malta also had large current account deficits due to large trade deficits. Both of these countries also have a large surplus in their service account due to tourism and the provision of business services. Generally the current account deficits of the new EU members are significantly larger than those of the three southern EU members during an equivalent period after their accession. In the coming years the current accounts of the EU-10 should benefit from increased transfers from the EU structural and cohesion funds and increased worker remittances.[203] Net capital inflows into the EU-8 amounted to 5.5 per cent of their GDP between July 2003 and June 2004, and their official reserves grew by 0.9 per cent of GDP or 16 per cent of the net capital inflow.

The south-east European countries had sizeable trade deficits ranging from a deficit of 7.2 per cent of GDP in Turkey to the extremely large deficit of 56.7 per cent in Bosnia and Herzegovina; Albania, Croatia, Serbia and Montenegro, and The former Yugoslav Republic of Macedonia also had sizable trade deficits of over 19 per cent. These large deficits were offset to some degree by either a significant surplus (i.e. over 10 per cent of GDP) in the services account as in Croatia (tourist services), or a large surplus in the transfer account as in Albania (primarily workers' remittances), Bosnia and Herzegovina (mostly workers' remittances), Serbia and Montenegro, and The former Yugoslav Republic of Macedonia. Net capital inflows into south-east Europe amounted to 8.6 per cent of their GDP with 2.6 per cent of GDP allocated to reserves.

Each of the CIS energy importers had a sizable merchandise trade deficit with a smaller current account deficit due to a surplus in the income and transfers account. The Republic of Moldova's trade deficit of 31.1 per cent of GDP was particularly large and similar to that in the previous year. Armenia, Georgia and Tajikistan had trade deficits of over 10 per cent of GDP with smaller but still significant current account deficits; Georgia's current account has deteriorated over the last few years. Net capital inflows into the energy-importing CIS countries were equivalent to 5.8 per cent of GDP while the change in reserves amounted to 0.7 per cent of GDP.

The levels of gross external debt and total official reserves for the three regions are remarkably similar, the EU-8 and the south-east European countries (excluding Turkey) being almost identical. Turkey's official reserves are comparatively low. Reserves of the CIS energy importers are less than half the levels of the other regions (including the CIS energy exporters) although their external debt is only slightly lower.[204] All of the CIS energy importers stand out as having relatively low levels of reserves, especially in relation to the levels of their external debt. Much of this debt is public debt and much of it is owed to official creditors (box 6.1.1).

(ii) Foreign direct investment

Of the various types of capital flows, foreign direct investment (FDI) is generally considered to be the most desirable. Capital inflows such as bank loans and bond funds, tend to crowd out domestic investment; however FDI tends to increase national investment in an equal amount.[205] FDI is generally considered less volatile during financial crises and unlike debt, which is fixed in nominal terms, it is re-priced as conditions evolve and does not involve a currency or a maturity mismatch.[206] FDI can also provide the EME with much needed technological and managerial expertise. A country may gain the benefits from FDI without also being dependent on net capital inflows or increasing its net external debt. Two recent growth experiences highlight this distinction. Both Ireland during 1991-1999 and China during 1990-2002 (except for 1993) received large FDI inflows that are generally credited with playing an important role in their growth performance, yet during these periods both countries had current account surpluses every year. Given the clear advantages of FDI over debt, a more active policy to shape the structure and volume of such capital inflows may be warranted.

During 2003 worldwide FDI flows stabilized after declining in the previous two years due to the slowdown in economic activity during this period that reduced the supply of internal company funds available for investment.[207] FDI inflows into the EME totalled $42 billion from July 2003 through June 2004; this is only

[203] Complete mobility of labour for the EU-10 will not be fully implemented until 2010. Currently, however, there are no significant restrictions in Ireland, Sweden and the United Kingdom.

[204] Debt levels in many of the CIS countries (see the notes to table 6.1.1) are not reported using standard IMF concepts and caution should be used in making cross-sectional comparisons.

[205] B. Bosworth and S. Collins, "Capital flows to developing economies: implications for savings and investment", *Brookings Papers on Economic Activity,* 1 (Washington, D.C.), 1999, pp. 143-169.

[206] The theoretical and empirical evidence that FDI is a safer form of finance for countries that are unable to issue long-term debt in their own currency is reviewed by E. Fernandez-Arias and R. Hausmann, "Capital inflows and crisis: does the mix matter?", *Foreign Direct Investment Versus other Flows to Latin America* (Paris, OECD, 2001), pp. 93-110.

[207] According to UNCTAD, reported worldwide inflows of FDI declined in 2003 while outflows increased; in theory these should equal, but different reporting practices and timing issues result in different sums. UNCTAD, *World Investment Report 2004: The Shift Towards Services* (United Nations publication, Sales No. E.04.II.D.33).

Box 6.1.1

Debt sustainability in the low-income CIS countries

External debt sustainability remains an important policy issue in five low-income CIS countries (Armenia, Georgia, Kyrgyzstan, the Republic of Moldova and Tajikistan). While much has been accomplished in these five economies in terms of macroeconomic stability, fiscal consolidation, institutional development and resumption of growth, one area that remains a potential concern is external debt, which has reached very high levels in a number of them. From a situation of virtually no debt in 1992, these five countries have seen a rapid increase in the ratio of external debt to output during the late 1990s.[1] This increase in debt occurred even as their currencies appreciated and the average interest rate on the debt declined during this period. However, since 2001, driven by robust export performances, these countries have experienced sustained growth in real GDP. External debt service indicators have also improved in all five countries with a general decline in various debt ratios. As of June 2004, the ratio of gross external debt to GDP ranged from a low of 44 per cent in Georgia to a high of 111 per cent in Kyrgyzstan.[2] By the end of 2003, the debt service to exports ratio ranged from a low of 7.5 per cent in Armenia to a high of 20.9 per cent in Kyrgyzstan.[3]

Against this background, individual country performances have varied. While Armenia, Georgia and Tajikistan have grown out of their debt problems, Kyrgyzstan and the Republic of Moldova continue to have debt indicators that are sources of concern for both the national policy makers and the creditors.

Country performances

Buoyed by a favourable debt restructuring and strong economic growth resulting from, among other factors, structural reform, external debt is expected to remain fiscally sustainable in the medium term in Armenia, Georgia and Tajikistan. Armenia concluded a favourable debt restructuring in 2003. For Georgia, the conclusion of an agreement with the IMF paved the way for a Paris Club rescheduling on Houston terms in July 2004.[4] The recently concluded debt-for-equity swap agreement between Russia and Tajikistan will result in a significant reduction of debt service ratios in the future as this agreement implies the cancellation of the Russian debt, which accounts for about a third of Tajikistan’s total debt stock.

In Kyrgyzstan, on the other hand, more than half of its external debt is owed to multilateral organizations, while bilateral debts account for about one third. The scheduled debt service weighs heavily on the budget, absorbing about one third of total revenue and constraining the development of social protection and poverty reduction programmes. This debt overhang could be potentially discouraging to many foreign investors. The government has recently approved a debt reduction strategy which calls for a streamlining of the public investment programme, accepting new loans only with a high grant element, and a programme of debt repayments using potential proceeds from privatization, debt equity swaps and other sources.

Although the stock of public and publicly guaranteed debt in the Republic of Moldova as a ratio of GDP has seen a recent decrease, debt service obligations absorb over 40 per cent of central government expenditures, reducing resources available for social expenditures in particular and for the country’s development in general.[5] More than half of the outstanding public and publicly guaranteed debt is owed to IFIs, while debt to bilateral official donors represents about another quarter.[6] Although recent *non-concessional* debt restructurings with commercial and bilateral creditors have provided temporary cash flow relief, they have increased future debt service obligations. There is a potential risk that the substantial financing gap will be difficult to meet, while remaining current on debt service obligations. This raises questions regarding Moldova’s capability to meet these obligations in full, without seeking debt rescheduling and/or debt relief. However, there are some encouraging signs pointing to a possible increase in the country’s trend output growth in the medium term. Relatively modest FDI inflows have contributed to an improving export performance in recent years while shipments to western Europe have increased. Further, the authorities intend to intensify cooperation with the EU within the framework of the Stability Pact for south-east Europe and through a closer association in 2007 when neighboring Romania joins the EU. This could provide the Republic of Moldova with a much needed anchor for its systemic reforms that would enhance significantly the business environment and make economic development more sustainable.

Debt reduction strategy

A major motivation for debt relief arises from the presumption that a deleterious interaction exists between a heavy debt burden (or a debt overhang) and economic growth. The widely discussed “debt overhang theory” suggests that a heavy debt burden creates a disincentive for private investment due to concerns for future taxes and/or debt-induced crises. This reduces investment spending leading to a slowdown in economic growth. The cycle continues with further reduction in investment following the economic slowdown, an increase in the debt-income ratio, and a reinforcement of the disincentive effect, which ultimately leads to stagnation.

The healthiest way out of the debt trap is strong economic growth. Since 2001, these five countries have experienced strong growth, which has eased the debt situation in most of them. The major challenge for these governments will be to sustain the pace of growth and maintain macroeconomic stability by making the necessary structural reforms.

In addition, the governments have recognized the importance of a debt reduction strategy, including strong fiscal adjustment, and a number of them have already embarked on the process. External debt sustainability in these countries requires a delicate balance between the potentially conflicting needs to spend more on health, education, infrastructure and other poverty reduction initiatives, while at the same time maintaining a tight fiscal stance. In order to meet this challenge, a debt reduction strategy

Box 6.1.1 (concluded)

Debt sustainability in the low-income CIS countries

should include, among others: a substantial fiscal adjustment and strengthening of public finance institutions, including tax policy changes with a view to broadening the tax base and strengthening and simplifying the tax and customs administration to improve compliance and governance;[7] acceleration of structural reforms that support growth and poverty reduction;[8] ongoing work with IFIs and bilateral donors to attract technical assistance,[9] as well as *concessional loans* and grants consistent with commitments made with respect to attainment of the Millenium Development Goals; and not contracting any new *non-concessional* debt.[10]

The attraction of non-debt sources of financing, in particular foreign direct investment, should be deemed a policy priority. This requires sustained efforts to improve the business climate, which would also have a positive impact on growth rates, thus reducing the relative debt burden. Privatization can obviously play an important role in this area. However, the divestiture of state assets must take place within the framework of well-designed programmes to avoid the revenue damaging effects associated with distress sales.

