THE ECE ECONOMIES AT MID-1998

1. Introduction

Developments in the first half of 1998 were marked by the contrast between a deepening economic crisis in East Asia and a continuing economic upswing in the western market economies and the transition economies. In East Asia, the economic and social costs of adjustment to be faced after the turbulence in the financial markets have become more visible in 1998. A significant deterioration of the economic situation in Japan, which moved into deep recession, and the associated sharp depreciation of the yen have seriously dampened prospects for recovery in the region, however. In North America, the economic expansion has continued at a high rate. In western Europe, the cyclical recovery has continued at a moderate pace. Economic developments have also, in general, been favourable in the transition economies, but they are still vulnerable to financial instability as a result of large domestic or external imbalances, real currency appreciation, weak banking systems, and relatively high exposure to short-term capital inflows. The recent financial turmoil in Russia, which erupted in May 1998, is an illustration of these risks.

2. The western market economies

Economic developments in the western market economies were generally positive in the first half of 1998. The expected negative effects of the east Asian crisis on net exports have only gradually started to appear and so far they have been offset by stronger domestic demand. In general, the western countries have so far mainly experienced the beneficial effects of the Asian crisis: falling inflationary expectations have put downward pressure on interest rates and this has supported domestic demand. Falling interest rates have also contributed to the rise in asset prices and, hence, household wealth, which has also been supporting private consumption expenditures.

Economic forecasts prepared in the spring pointed to a rather favourable development in western Europe and North America in 1998 and 1999. In western Europe, the dominant expectations are still for a steady, albeit moderate, strengthening of cyclical forces; the current forecasts still point to an average annual growth of GDP in western Europe of 2¾ per cent, but this may now be an upper estimate. In contrast, the often anticipated cyclical slowdown ("soft landing") has yet to appear but is still expected to occur later this year in the United States; current forecasts for annual growth in the United States economy in 1998 are in general close to 3 per cent but given the likelihood of a stronger than expected slowdown in export growth, the outcome could be nearer 2.7 per cent. It was clear that these benign changes depended to a large degree on how serious the ramifications of the 1997 crisis in Asia would be and on the persistence of low inflationary expectations in the United States.

The economic crisis in East Asia, however, has deepened significantly in the first half of 1998. In the emerging economies of the region, the decline in output or the slowdown in economic growth, which is now forecast for 1998, is much larger than expected earlier. The east Asian crisis has also acquired a much larger dimension with the deep recession in Japan against the background of a persistent crisis in the banking sector. The recession in Japan, if not quickly reversed, will aggravate the economic crisis in the east Asian emerging markets and delay their recovery. In combination, these developments will also affect growth prospects in other parts of the world economy, notably the United States. Import demand in East Asia will be lower than expected as a result of depressed domestic demand, while the pressures to step up exports to other regions of the world economy will be accentuated. The adverse changes in export demand facing the western market economies will be aggravated by the marked weakness of international raw materials prices, notably of crude oil, as witnessed recently. This, in addition to the shortfall of demand from Asia, will depress the export revenues and domestic incomes of commodity exporting countries and, consequently, their demand for products from the rest of the world.

The upshot is that the contribution to growth of the real net foreign balance in North America and western Europe in 1998-1999 is likely to be smaller (or the negative impact to be larger) than expected earlier this year, with concomitant negative repercussions on the strength of domestic demand. In other words, the downside risks to the short-term economic outlook for the western market economies have increased during the last few months.

In the **United States**, the available data suggest that relatively strong growth continued in the second quarter, but the expansion is now only supported by the growth of domestic demand. Changes in real net exports are expected to exert a significant drag on domestic activity levels in the second half of 1998 reflecting the strong dollar and the trade effects of the Asian crisis. Thus, even without a tightening of monetary policy there is likely to be a more or less strong slowdown in the pace of economic expansion in the second half of 1998.

A pronounced slowdown in output growth, however, could lead firms to revise downwards their profit expectations and, consequently, their investment expenditures. This will have negative ramifications not only for stock market prices but also for the situation in the labour market and the income prospects of private households. As was pointed out in the previous issue of this *Survey*, household debt has risen to very high levels in the current expansion and any deterioration in the financial position of households is therefore likely to have a significant dampening impact on consumption expenditures and the growth of GDP unless offset by increases in government consumption or foreign demand.

In **western Europe**, the cyclical momentum associated with the strengthening of intraregional trade has so far helped to offset the negative effects of the Asian crisis. Long-term interest rates are close to historic lows, and fiscal policy has shifted to a broadly neutral stance. But net export growth will be affected by the deepening crisis in East Asia and by a slowdown in economic activity in North America and in developing countries outside Asia. There are also downside risks originating within western Europe, notably the increased risk of a "hard landing" in the United Kingdom due to the recent additional tightening of monetary policy.

3. The transition economies

For the transition economies taken as a whole, the positive trends which prevailed in most of these countries in the second half of 1997[1] have been maintained during the early months of 1998.[2] Preliminary data for the first quarter suggest that output continued to rise in the transition countries as a whole and in all the main subregions as well. The performance of individual countries remains quite heterogeneous, but there appears to be less variation among them so far in 1998 as compared with previous years.

Rising demand in western Europe has contributed to the continuing strength of economic performance in eastern Europe and in the Baltic region: total exports from these countries continued to rise strongly in the first quarter of the year. Rates of inflation continued to fall in most transition economies and there has been some improvement (or at least no further deterioration) in the external balances of some east European countries. However, the fall in world commodity prices in 1998 has had a negative impact on the export earnings of Russia and other CIS primary commodity exporters.

Although on balance developments have remained positive in the first half of the year, economic performance in some countries has remained bleak and in others has been marked by considerable volatility. The most serious disturbance occurred in Russia which was shaken by financial instability in May-June. The shockwaves of this sudden turbulence were felt on all financial markets in central and eastern Europe and in the Baltic region. Neighbouring Belarus was also hit by financial turmoil in March-April leading to a sharp drop in the exchange rate of the national currency. Economic performance in most of the south-east European transition countries has remained rather weak.

Political cycles seem to be gaining importance in terms of their impact on the economic environment in the transition economies. In the Czech Republic, Hungary, the Republic of Moldova and Ukraine 1998 is an election year, and both pre- and post-election hesitance of investors about the future course of economic policy has been affecting financial markets in these countries. However, the change of government in Poland after the 1997 elections has had no disturbing effect on economic performance; on the contrary, there has been a remarkably smooth continuity in the underlying course of economic policy.

One of the important policy events in early 1998 was the formal opening by the European Union of the enlargement process towards central Europe. The target of full EU membership – if pursued consistently – will set a rather rigid policy framework for the applicant countries during the pre-accession period leaving relatively limited degrees of freedom for deviations from this course. If there is a strong political commitment by policy makers *both* in the EU itself and in the candidate countries to accelerate the process of EU accession (as is the declared aim of practically all the influential political forces in the region), this in itself will provide another safeguard of political and economic stability – as well as of stability in the course of economic policy – in these countries.

The short-term economic outlook for the transition economies as a whole remains positive and