Notwithstanding the recent improved economic performance, the downside risk arises from a high concentration of exports in commodities like gold in Kyrgyzstan, aluminium in Tajikistan and diamond polishing in Armenia, and potential external liabilities from the stock of energy sector arrears in Georgia (up to 6 per cent of GDP and 18 per cent of exports in 2003) and the Republic of Moldova (6 per cent of GDP and 12 per cent of exports in 2003).[11] One possible way to meet this downside risk would be through export diversification in Armenia, Kyrgyzstan and Tajikistan.[12]

While strong economic growth based on structural reform coupled with successful implementation of a debt strategy programme have eased the debt situation in Armenia, Georgia and Tajikistan by making it fiscally sustainable, Kyrgyzstan and the Republic of Moldova will continue to have debt indicators that are close to the thresholds established under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative of the IMF and World Bank. These two countries will require additional assistance in the form of debt relief and highly *concessional* financing in order to achieve debt sustainability and sustained economic growth.[13]

A *non-concessional* flow rescheduling under the Paris Club Houston terms would only defer the problem for the time being, as it would only temporarily relieve the liquidity constraint by providing cash relief. It may even make the situation more difficult on a cash basis as debt service would suddenly jump back to high levels at the end of the consolidation period. Large amounts of *concessional* financing and grants under the Paris Club Naples terms, on the other hand, would result in smaller financing gaps so that debt sustainability indicators would keep declining and return to a sustainable level. Nevertheless, in order to avoid vulnerability to internal and external shocks, the potential debt relief must also be accompanied by cautious external borrowing and maintenance of official reserves coverage at levels significantly higher than those in other CIS countries.

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[1] Lending to most of the CIS-5 countries was more restricted before 1995 due to political instability and internal military conflicts. For a detailed discussion of the factors leading to debt accumulation in these countries, see UNECE, *Economic Survey of Europe*, *2001 No. 1*, pp. 159-163.

[2] UNECE Statistical Database.

[3] International Monetary Fund and World Bank, *Recent Policies and Performance of the Low-income CIS Countries. An Update of the CIS-7 Initiative* (Washington, D.C.), 23 April 2004, p. 15.

[4] The Paris Club refers to the meetings between government creditors, mainly OECD countries and debtor countries under the auspices of the French government. For a brief history of debt relief provided under different terms of the Paris Club see, among others, W. Easterly, "How did highly-indebted poor countries become highly indebted? Reviewing two decades of debt relief", *World Development*, Vol. 30, No. 10, October 2002, pp. 1677-1696.

[5] Latest figures from the National Bank of Moldova show that, at the current exchange rate, the ratio of public and publicly guaranteed debt to GDP has decreased from 49 per cent in 2003 to 36 per cent in June 2004 [www.bnm.org/english/docs/comments/108_3659.pdf].

[6] National Bank of Moldova.

[7] Fiscal consolidation through expenditure cuts may be counterproductive as this may suppress growth. So the main focus should be on raising revenue without risking negative implications on economic activity. As emphasized in previous issues and in this *Survey* (see chap. 5), a major concern in this regard is the low efficiency of tax collection.

[8] The acceleration of domestic structural reforms remains an essential ingredient of a strategy oriented towards reducing the debt burden and serving to unlock the necessary support from the IFIs and other creditors.

[9] A relatively small amount of external aid in terms of technical assistance focused on raising the efficiency of tax collection could have very high returns.

[10] The World Bank granted IDA-only status to these countries in 2000. These countries also have access to *concessional* resources from the IMF, including those under the Poverty Reduction and Growth Facility. For official creditors as a group, the grant element of new loan commitments to these countries jumped from around half in the late 1990s to about three fourths in 2003.

[11] For these figures, see International Monetary Fund and World Bank, op. cit.

[12] On the benefits of diversification, see chap. 1.2(iii).

[13] For example, without further rescheduling, the ratio of debt service to fiscal revenue in Kyrgyzstan would increase from 17 per cent in 2004 to 28 per cent in 2005.

slightly above the rate over the last two years. FDI inflows into the EU-8 declined considerably in 2003 to $11.3 billion from $22.6 billion in 2002; in the last four quarters inflows continued at the lower rate and amounted to $12.7 billion. Although it rose 21 per cent (year-on-year) during the first six months of 2004 ($7.9 billion), FDI remains at a significantly lower level than during the 1999-2002 period. This decline, however, was not the result of any general disenchantment with the economic prospects of the EU-8, but a reflection of the general unwinding of the privatization process, primarily in the Czech Republic, Hungary and Slovakia. Over the last year, FDI inflows as a per cent of GDP were particularly large for Estonia (8.9 per cent) and particularly low for the EU-8's richest member, Slovenia (0.9 per cent), which has not encouraged FDI. Cyprus and Malta received significant FDI inflows amounting to 8.6 and 7.6 per cent of their respective GDPs.

FDI likely to increase

For a number of reasons FDI inflows into the EU-10 are expected to increase in the coming years. A stronger world economy is likely to generate additional corporate profits and thus the world supply of investible funds for FDI is likely to increase. The attractiveness of the EU-10 as a location for FDI should also increase with EU membership, since the business climate has improved now that they have adopted the full body of EU law. In the immediate years after accession, FDI inflows increased significantly in Portugal and Spain but not in Greece. The provision of €21.5 billion of EU Structural Funds for infrastructure enhancement over the 2004-2006 period is likely to crowd-in additional private investment. In order to fulfil the government deficit and debt level requirements of the Maastrict Treaty for euro adoption, a number of countries are likely to privatize additional public companies as a way to obtain funds. The ability to obtain funds in this manner raises the possibility of "excessive privatization" where companies are privatized not on grounds of economic efficiency but to meet fiscal revenue requirements. In addition, several of the EU-10 have lowered corporate tax rates from already low rates, as a means of attracting FDI. There are, however, aspects of EU membership that could act to reduce FDI inflows, such as higher labour and environmental standards that could increase the costs of operating in the new member states.

The belief that FDI can be an important factor contributing to growth is well established, although the empirical evidence is more nuanced than is generally believed and the evidence for technological spillovers to domestic firms is weak. Undoubtedly, FDI is like other aspects of international integration such as trade openness, in that a country needs to have in place the appropriate domestic institutions in order to fully benefit from it. For example, regression analysis finds that the benefits to growth of FDI depend on the trade openness of the economy; the real advantage of FDI appears to lie in its ability to promote trade integration with the rest of the world.[208] For the EU-8 countries, there was a negative relationship between the level of FDI (as a percentage of GDP) and the real growth rate during 1994-2001. There was also no statistical relationship between FDI and the level of gross fixed investment. It has been argued that the normal pattern of FDI in increasing investment did not hold for these countries due to the unique circumstances that prevailed during the transition phase. More specifically, FDI during this period was dominated by acquisitions related to privatization rather than greenfield investment, and the proceeds were largely consumed, often by financing government expenditure.[209]

FDI inflows (as a per cent of GDP) into the south-east European economies have been increasing over the last several years, and during the first six months of 2004 the FDI inflow percentage of GDP was greater than the rate in either 2002 or 2003 in all of the south-east European economies except Croatia and Serbia and Montenegro. Over the last four quarters, FDI inflows as a per cent of GDP were similar for the EU-8, south-east Europe and the CIS at about 2.5 per cent of GDP. However, with the exception of Turkey, south-east European inflows were almost twice as large as those to the other regions, and each of these countries had inflows greater than the EU-10 average of 2.7 per cent. This is surprising given the historic opportunities present in the EU-10 and the political uncertainty and more limited progress with institutional reform in the south-east European countries (excluding Turkey). One explanation is that although the inflows were relatively large, the cumulative stock of FDI inflows (23.7 per cent of GDP excluding Turkey) in the south-east European countries is lower than in the EU-10 (33.1 per cent), and that there were more privatizations to attract inflows. FDI inflows were particularly large in Bulgaria (8.7 per cent of GDP) and Serbia and Montenegro (7.3 per cent). Bosnia and Herzegovina is noteworthy for its very large net capital inflows amounting to 37 per cent of its GDP; however, only 6 percentage points of this consisted of FDI inflows, the rest being composed largely of capital transfers and long-term borrowing. FDI inflows into Turkey over the last 12 months were quite low, at only 0.9 per cent of GDP; this is only slightly above the low annual rates in 2002 and 2003.

FDI inflows into the CIS have been on a moderate upward trend since 2000. Over the last 12 months, inward FDI into the CIS was essentially the same as the EU-8 average of 2.5 per cent of GDP. However, the CIS average is dominated by Russia whose FDI inflow was quite low at 1.3 per cent of GDP; for the CIS excluding

[208] OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalization* (Paris), 1998.

[209] J. Mencinger, "Does foreign direct investment always enhance economic growth?", *Kyklos*, Vol. 56, Issue 4, 2003, pp. 491-508. In some cases the proceeds were also used to pay off foreign debt.

Russia, their inflows amounted to 6.5 per cent of GDP, well over twice the level for the EU-8. Cumulative FDI inflows as a per cent of GDP for the CIS excluding Russia are only slightly below the EU-8 level. However, Russia's cumulative FDI inflow of 8.2 per cent is the lowest of any EME except Turkey and its FDI inflow per capita was only about one tenth of that of the EU-8.[210] Several countries, including Armenia, Azerbaijan and Georgia (averaging 30.3 per cent) and Kazakhstan (8.5 per cent) attracted large amounts of FDI relative to GDP during 2003QIII-2004QII. Azerbaijan's FDI inflow to GDP ratio of 50.4 per cent over the last year is one of the highest in the world by this measure. Except for Azerbaijan and Kazakhstan, all the other CIS members have cumulative per capita FDI inflows similar to or less than Russia.

As countries develop they initially receive inflows of FDI; only after reaching a relatively higher level of development do significant outflows begin. Except for Russia, this pattern appears to be holding for the ECE emerging market economies, all of which have very small FDI outflows. Russia is unique among the EME in that its FDI outflow has generally exceeded its inflow. According to UNCTAD, Russia's estimated stock of outward FDI of $52 billion at the end of 2003 was approximately equal to its inward stock of $53 billion.[211] Russian outflows of FDI are concentrated in the CIS and the EU as their firms attempt to establish a foothold in these markets. Since a significant amount of Russian outward FDI is undertaken by state-owned enterprises, some of this investment may be influenced by geopolitical rather than purely economic considerations. Recent empirical analysis suggests that FDI outflows can also be beneficial for the parent country.[212] Russia, Ukraine and Uzbekistan were net exporters of capital over the last year. Because of political uncertainty, they continue to have significant capital flight (see box 5.1.1).

More generally, the investment climate in the CIS could be improved with additional institutional reform. Extensive government regulation combined with weak public administration, barriers to entry, ineffective bankruptcy procedures and weak corporate governance continue to be cited as impediments to FDI.[213] An additional factor limiting investment in Russia and the other CIS oil exporters may be due to limited opportunities as a result of the "Dutch Disease", whereby rouble appreciation due to booming oil exports has lowered the competitiveness of, and thus the desire for, investment by firms in other sectors. Russia's and to a lesser degree the other CIS oil exporters' need for FDI is not based upon the need for capital funds, for which they have sufficient amounts of their own, but on the need for foreign management and technology, and as a mechanism to increase domestic competition.

Although the poorer CIS countries were able to attract reasonable levels of FDI over the last year, they face a major challenge in continuing to attract FDI: they lack natural resources; they are far from the European market, which will always limit to some extent their trade with this market; and they are unlikely to become members of the EU in the foreseeable future. For them, faster institutional reform would be desirable. Regional cooperation to improve transport links among the CIS members is also needed. Regional trade integration with the other CIS members, as well as WTO membership could help to promote FDI and economic growth by creating larger markets where economies of scale can be exploited. However, even this option may only provide limited benefits for the smaller CIS nations since a number of theoretical analyses using core-periphery trade and investment models[214] often show that the benefits of integration generally go to the core area; in this case that would be Russia.

6.2 International trade of eastern Europe

Merchandise trade booms in the new EU member countries…

The continued buoyancy of global economic growth gave a strong impetus to the trade of the enlarged European Union, especially in the first half of 2004, both with third country partners and among the member states themselves.[215] The new EU members from central Europe and the Baltic region were important contributors to this growth (table 6.2.1, chart 6.2.1): the expansion of their aggregate exports and imports accelerated in the first eight months of 2004, growing in volume at annualized rates of 16-18 per cent, well above the EU-25 average.[216] In

[210] The low level of FDI inflows into Russia is discussed in detail in *OECD Investment Policy Reviews: Russian Federation* (Paris), 2004.

[211] UNCTAD, op. cit., annex tables B.1-B.4. However, the UNCTAD data do not reflect recent upward revisions in Russian FDI inflows, which if included, would give Russia a small net cumulative inflow.

[212] B. Lee, *FDI from Developing Countries: A Vector for Trade and Development* (Paris, OECD, 2002).

[213] C. Shiells, *FDI and the Investment Climate in the CIS Countries*, IMF Policy Discussion Paper PDP/03/5 (Washington, D.C.), November 2003. Standard & Poor's still characterizes Russia as needing significant structural reform, including judicial, administrative and financial sector reforms.

[214] This refers to a class of widely used trade models which include increasing returns, agglomeration effects and transportation costs; this model was initially developed by P. Krugman, "Increasing returns and economic geography", *Journal of Political Economy*, Vol. 99, 1991, pp. 483-499.

[215] An assessment of the overall impact of accession on the new EU members' trade within the EU in 2004, however, remains difficult due in part to changes in the trade reporting systems after May 2004 (box 6.2.1) and also because of the one-off effects of trade liberalization on "sensitive" goods.

[216] According to Eurostat data, total EU-25 exports to third countries increased more than 10 per cent in the first six months of 2004 (imports, above 6 per cent) in volume while intra-EU transactions grew by 6 per cent, year-on-year. Allowing for the strengthening of the euro and export price developments, year-on-

Box 6.2.1

Foreign trade statistics in the new EU member countries after accession

Foreign trade reporting practices have changed on several occasions in most of the new EU member countries during the last 10 to 15 years, particularly as regards the publication of official trade data according to the *general trade* or *special trade* reporting systems. The former system embraces all goods entering or leaving the economic territory of a country with the exception of simple transit trade; the latter system excludes goods from a foreign country, which are received into customs warehouses unless they subsequently go into free circulation. By 2004, almost all countries were using the *special trade* concept for their official foreign trade statistics. Lithuania's foreign trade, however, was reported as *general trade*, while Slovenia used an "extended" version of *special trade.* Until their accession to the EU, foreign trade statistics in the new member countries were collected by the customs authorities on the basis of customs declarations, and processed and published by the national statistical offices.

Upon accession to the EU internal customs borders were eliminated and customs data on trade between individual member countries of the EU ceased to be collected at the border. To continue recording this intra-union portion of foreign trade, a system (Intrastat) based on information collected from enterprises on their trade transactions with EU partners was adopted by the new EU members. Trade with non-EU countries is recorded on the basis of customs data according to the *special trade* concept and are uniformly reported by national statistical offices as so-called Extrastat data. Since May 2004, the national statistical offices have also published data for total foreign trade based on various adjustments to reconcile data from these two, not fully compatible systems. While work on compiling comparable data in historical time series is still in progress, Eurostat, in collaboration with national statistical offices, has already published estimates of intra-EU trade for the new EU member countries since 1999.

The major sources of incompatibility between recent and earlier foreign trade data

Intra-EU statistics are compiled according to the EU's own definitions and not on a *general* or *special trade* basis. Intrastat's coverage is closer to the wider concept of *general trade*; thus, currently reported values for trade with the EU-25 may well be higher, in some cases notably so (Estonia), than those based on the previous methodology.

In turn, the coverage of intra-EU trade obtained through enterprise surveys is not as complete since data are not collected from a large number of small businesses (non-VAT-payers). In Hungary, for instance, some two thirds of registered enterprises (representing, however, less than 2 per cent of trade value) do not report on their trade with partners in the EU. Further, with the introduction of Intrastat, almost none of the border trade with the neighbouring regions is captured. National statistical offices, however, make some adjustments for this "missing trade", as well as for enterprises' late responses to the surveys.

Another difference between the earlier and current systems is in the partner country allocation. For exports (Extrastat) and dispatches (Intrastat), the trading partner continues to be the country of final destination (as far as it is known at the time of dispatch). For imports, the trading partner is supposed to be the country of origin in the case of extra-EU partners, and the country of consignment in the case of intra-EU trade. Under the previous system all imports were allocated uniformly to the country of origin (the practice of most of the new EU members) or according to the country of consignment. After May 2004, some of the new EU member countries started reporting imports on a country of consignment basis for extra-EU trade, which has made the comparability of the geographical structure of trade over time more problematic. The difference between imports recorded by country of origin or country of consignment can be quite considerable: for example, in the first quarter of 2004, the share of Lithuania's imports from the EU-15 accounted for 41.4 per cent of the total according to the country of origin method, and for 46.5 per cent according to the country of consignment method; similarly, its share of imports from Russia varied between 24.4 per cent and 20.3 per cent under the two procedures (this could imply the re-export of Russian goods by EU countries). Thus, since the Intrastat rules are applied henceforth to intra-EU imports, in the case of Lithuania these are relatively inflated if compared with those from Russia.

Most of these trade data problems will eventually be resolved, but at present they point to the need for caution in assessing the foreign trade performance of the new EU member countries.

addition to favourable external demand, certain one-off effects of the full trade liberalization that occurred at the date of accession to the EU supported this growth.

An increasing number of east European producers appear to have succeeded in reaping the benefits of the single EU market. At the same time the big exporters, mainly firms with significant foreign participation, were able to take advantage of the well-established EU commercial ties with third countries.[217] Moreover, the

year increases of 8-9 per cent in euros in July-September suggest continued growth in trade volumes. Eurostat, *Euro-indicators,* News Release STAT/04/137, 22 November 2004 and UNECE secretariat computations, based on short-term indicators of external trade available at [europa.eu.int/comm/eurostat/newcronos/].

[217] The extension to the new members of Mutual Recognition Agreements (MRAs) between the EU and the third countries is a case in point. Prior to the enlargement, the EU undertook measures to ensure that all its trade partners would grant the same treatment to the new members from 1 May 2004. However, there were some delays: for instance, the Russian Federation, after intense negotiations, agreed to the extension of the Russia-EU "Partnership and Cooperation Agreement" to the 10 new EU member countries

TABLE 6.2.1

International trade of European emerging market economies, 2003-2004

(Rates of change and shares, per cent)

	Merchandise exports (growth rates)		*Merchandise imports (growth rates)*		*Trade balance (per cent of GDP)*	
	2003	*2004 Jan.-Sep.*[a]	*2003*	*2004 Jan.-Sep.*[a]	*2003*	*2004 Jan.-Jun.*
New EU members	29.1	30.6	26.1	28.5	-7.0	-7.1
Cyprus	9.3	9.5	9.8	29.2	-27.8	-31.6
Czech Republic	26.6	33.8	25.9	30.7	-2.9	-1.5
Estonia	31.6	31.7	35.4	35.3	-21.6	-24.9
Hungary	23.7	27.0	26.4	27.0	-6.1	-6.7
Latvia	26.2	18.4	28.9	17.2	-21.1	-21.9
Lithuania	30.7	30.3	27.3	28.7	-14.1	-14.7
Malta	11.1	10.2	19.8	15.1	-18.3	-20.7
Poland	30.6	35.7	23.4	29.6	-6.9	-6.8
Slovakia	51.7	28.0	35.9	29.9	-2.0	-1.5
Slovenia	23.3	21.7	26.7	23.4	-3.9	-4.8
South-east Europe	28.4	31.3	31.8	36.4	-13.1	-16.4
Albania [b]	35.2	12.4	24.1	0.2	-23.1	-16.5
Bosnia and Herzegovina	35.4	30.8	22.1	21.1	-46.6	-42.0
Bulgaria	30.7	28.0	35.9	30.6	-16.6	-19.8
Croatia	25.7	29.9	32.4	18.1	-27.9	-26.3
Romania	27.0	33.2	34.4	35.5	-11.2	-13.2
Serbia and Montenegro	11.5	21.1	18.8	40.9	-25.4	-30.2
The former Yugoslav Republic of Macedonia	22.2	20.2	15.3	22.1	-20.1	-22.8
Turkey	30.0	32.3	33.3	42.4	-9.2	-13.4
Memorandum items:						
EU-25 (extra-EU trade)	17.4	20.6	17.9	19.2	-0.4	-0.6
Baltic states	30.0	28.1	30.0	27.4	-18.1	-19.3
Central Europe	29.5	31.2	26.2	28.9	-5.4	-5.1
South-east Europe without Turkey	26.5	30.1	30.3	29.8	-19.8	-21.4

Source: UNECE secretariat calculations, based on national statistics and Eurostat data.

Note: Foreign trade growth is measured in current dollar values. Trade balances are related to GDP at current prices.

a Over same period of the previous year.

b January-June instead of January-September.

effects of accession to the EU were accentuated by enlarged export capacities (Estonia)[218] or the improved cost competitiveness of exporters. The depreciation of the dollar against the euro, as well as the currencies of the new EU members, boosted dollar-denominated imports earlier in the year. The fall of the dollar also mitigated the impact of rising dollar prices for fuels and further dampened the prices of intermediate goods from China and other Asian countries linked to the dollar. This helped to raise or at least to safeguard the profit margins of the EU-8 exporters, particularly in countries where their exchange rates appreciated in real effective terms (chart 6.2.2).

Aggregate exports of the new EU member countries to partners outside the EU soared by some 25 per cent in volume in the first eight months of 2004, compared with the same period of 2003, while their dollar value increased by more than one third (for individual countries, see chart 6.2.1). The CIS (largely Russia) and south-east European markets, followed by the developed economies outside the EU, absorbed most of this export growth. This reflects the strong growth of demand in these markets, coupled in some cases with lower trade barriers after 1 May 2004. In the Czech Republic, Hungary, Slovakia and Slovenia exports of capital goods to non-EU partners rose by 35 to 55 per cent in volume (in Estonia, they doubled) in the first eight month of 2004. Foreign owned firms generated the bulk of this increase. In Lithuania and Poland, firms with foreign participation were mainly important in increasing exports of consumption goods.[219]

Merchandise exports to countries within the enlarged EU also rose at two-digit rates in volume, taking the EU-8 producers' market share of the EU-25 to 8.5 per cent in May-August 2004. This was a 1 percentage point gain over the same period of 2003. In this trade, a notable development was a strong pick-up in exporting by small- and medium-size enterprises.[220] The removal of customs barriers (including quotas) and other restrictions has especially boosted exports of agricultural products, food and beverages and some other "sensitive" goods. In Poland, for example, reported food exports to the EU grew by more than 50 per cent in dollar value in May-August

on 27 April 2004, but the accord only came into effect after its final ratification on 6 November 2004. As of 1 May 2004, the 10 new EU member states started to apply the EU's Common Commercial Policy in its entirety, including the EU's bilateral trade agreements, its multilateral commitments, its trade safeguards and, especially, its common external tariff. The external tariffs in the new member states were expected to fall from an average of 9 per cent to 4 per cent. European Commission: Press Releases, *Trade Implications of EU Enlargement: Facts and Figures,* MEMO/04/23 (Brussels), 4 February 2004 [europa.eu.int/rapid/].

[218] See chap 3.2. In 2003, there was also a very large increase in FDI-financed productive capacities in the automotive sector of Slovakia, which helps to account for the large increases in export volume in the second half of 2003 and in the beginning of 2004 (chart 6.2.1).

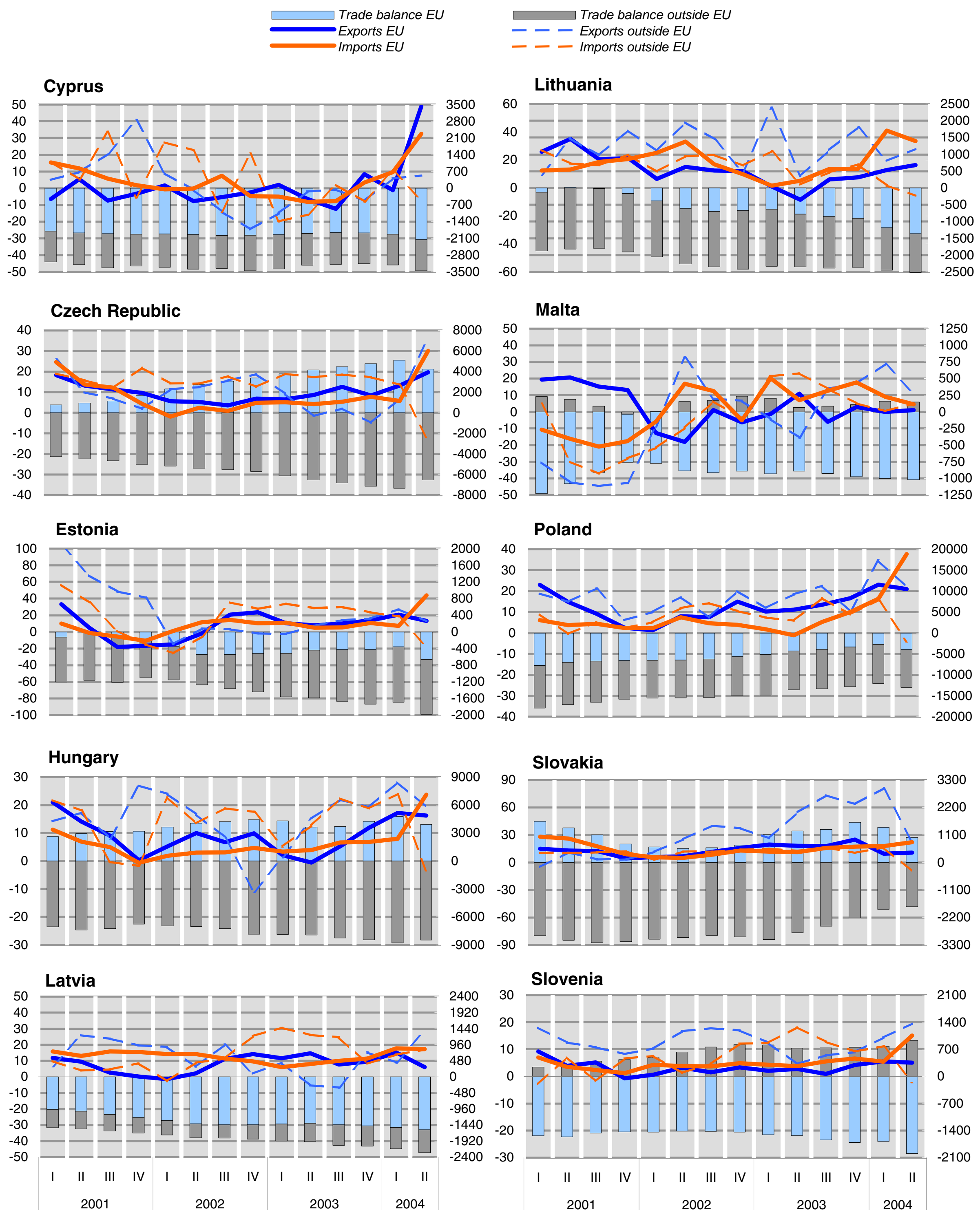
[219] According to the Eurostat methodology, the broad economic category "consumption goods" refers to the BEC's "consumer goods" grouped together with passenger cars.

[220] In Hungary, for instance, exports from small enterprises (5-49 employees) grew by 38 per cent in real terms, year-on-year, during the first half of 2004 (Kopint-Datorg, *Economic Trends in Eastern Europe,* No. 3 (Budapest), Autumn 2004, p. 45.) The much more active participation of firms at the various international fairs is also a good indication of this development: for example, at the biggest food industry fair in eastern Europe, *Polagra – Food 2004*, held in October in Poland, the number of exhibitors from eastern Europe was 30 per cent higher than in 2003 (Ministry of Agriculture and Rural Development of Poland, *Food and Polagra International Fairs 2004*, 10 October 2004 [www.minrol.gov.pl]). A similar experience is attested by SME development agencies in many other east European countries.

CHART 6.2.1

Merchandise trade in the new EU member states, 2001-2004QII

(Trade balance in million euros, percentage changes of export and import volumes over the same quarter of the previous year)



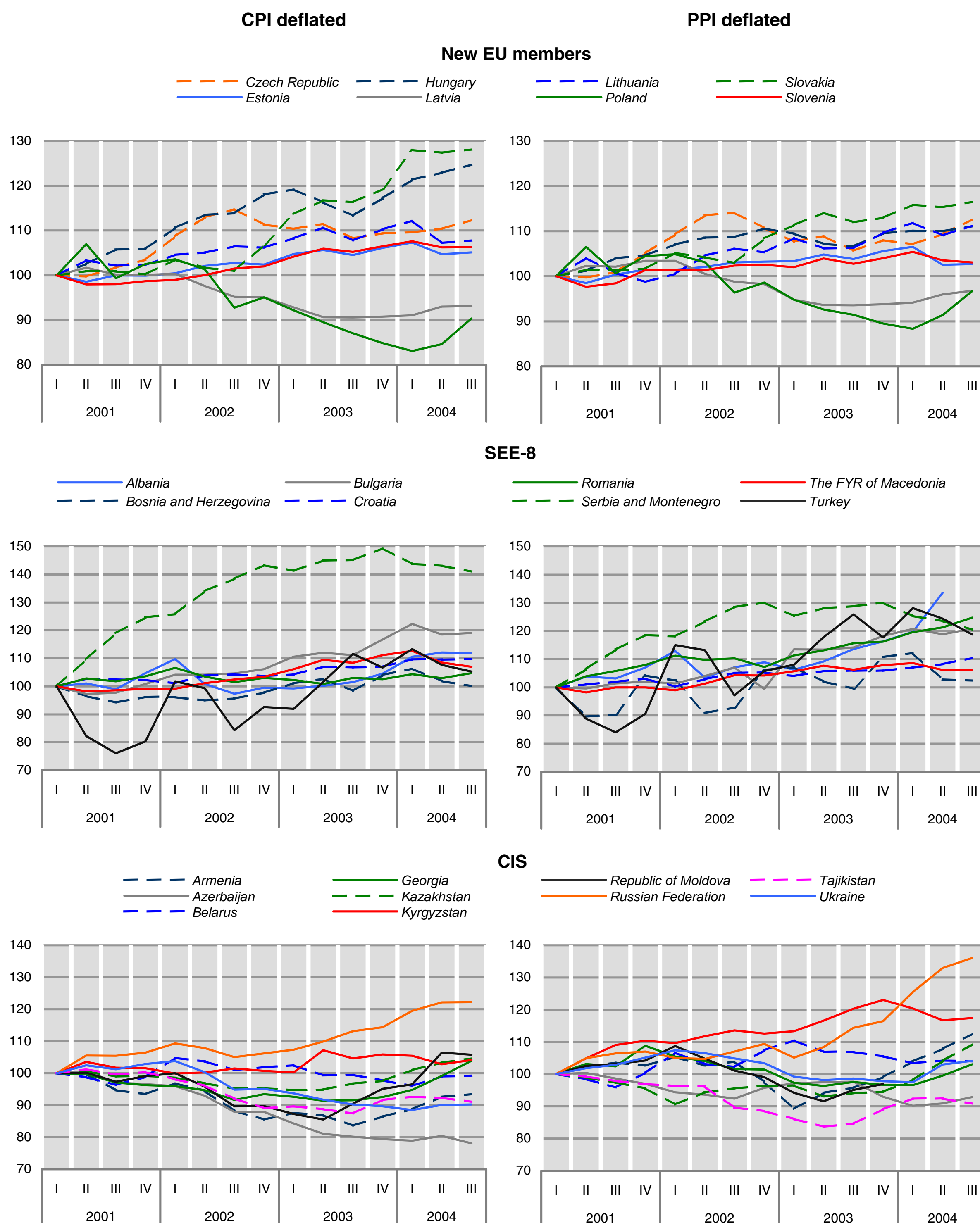
Source: UNECE secretariat calculations, based on Eurostat data of trade values and seasonally and working day adjusted trade volume index (2000=100).

Note: Merchandise trade balances in the final month of the quarter cumulated over 12 months.

CHART 6.2.2

Real effective exchange rates in the ECE emerging market economies, 2001-2004QIII

(Indices, 2001QI=100)



Source: National statistics and UNECE Common Database.

Note: The real effective exchange rates were computed from the nominal exchange rates against the euro and the dollar, deflated by the domestic and European Union or United States consumer and producer price indices. In the case of the CIS, changes against the Russian rouble and Russia's consumer and producer price indices were also taken into account. The shares of the EU and rest of the world (and Russia for the CIS) in total exports of individual ECE emerging market economies were used to determine the euro, the dollar and the rouble trade weights, respectively. An increase in the index denotes real appreciation and vice versa.

2004, year-on-year.[221] Accession to the EU has also given a strong stimulus to border trade.[222] Aided by a perceptible price advantage, comparable quality and, in some cases, consumers' desire for novelty, the presence of food and agricultural products from central Europe and the Baltic countries has increased not only in the neighbouring Austrian, German, Italian and Scandinavian markets, but also in the more distant markets of France, Ireland, Portugal and Spain. Other, generally labour-intensive consumer goods, in particular clothing and footwear, continue to face strong competition in the EU from cheaper south-east European and Asian products.[223]

The boom in the new EU member countries' imports in 2004 was driven not only by the growth of domestic demand but also by the needs of an expanding export sector. These trends are expected to continue in 2005. In the first four months of 2004 imports also increased due to stockpiling in anticipation of changes in administrative rules and customs duties upon accession.[224] Although the boom in imports has abated somewhat since then, their volume in the first eight months of 2004 was still some 19 per cent higher than in the same period of 2003. While lagging behind exports in volume, the dollar value of imports increased more or less in line with exports as the rise in world commodity prices began to inflate import expenditures in the second quarter. Moreover, intra-EU imports rose sharply after 1 May 2004,[225] with capital and consumption goods accelerating in the Czech Republic, Estonia, Hungary, Poland and Slovakia. The terms of trade deteriorated for the region as a whole, and the aggregate merchandise trade deficit increased both in dollars and euros, and in relation to GDP (table 6.2.1, chart 6.2.1). By the end of August, the cumulative 12 months of deficits were substantially higher than in 2003 in Hungary, Slovenia and the three Baltic countries; in Poland the deficit increased slightly in dollar terms but fell in terms of euros, while in the Czech Republic and Slovakia the deficits shrank because of a sharp deceleration of import growth.

The merchandise exports of the new EU member countries are expected to continue to grow rapidly in 2005, partly because of the increased opportunities for a broader range of businesses to trade on the internal EU market. This could mitigate the dampening effect of a possible weakening in the recovery in the major EU economies. Some setback for east European textile (including clothing) exporters, however, can be anticipated due to the expiration of the international textile quota system on 31 December 2004.[226] In contrast, access to the EU subsidy system for east European EU exporters of agricultural products, and additional financing from structural funds, could boost this sector's exports in both the short and medium term.

Immediately after accession there was a sharp slowdown of imports from non-EU partners, but this is unlikely to last long, as demand, particularly for intermediate goods from the export sector, is expected to continue to grow rapidly in 2005.[227] With housing and consumer credit more readily available, a rising demand for consumption goods is also expected to further boost imports, particularly since all import restrictions on purchases from other EU countries were abolished on accession,[228] and protection against imports from third

[221] The meat industry, which is the biggest sector of the food industry in Poland, nearly doubled its average monthly export sales in May-August 2004. According to Eurostat, food is Europe's second largest manufacturing sector: for most new EU member states food industries account for more than 20 per cent of total manufacturing value added, while the average for the EU-25 is 11.5 per cent. Eurostat, "The food industry in Europe", *Statistics in Focus: Industry, Trade and Services,* 39/2004 [epp.eurostat.cec.eu.int].

[222] According to some estimates, trade turnover on the open air markets on Poland's western border is currently some 40 per cent higher than before May 2004. *Rzeczpospolita,* 25 October 2004.

[223] In fact, clothing and footwear exports to the EU from Poland, Slovenia and a few other EU-8 countries stagnated or even declined in May-August 2004, year-on-year. Most affected were exports to the eastern EU partners since, after accession, access to these markets became free or less protected vis-à-vis south-east European and Asian producers (see the subsection below on south-east European trade).

[224] These increases were clearly reflected in a surge in the volume of imports of consumer and capital goods originating from non-EU markets: in some cases, the EU import regime was seen as less favourable than that applied by central European and Baltic countries under bilateral trade agreements, which were to be cancelled upon accession to the EU, hence importers opted for an increase of inventories. In aggregate, seasonally adjusted imports from non-EU-25 partners in March and April 2004 were 28 per cent above the average monthly levels in 2003 for consumer goods and 32 per cent up for capital goods; Czech, Estonian, Latvian and Slovak importers were most active in stockpiling consumer goods, while imports of capital goods by Polish and Slovene businesses saw rises of some 50-80 per cent and those of Latvia more than doubled.

[225] The change in the recording of imports from "country of origin" to "'country of consignment" may have brought some loss of comparability of the statistical data (box 6.2.1), and so some of these changes may eventually have to be revised.

[226] The European Commission has prepared a plan, including a proposal for the creation of a special reserve fund within the structural funds that could be used to alleviate the impact of quota-free trade and help the textile industry to restructure and modernize. European Commission: *Trade Issues,* Textile sector: legislation, reports and texts (Brussels), 12 and 26 October 2004 [trade-info.cec.eu.int].

[227] Intermediate goods account for over 60 per cent of total non-EU imports in the eastern EU countries. In July-September these imports were some 30-40 per cent higher, year-on-year, in dollar value, in the three Baltic countries, and 10-15 per cent in Poland and Slovenia.

[228] In Poland, for instance, new regulations (regarding technical requirements and an obligatory verification system) are to be introduced early in 2005 in order to curtail imports of used cars that inundated the Polish market after its previous import restrictions ended on 1 May 2004: nearly 500,000 used cars were imported from the EU in May-September, 30 times the number of the previous four months. (Since May, more than half a billion zlotys in excise duty has been levied on imports of used cars.) These imports badly affected locally-produced new car sales, which according to some estimates could be about 20 per cent down in 2004, year-on-year. *Gazeta Wyborcza*, 16 October 2004, and "Poland this week", *Reuters News Service*, 18 October 2004.

countries was generally reduced by adoption of the common EU commercial policy.

Thus, if oil and other major commodity prices stay at recent levels, the merchandise trade balances of many EU-8 countries are likely to deteriorate further, raising problems for policy makers. Debates about how to improve export competitiveness and provide assistance in penetrating foreign markets remain high on the agenda in all of the new EU countries. However, the instruments available to the authorities in the short run are rather limited: freezes on public sector wages have a limited impact, are highly unpopular and may lead to a drain of qualified labour from public services;[229] and interventions on the exchange rate market are often counterproductive, given the export sector's reliance on imported inputs.[230]

Trade of south-east European countries expands rapidly

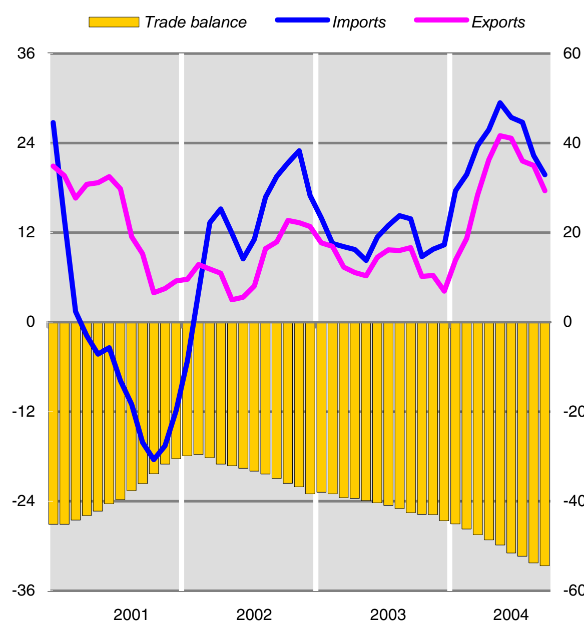
In south-east Europe, the rapid acceleration of export and import growth in the first six months of 2004 (chart 6.2.3) seems to have abated slightly in the months that followed in some countries but gained further momentum in Bulgaria, Croatia, Serbia and Montenegro, and The former Yugoslav Republic of Macedonia. The rapid growth of exports mainly reflected strong foreign demand, but for Turkey and some of the western Balkan countries, the enlargement of the EU also provided better access to the markets of the new EU member countries.[231]

Relatively low labour costs in general, coupled with a degree of success in keeping wage increases below those of productivity in Bulgaria and Croatia, and more recently in Turkey (see chap. 4.2 above), have led to increased outsourcing orders by companies in the EU and other developed countries (traditionally in the clothing and footwear sectors and, more recently, in machinery and electronics). Low labour costs have also prompted foreign investors to increase productive and infrastructure capacities in the four EU candidate countries. Increased economic stability and the approach of EU accession (Bulgaria and Romania) may have also helped to increase trade and attract FDI. The exports of the four EU candidate countries to all major partner groups increased rapidly, but those to trading partners in south-east Europe soared some 45 per cent in dollar value, thanks in part to improved regional cooperation.[232] The profit margins of exporters, however, continued to be rather tight in some of these countries, due in part to an appreciation of their domestic currencies (chart 6.2.2). This applied less to Turkey, where the terms of trade improved perceptibly in January-September 2004 as a result of higher export prices. Export prices also increased in Bulgaria, but were outpaced by the rise in import prices in the second and third quarters of 2004.[233]

CHART 6.2.3

Merchandise trade in south-east Europe, January 2001-September 2004

(Trade balance in billion euros, percentage changes of export and import values over same month of the previous year)



Source: National statistics and UNECE Common Database.

Note: Merchandise trade balances at the end of the month, cumulated over 12 months. Monthly year-on-year percentage changes for exports and imports based on the three-month moving average values in euros.

Stronger regional cooperation (box 6.2.2) and improved access to the enlarged EU market under the EU-sponsored Stabilization and Association Process have supported the expansion of exports from the western Balkan countries. Their exports to other countries in the region and to the CIS grew most rapidly, while those to the EU and other developed market economies increased in dollar terms but stagnated or declined in euros (and probably in volume as well). The latter was mainly due to

[229] However, large increases in public sector wages tend to have a strong spillover effect on the private sector in these countries. For instance, the escalation of wages in Hungarian industry in 2002-2003 (see sect. 3.2(ii) above) was prompted in part by increases in public sector wages.

[230] More details on the implications of fiscal and monetary policy on competitiveness in the medium to long term in the new EU member countries are presented in chap. 3.

[231] This improvement stems from the Turkey-EU agreement on Customs Union (in force since 1999) and from free EU market access extended to more than 80 per cent of exports from the western Balkan countries under the Stabilization and Association Process arrangements. Some of these countries did not have preferential trade arrangements with the countries that acceded to the EU on 1 May 2004, enjoying only MFN status until then.

[232] Several free trade agreements between Turkey and the south-east European countries as well as between the other three EU candidates and the western Balkan countries (box 6.2.2) came into force recently.

[233] Data on export and import price developments in 2004 in the other south-east European countries were not available at the time of writing this *Survey*.

Box 6.2.2

Towards a free trade area in south-east Europe

Since the Kosovo crisis in 1999 there have been several attempts to revive trade among the south-east European countries. With the active involvement of the international community, especially the EU, these attempts finally started to produce results under the auspices of the Stability Pact for South-eastern Europe. In June 2001, a Memorandum of Understanding (MoU) on Trade Liberalization and Facilitation was signed by Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia and Montenegro and The former Yugoslav Republic of Macedonia. In 2002, the Republic of Moldova joined these countries in the process of trade liberalization. Due mainly to political reasons, however, the south-east European countries did not adopt a multilateral approach to trade liberalization but resorted to negotiating a network of bilateral free trade agreements (FTAs) with the prospect of eventually creating a "virtual" free trade area in the region. In little more than three years a network of 28 bilateral free trade agreements was created (including five FTAs that had been signed prior to June 2001), and by September 2004, according to the Stability Pact Working Group on Trade Liberalization and Facilitation (WGT), 22 of these FTAs were in force. The MoU commitment to reach a 90 per cent threshold in terms of tariff lines and actual import value liberalization has been achieved in many of the FTAs that are in force and is within reach to the rest within the maximum six-year transitional period.[1]

Although the majority of the 28 FTAs were elaborated according to the same set of rules, they are not uniform in several important areas, including notably their coverage of agricultural goods, public procurement and services. Bilateral agreements have advantages in that they are easier to implement since only the two countries involved have to agree, but they do not lead to the same degree of integration that is likely to result from a free trade area or a customs union. It would therefore appear desirable to create some type of umbrella over all these FTAs with the aim of ensuring consistency and making the trade content rules less difficult to fulfil, a benefit desired by the domestic and international business community.

In 2004, recognizing the benefits of such a move and encouraged by the international community, the south-east European countries started to consider the next step in their regional integration process. Currently, three main alternatives are under discussion: (1) a simple harmonization of the existing FTAs under the auspices of the Stability Pact's WGT. This could be limited to a simple harmonization of the structure of the agreements (i.e. how the agreements are worded, chapters numbered, etc.) or could also involve harmonization of the provisions of the agreements; (2) an extension of CEFTA[2] towards the rest of the south-east European countries; and (3) creating a new South-east European Free Trade Area (SEEFTA).

The first alternative would be the least costly in terms of the managerial and administrative work involved, and would be the simplest and easiest to implement. It would also allow for at least a partial international supervision of its implementation. However, the economic benefits from such harmonization would be rather limited.

Expanding CEFTA would probably be less costly for the three existing members but would require the other five countries to incorporate their existing FTAs into a new Treaty (CEFTA), which, as it stands now, has in some cases a more restricted product coverage (e.g. agricultural products) and no provision concerning the new trade issues (services and public procurement) that are covered in many of the current FTAs. With the three current CEFTA member countries heading for EU accession, the elaboration of new provisions, however, is very unlikely. Admission to CEFTA, moreover, currently requires WTO membership, which is not an immediate prospect for Bosnia and Herzegovina or for Serbia and Montenegro.[3]

Creating a new free trade area, SEEFTA, would be a more difficult task but it might also provide more flexibility in fostering the regional integration process. If the process started with a simple harmonization of the existing FTAs, aligning them on the best available text, and moving on to the inclusion of provisions for other matters (services, public procurement, etc.), the result could be a larger and more attractive market for domestic and foreign businesses. If the existing CEFTA member countries (EU candidates) were uninterested in such an option, a SEEFTA could still be created among the remaining five countries as long as there appears to be a political will to cooperate on the issue.

The process of identifying the best ways to intensify regional integration is expected to continue under the auspices of the Stability Pact's Working Group. Until now, however, it has been difficult for the eight countries to agree on a common position on any of the above-mentioned alternatives. Their concerns appear to have been due more to political sensitivities rather than economic policy considerations. In any case, additional work is needed to ensure the actual implementation of the existing FTAs.

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[1] Unless otherwise indicated, the factual information presented in this box has been obtained from materials available on the Stability Pact for South-eastern Europe website [www.stabilitypact.org/trade/].

[2] Since May 2004, CEFTA has consisted of three members (all EU candidates): Bulgaria, Croatia and Romania. The former Yugoslav Republic of Macedonia is currently negotiating accession to CEFTA.

[3] Both countries are actually loose unions of several autonomous entities with their separate markets, currencies, legislation and governing bodies, and have difficulty in presenting their common position in the WTO accession negotiations. (A two-track approach, allowing the separate entities to negotiate accession in parallel, was recently suggested by some WTO members in order to speed up the process.) Bosnia and Herzegovina loosely unites the Federation of Bosnia and Herzegovina (FBiH), Republika Srpska and the Brcko District; while the state union of Serbia and Montenegro, established in February 2003, actually represents two independent republics. In addition, Kosovo, which is part of Serbia, is at present under the authority of the United Nations Interim Administration (UNMIK). Since June 2004, UNMIK/Kosovo has been gradually integrated into the network of FTAs of south-east Europe.

supply-side constraints: recent setbacks to industrial output in Albania and The former Yugoslav Republic of Macedonia, under-investment in productive and infrastructure facilities, and the virtual absence of greenfield FDI in the region have held back the development of the export sector. However, there was an increase in outsourcing from EU firms that has mainly helped to boost textile and footwear exports from most of these countries.[234]

Rapid import growth in south-east Europe in 2004 reflected the strong growth of domestic demand, particularly in the four EU candidate countries. In the latter group, the exporting sectors' needs for capital and intermediate goods are being met by imports, but it was consumption goods that fuelled their growth in 2004, particularly in Turkey.[235] Imports of fuels and intermediate goods in the western Balkan countries have grown steadily in value (inflated in part by higher commodity prices on international markets). Imports of capital goods picked up most noticeably in Serbia and Montenegro due to inflows of FDI. However, the rise in imports of consumption goods – which account for at least one fifth of total merchandise imports in the western Balkans – have outpaced the other import categories.

Merchandise trade deficits, in dollars, increased across the region. In relation to GDP, the deficits were noticeably higher than a year earlier in five of the eight south-east European countries (table 6.2.1). Checking the rise of merchandise trade deficits is a difficult task, particularly in some of the west Balkan countries which are still recovering from the effects of armed conflict.

In the EU candidate countries, where the process of economic transformation is more advanced, the authorities have been able to deploy various monetary and fiscal policy instruments to curb the consumer demand for imports. This could include restrictions on credit, the abolition of certain incentives and tax breaks (already scheduled in Turkey), and so on. However, being closely tied to the EU commercial policies and parties to the WTO, they are less free to impose additional import restrictions. Another important task facing policy makers in the region is to create an environment that will attract more FDI and enhance the competitiveness of domestic industries, thus helping them deal with a very difficult external environment. Textile producers and major exporters in several south-east European countries, especially Bulgaria, Romania and Turkey, could face such a challenge in early 2005 when the WTO Agreement on Textile and Clothing comes to the end.[236]

6.3 International trade of the CIS

In the first six months of 2004, year-on-year, the aggregate dollar value of international trade of the CIS region continued to expand significantly for the second year in a row (table 6.3.1).[237] The value of merchandise exports in the CIS increased by more than a quarter.[238] The improvement was largely the result of higher commodity prices as most CIS countries are highly dependent on foreign sales of crude oil, oil products, natural gas, base metals, cotton and gold.[239] The volume of Russian exports – indicative of the CIS as a whole – increased by 6 per cent, year-on-year, but average export prices increased by 15 per cent in the first half of 2004.[240]

The continuing high rate of economic growth in the CIS countries – driven by robust demand for consumer and investment goods – gave a strong impetus to merchandise imports.[241] Exchange rate appreciations in

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[234] Of the south-east European countries only Serbia and Montenegro does not yet have a preferential agreement with the EU on trade in textiles. The accord between Bosnia and Herzegovina and the EU came into force recently and has resulted in a considerable rise of clothing exports since the beginning of 2004 (particularly, from the Federation of Bosnia and Herzegovina where nearly 90 per cent of textile sector capacities are currently operating under outsourcing agreements). *South East European Newswire,* 17 June 2004. Note that the Federation of Bosnia and Herzegovina is one of the two entities (the other is Republika Srpska) that constitute the country under the Dayton Accord. The Federation covers 51 per cent of Bosnia's territory.

[235] In Turkey, passenger car imports boomed thanks in part to a generous $3,000 tax break for exchanging old vehicles for new ones. Although reduced by half in May 2004 the concession will remain in place until 2005. Relatively cheap consumer credit (about 10 per cent interest rate until August, 15 per cent since) has also helped. Oxford Analytica, *Turkey: Deficit Increases Lira Risks,* 11 October 2004.

[236] The WTO Agreement on Textiles and Clothing, which established a 10-year period for the elimination of the quotas, will expire on 31 December 2004, and trade in textile and clothing products will be subject to the general GATT rules. According to one estimate, Turkey may lose from 1 to 3 percentage points of market share for these goods in the EU and suffer a decline of some 2.2 per cent in its current export earnings. Fitch Ratings: Sovereigns, *Phasing Out the Multi-Fibre Agreement,* Special Report, 22 September 2004 [www.fitchratings.com].

[237] The aggregate dollar value of CIS exports continued to increase in the first three quarters of 2004 (at a faster rate than in the first half of 2004), mainly reflecting exports by crude oil producing countries. Azerbaijan, Kazakhstan and Russia all increased the value of their exports relative to the first half of 2004. Rates of growth in the value of imports were roughly unchanged both in aggregate and for individual countries.

[238] The CIS trade data are affected by the weaker dollar, which biases year-on-year comparisons measured in dollars.

[239] Prices of key CIS natural resource exportables increased considerably, year-on-year, in the first half of 2004. The dollar price of crude oil rose by 17 per cent and gasoline by 28 per cent, while prices for base metals such as aluminium, copper and nickel increased by 20, 67 and 63 per cent, respectively. Gold and cotton prices, which are important sources of export revenue in central Asia also increased significantly (15 and 21 per cent, respectively). The price of Russia's natural gas rose by 2 per cent.

[240] Russia is the only CIS country that publishes estimates of the volumes of aggregate trade.

[241] In the first half of 2004 compared with the corresponding period in 2003, retail sales increased in most CIS countries by at least 10 per cent while investment outlays continued to grow strongly (by between 12 and 61 per cent).

TABLE 6.3.1

CIS countries' trade with CIS and non-CIS countries, 2002-2004
(Value in million dollars, growth rates in per cent)

	Export growth		Import growth		Trade balances		
	2003	2004[a]	2003	2004[a]	2002	2003	2004[a]
Armenia	34.2	7.2	28.6	3.8	- 482	- 591	- 285
CIS	31.5	- 3.8	2.7	- 9.4	- 205	- 183	- 71
Non-CIS	34.9	9.8	40.0	7.9	- 277	- 408	-214
Azerbaijan	19.6	33.8	57.7	33.6	502	- 34	- 199
CIS	36.9	170.7	30.8	47.1	- 407	- 518	- 207
Non-CIS	17.4	13.2	74.9	26.9	909	484	8
Belarus	24.2	32.4	26.5	32.5	-1 071	-1 541	- 756
CIS	24.4	37.4	27.2	33.9	-1 911	-2 553	-1 700
Non-CIS	24.0	27.2	25.1	29.2	840	1 012	944
Georgia	27.7	66.7	44.6	57.1	- 384	- 614	- 467
CIS	27.0	96.5	23.5	59.0	- 121	- 143	- 106
Non-CIS	28.3	42.6	58.5	56.1	- 263	- 470	- 361
Kazakhstan	33.4	40.2	26.5	56.0	3 086	4 574	2 873
CIS	34.6	51.3	28.8	61.4	- 849	- 966	- 805
Non-CIS	33.0	37.1	24.5	51.2	3 935	5 539	3 678
Kyrgyzstan	19.8	44.9	22.1	43.6	- 101	- 135	- 83
CIS	19.4	49.4	27.1	57.9	- 154	- 209	- 140
Non-CIS	20.0	42.6	16.0	26.0	53	74	57
Republic of Moldova	22.7	33.3	35.1	34.0	- 395	- 612	- 313
CIS	20.9	26.9	45.1	35.9	- 59	- 170	- 104
Non-CIS	25.0	40.6	28.5	32.6	- 336	- 443	- 209
Tajikistan	8.3	25.9	22.3	63.1	17	- 83	- 170
CIS	- 26.3	12.6	9.5	61.0	- 359	- 461	- 365
Non-CIS	20.1	28.8	62.9	68.4	376	377	195
Turkmenistan	20.8	..	20.8	..	759	918	..
CIS	0.8	..	- 0.5	..	684	700	..
Non-CIS	45.2	..	35.3	..	75	218	..
Ukraine	28.5	50.8	35.6	33.0	980	59	2 411
CIS	38.2	56.8	28.3	33.8	-4 591	-5 460	-2 999
Non-CIS	25.4	48.9	43.8	32.1	5 571	5 520	5 410
Uzbekistan	26.9	..	9.8	..	89	527	..
CIS	23.3	..	15.2	..	- 314	- 315	..
Non-CIS	27.9	..	6.6	..	403	842	..
Total above	27.4	42.5	30.6	37.1	3 000	2 467	3 011
CIS	27.3	49.7	26.1	39.1	-8 285	-10 277	-6 497
Non-CIS	27.5	39.6	35.6	34.8	11 285	12 744	9 508
Russian Federation	25.9	22.0	24.2	30.9	60 001	76 312	42 805
CIS	31.3	35.8	28.5	40.9	5 376	7 343	4 427
Non-CIS	25.0	19.7	23.0	27.9	54 625	68 969	38 378
CIS total	26.4	27.7	27.3	33.8	63 001	78 779	45 815
CIS	29.4	41.7	26.8	39.7	-2 909	-2 933	-2 070
Non-CIS	25.6	24.4	27.5	30.3	65 910	81 713	47 885

Source: CIS Statistical Committee (Moscow); for Turkmenistan: Dow Jones Reuters estimates. For Uzbekistan: *Statistical Review of Uzbekistan 2003*, Taskhent 2004 (data adjusted for trade in services).

a January-June.

real terms against the dollar, ranging from 3 to 5 per cent in Azerbaijan, Kyrgyzstan and Ukraine to between 9 and 22 per cent elsewhere also supported increased imports.[242]

In addition, the recovery of intra-CIS trade – up by 40 per cent in value – was also responsible for a large part of the increase in the value of total merchandise CIS trade.[243] Russia, which accounts for almost half of total intra-CIS trade, recorded increases ranging between 15 and 19 per cent in both volume and prices. Moreover, Russian imports from the CIS were supported by the real appreciation of the rouble.[244] While currency appreciation may have been important for stimulating Russia's bilateral trade with the smaller CIS economies, its trade with the largest CIS economies was primarily driven by high rates of GDP growth. Belarus, Kazakhstan, Russia and Ukraine – which account for about 90 per cent of Russia's CIS trade – grew at rates of between 7 and 13 per cent, year-on-year, in the first half of 2004. This growth continued to sustain increased trade in a variety of investment and consumer goods.[245] Since the first half of 2002, the value of CIS trade has risen by two thirds, driven by strong economic growth in the largest CIS economies.

The four largest CIS economies have also continued to develop their "common economic space". The plan includes the creation of a free trade zone by July 2005. Consistent with this goal, the VAT regime in Russia was changed from the origin principle to the destination principle (applicable to sales of crude oil and natural gas to CIS countries).[246] The Russian government is also promoting a similar initiative to integrate some other CIS economies into the Eurasian Economic Community (Belarus, Kazakhstan, Kyrgyzstan and Tajikistan).

Overall, the Commonwealth of Independent States is an organization that aims at providing a framework for economic coordination and trade relations for the former Soviet Union republics (except the Baltic states). The original agreement stipulated the creation of a CIS free trade zone, but this has not been realized. Instead, CIS members have opted for bilateral free trade agreements, some of which have never been implemented. Moreover, many of the arrangements that have been implemented provide, to varying degrees, for quotas and tariff exceptions. In addition to these formal impediments to trade, there are also other barriers that impede trade within the CIS region. State monopolies frequently control the production or transport of key exportables; transport infrastructure is

[242] In some countries, however, domestic currencies depreciated in real terms against the euro (except in Georgia, Kazakhstan, the Republic of Moldova and Russia). This may have dampened their demand for goods traded in euros. Because of the divergent changes vis-à-vis the euro and the dollar, the value of aggregate CIS exports and imports expressed in euros increased by 15 and 20 per cent, respectively.

[243] The intraregional contribution to the increase in total imports was about one half and about a quarter of the increase in exports.

[244] The Russian rouble appreciated in real terms by up to 14 per cent against all the CIS currencies except that of the Republic of Moldova against which it depreciated.

[245] In dollar value, Russian trade with Belarus, Kazakhstan and Ukraine grew between one third and about a half.

[246] Under the August 2004 agreement, Russian exports of energy products will be zero-rated (before the change they were taxed at 18 per cent). The loss in revenue to the Russian budget – more than $1 billion annually – will be offset by increased taxation of extractive activities in Russia.

generally of poor quality; and political instability in many regions and corrupt practices at border crossings often greatly inhibit trade by raising the official and unofficial costs of shipping goods. In sum, despite considerable geographical diversification outside the CIS region,[247] the CIS member countries have retained significant economic ties and their potential for trade is greater than at present, but it has remained largely unfulfilled due to the absence of effective pan-CIS cooperation.[248]

In the context of the objectives for the above-noted CIS subregional trade organizations – while not the most crucial in appearance – there have also been discussions about coordinating efforts to join the WTO. Despite its advantages, WTO membership continues to present a major challenge for the majority of the CIS countries.[249] Of the eight remaining non-WTO members from the CIS, only Turkmenistan has not applied for membership.[250] The others are at various stages of the accession process. Azerbaijan and Uzbekistan are at the early stages of document submission, while the others are typically negotiating goods and services schedules and market access issues.[251] In May 2004, the EU and Russia agreed on terms for Russia's accession to the WTO. As part of the agreement, Russia is to raise gradually the domestic price of natural gas above its cost of production, but will not match west European price levels as originally demanded by the EU. This agreement brings Russia a step closer to WTO membership, but it has yet to reach similar deals with its remaining key trade partners. Thus, Georgia – already a WTO member – has raised questions about a number of trade impediments in its bilateral negotiations with Russia.[252]

In general, international trade policies in the CIS area continue to be politically sensitive. Moreover, large variations in taxes and subsidies create profitable arbitrage opportunities for quasi-legal border trade.[253] For example, in September, a free trade agreement between the Republic of Moldova and Ukraine had not been ratified by the Ukrainian parliament whose members justified their refusal by the need to protect domestic producers. Also in September, the Moldovan government announced that it was planning to raise import duties on alcoholic drinks purchased from non-WTO members, in an effort to stem the flow of alcoholic beverages from Ukraine, which are cheaper due to lower excise taxes. In central Asia, where the high transit cost of shipping is already a major deterrent to merchandise trade, matters are often made worse by cumbersome customs and border regimes. Uzbekistan, for example, has introduced a new regulation that requires imported goods be sold by those who bring them into the country. The new requirement is reportedly aimed at regulating bazaar trade, but it undermines a system of shuttle trade, based on a division of labour between importers and bazaar sellers. In contrast, Kyrgyzstan's exports to Kazakhstan rose by over 80 per cent, helped by reductions in transit fees and the easing of various regulations that have made mutual trade more profitable.

High commodity prices continue to stimulate exports

As noted above, the aggregate dollar value of exports from the CIS increased considerably in the first half of 2004. In the European CIS economies, such as Russia and Ukraine, rising commodity prices – due to robust external demand – were generally accompanied by greater export volumes. However, Russian exports – mostly crude oil, natural gas and metals – increased more slowly than those of other three European CIS economies. Production constraints, transport bottlenecks and the duration of natural gas contracts, all impeded larger increases of exports.[254] As Russia's state-owned oil pipeline monopoly was reportedly operating at full capacity, the high prices of crude oil justified the use of alternative – albeit more costly – export routes such as railcars.[255] The volume of exports of oil products was

[247] The CIS countries also have more potential to trade with countries outside of the region. For example, after accounting for distance, by one estimate the CIS countries could have tripled their trade with the EU if they had made greater progress in transition from central planning to market. K. Elborgh-Woytek, *Of Openness and Distance: Trade Developments in the Commonwealth of Independent States, 1993-2002*, IMF Working Paper, WP/03/207 (Washington, D.C.), October 2003.

[248] The presidents of Kazakhstan, the Republic of Moldova and Russia have publicly criticized the organization and its ineffectiveness. "CIS: group functions as vehicle of Russian influence", *Oxford Analytica*, 22 September 2004.

[249] For example, Russia – by virtue of its not being a WTO member – could not claim compensation for the admission of new members to the EU in May 2004.

[250] The current WTO members from the CIS are Armenia, Georgia, Kyrgyzstan and the Republic of Moldova.

[251] Azerbaijan began a second round of talks on its accession in October 2004. The country's accession process is expected to receive technical assistance from other WTO members, the United States and the EU in particular.

[252] For example, "uncontrollable flows of smuggling from Russia", the operation of "illegal customs checkpoints", and the restriction of Georgian wine into Russia by railway only. TACIS, *Georgian Economic Trends*, No. 3, 2004, p. 33. The country is also trying to secure a formal certification of its wine and mineral water by the European Commission so it can export these goods (traditionally sent to Russia) to the EU.

[253] The average import tariff in the CIS is about 9 per cent and it has gradually declined over time. But the IMF's trade restrictiveness index for the CIS (which includes taxes and non-tariff barriers to trade) is twice the level of that for the central European countries.

[254] In Russia, crude oil and natural gas producers boosted their export revenues but only slightly increased the volumes of exports (up by over 4 per cent), which reflected higher extraction rates (up by 10 and 5 per cent, respectively).

[255] This trend has continued. For the January-September 2004 period, oil exports by rail rose by 5 per cent, year-on-year. Moreover, Russian oil producers re-routed oil deliveries from inland destinations such as central Europe (down by a quarter) and to seaports (up by almost 60 per cent), which are more profitable. "Exports by rail in January-September rose 5 per cent", *Reuters News Service*, 15 October 2004. Paradoxically, the Polotsk-Ventspils pipeline was greatly underutilized (by almost half of its capacity) in 2004, while crude oil shipments by rail to the Ventspils terminal increased by over 2 million tons. "Prospects and pitfalls of oil transit through Ventspils port", *The Baltic Times*, 11 November 2004 [www.baltictimes.com].

down, however, consistent with output in the Russian refining sector. Exports of steel products rose by a third in volume, making steel and other metals the fastest growing category of exports in the first half of 2004.[256] Similarly, the value of Russia's machinery and equipment exports surged by more than a fifth supported by high rates of economic growth in the region.[257]

Ukrainian exports grew very rapidly owing to the continued boom in the global steel and chemicals markets, particularly in Asia, which has become the principal destination for its ferrous metal exports. Steel and chemicals exports, accounting for almost half of the country's foreign exchange, rose by about a half in value terms compared with the first six months of 2003. The recent completion of new refining capacity is also bearing fruit: various oil products – which now account for about 15 per cent of total exports – benefited from increased prices. Exports of machinery and equipment (including transport vehicles) almost doubled in value on the strength of Russia's surging import demand.

The economies of Belarus and the Republic of Moldova are relatively less dependent on the global business cycle but, at the same time, are more closely dependent on Russian import demand, especially for machinery and equipment and agricultural products. In Belarus, where strong Russian demand continued to support agricultural and manufactured exports, the value of exports increased by a third. The expansion was broadly based on major export items such as machinery and equipment, transport equipment and food.[258] In the Republic of Moldova**,** the value of exports was driven primarily by increased sales of clothing products that originate in and are destined for the EU (after local processing) as well as more traditional products such as vegetables to other CIS markets.[259]

In the last few years, in the Caucasian region of the CIS*,* Armenian exports of jewellery to Belgium and Israel have usually dominated movements in its total exports. In the first half of 2004, output in the diamond processing sector, which is the main source of both industrial output and exports, slumped 11 per cent. This slump was due to a slowdown after two years of rapid growth and disruptions in the supply of raw materials. As a result, Armenia's exports were the slowest growing in the CIS (up by 7 per cent). In contrast, Georgia's exports rose by two thirds in value, largely reflecting the delivery of military aircraft in the second quarter of 2004. Higher prices for ferrous scrap and waste, usually destined for Turkey, also contributed.[260] The value of Azerbaijan's exports – about 80 per cent dependent on oil – also rose by a third due to a one-off sale of oil extraction equipment to Turkmenistan. The more traditional sales of oil products to non-CIS markets increased in volume by about a quarter, but exports of crude oil were down by 11 per cent as a result of sluggish extraction rates.

In central Asia, Kazakhstan was one of many CIS natural resource producers taking advantage of higher commodity prices. The volume of oil exports rose by 16 per cent (year-on-year), various steel products rose by up to 10 per cent, and copper sales rose by 13 per cent in the first half of 2004.[261] In Kyrgyzstan, the growth of exports reflected higher gold prices and production from the Kumtor mine, strong external demand and improved access to regional markets.[262] In Tajikistan, higher prices for aluminium and textiles (including cotton fibre), which account for almost all of the country's exports, boosted their total value by a quarter.[263] In Turkmenistan, where the official data remain scant and their reliability questionable, the total value of exports reportedly increased by 13 per cent due to an increase in the volume of natural gas exports. (Natural gas is sold under a fixed price contract but the volume is believed to have increased by 5 per cent.) Exports of oil products were up by 20 per cent in volume – a reflection of the value adding strategy of processing domestic crude oil. Similarly in Uzbekistan, international trade data are often unavailable or provided in a format that is not easily comparable with other countries. Gold and cotton exports are believed to have increased in the first half of 2004.

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[256] The composition of Russian exports did not change significantly. Exports to non-CIS countries continue to rely on sales of crude oil, oil products and metals (over 80 per cent of the total), while these same commodities account for slightly more than half of Russia's exports to the CIS. Since 2003, the share of steel and base metals in total exports has increased by about 5 percentage points; this was due to increases in both volume and price and was mostly at the expense of oil and oil products.

[257] Russian exports of machinery and equipment go mainly to other CIS countries ($2.5 billion or 86 per cent of total capital goods exports in the first half of 2004).

[258] As in the past, export growth was driven by Russian import demand, which accounts for about half of the value of Belarus' total exports. In the first half of 2004, exports of food to Russia rose by almost two thirds, consumer goods by a third and machinery by almost 40 per cent in value. Non-CIS sales – mostly crude oil, oil products and chemicals – increased by up to 15 per cent in volume.

[259] However, exports of food, beverages and tobacco – consisting mostly of sales of wine to Russia – expanded more slowly than total exports.

[260] The newly elected government has claimed some success in curbing smuggling, and this appears to have resulted in increases in recorded trade.

[261] The corresponding dollar values increased by much more: oil by 34 per cent, steel products by up to 72 per cent depending on the product, and copper by 73 per cent. Crude oil, natural gas and steel production increased by 10 per cent, 48 per cent and up to 18 per cent, respectively.

[262] Exports to the CIS markets rose mainly due to increased exports of sugar, fruit and vegetables, and building materials, but their share in total exports is relatively small.

[263] The volume of cotton shipments was flat while aluminium sales rose by 16 per cent. Tajikistan also generates electricity that is largely sold to Uzbekistan. The country is trying to diversify and will sell electricity to Russia through Kazakhstan and Uzbekistan after signing a contract with Russia in the first half of 2004.

Energy prices, investment and consumption drive imports

The dollar value of CIS imports increased by a third in the first half of 2004, year-on-year. The increases were very large in all the CIS countries (except Armenia) ranging from 31 per cent in Russia to 63 per cent in Tajikistan. Russian imports were driven by domestic investment and consumption. In the first six months of 2004, imports of machinery and equipment rose by almost a half, and capital goods are expected to continue to be the most important single category of Russian imports. The modernization of the existing capital stock and investment in new productive capacity has also been behind rising imports in most of the CIS.

In Azerbaijan, import growth continued to be related to the expansion of the pipeline system and further exploration and development of the country's oil and natural gas fields. Similarly, in Georgia pipeline construction made a large contribution to the 60 per cent rise in imports. As noted above, some of these increases may be exaggerated as changes in government policies as well as tighter border controls have led to more imports being captured in the official statistics. In Kazakhstan imports of machinery, equipment and transportation vehicles increased by more than a half and now account for over a quarter of total imports.

For the CIS energy importers and the major net energy exporters, both importing energy from neighbouring countries because of the legacy of the Soviet-designed transport system, the increased dollar value of imports was related to both higher volumes and prices for crude oil, natural gas and electricity. Azerbaijan's imports of natural gas and electricity increased by 14 and 23 per cent, respectively, in volume. The rise in Belarussian imports is partly due to higher import volumes for crude oil and natural gas (up by 4-6 per cent). Kazakhstan, a major crude oil producer, imported much larger volumes of natural gas and electricity (43 and 64 per cent, respectively), while its imports of oil products more than doubled. Similarly Kyrgyzstan imported significantly greater volumes of crude oil, oil products and natural gas. The Republic of Moldova and Tajikistan imported more electricity and oil products. In Ukraine, imports of fuels and mineral products were up by one third in value.

Some recent empirical research has examined the trade patterns of the CIS countries in order to determine the degree to which they differ from those of other countries in similar circumstances.[264] Factors included are the levels of development and the economic sizes of not only the CIS countries but their trading partners as well; in addition this analysis considers the distances between trading partners and whether or not they use a similar language or are in a similar trading bloc. This study, based on 1996-2000 trade flows, analyses the value of trade, its geographical distribution and its commodity composition. Since 2000, there have only been minor changes in the CIS economies' structures of trade. Russia and Ukraine appear to have trade patterns in terms of value and geographical destinations that are generally consistent with expectations based upon world trade patterns. Sectorally, however their exports are overly concentrated in a few natural resource-based products. The poorer CIS countries, including the central Asian countries, Belarus and the Republic of Moldova, although trading normally within the CIS, appear to "under-trade" with the rest of the world. What is missing in their trade is mainly manufactures.

Thus, the clear pattern that emerges from this analysis is that trade in manufactures, especially with non-CIS countries, is much smaller than what would be expected based upon average world trade patterns. In many cases, the manufacturing sectors in the CIS simply have not adjusted to the movement from a planned to a market economy, and these countries find themselves partially excluded from global manufacturing chains. Limited access to foreign markets for their manufactures is a factor contributing to this problem, as is their non-membership to the WTO. This finding of "missing" manufactures trade has several important implications. Given that manufacturing is likely to be labour intensive in these countries, the lack of a manufacturing base contributes to low levels of employment. Globally, productivity growth in almost all countries tends to be driven by the manufacturing sector; thus the absence of a viable manufacturing base greatly weakens the economic dynamism of these countries and reduces their potential for long-term sustainable growth based upon technological advancement. Dependence on commodity trade subjects the CIS to the risks of instability in export earnings and possibly exposes them to a long-run deterioration in their terms of trade. Since the trade of these countries is primarily inter-industry trade, they have been unable to get the benefits associated with intra-industry trade in manufactures such as economies of scale and increases in product variety. Where there is an inter-industry trade pattern, changes in trade policy tend to produce painful adjustment costs; as a result there tends to be greater political opposition to trade liberalization than when trade patterns consist more of intra-industry trade.

Given these differences in the actual CIS trade pattern relative to the expected pattern, an obvious question is to what degree government policy should attempt to address them. While there has been considerable progress in achieving macroeconomic stability, the CIS countries need to put greater emphasis on the establishment of high quality institutions, a well-functioning infrastructure, market determined prices, liberalized trade, an openness towards FDI, and progress on WTO accession and regional trade integration.

[264] This analysis uses a gravity model, which is the standard analytical framework for examining these types of issues. L. Freinkman, E. Polyakov and C. Revenco, *Trade Performance and Regional Integration of the CIS Countries*, World Bank Working Paper, No. 38 (Washington, D.C.), August 2004.

Overall, however, there remains a question as to whether this should be the extent of policy to address this issue or whether more specific policy interventions are desirable to address the lack of manufacturing trade.[265] Although an industrial policy, an import substitution programme, or an export promotion programme as a means of fostering manufacturing industries have been out of favour for more than 20 years in the policy advice provided by the international financial institutions, the poor growth performance of many of the countries following their advice has given rise to significant criticism of their market oriented "hands off" policy recommendations. From a technical point of view, there are a number of valid arguments as to why more activist government policies might be desirable, but in practice they often lead to rent-seeking behaviour that can be more costly than the initial problem. Regardless of the possible economic rationale for some type of manufacturing promotion programme, WTO policies (assuming accession) are likely to limit significantly the type of programme that could actually be implemented. The ability to conduct a successful industrial policy, however, requires a highly advanced and coordinated institutional structure (see chapter 1.2(iii)). Given the generally weak institutions in many of the CIS countries, the best advice for now may be to concentrate initially on the fundamentals including early WTO accession and improved governance, and only after more progress has been achieved in these directions, should the possibility of an "active" industrial policy be considered. An additional way to minimize the impact of export earnings volatility instead of altering the sectoral composition of output is to export the risks to foreigners. This can be accomplished in several ways such as encouraging more foreign ownership of the natural resource industries or encouraging domestic producers to hedge their risk by using futures and options markets.

[265] The proper role of government in addressing an export pattern concentrated on a few commodities has generated a long and controversial literature dating back to the seminal contributions of Raul Prebisch of the United Nations Economic Commission for Latin America. Gunnar Myrdal, the first Executive Secretary of the UNECE, also argued that specific government policies should be directed towards modifying an export structure concentrated on commodities.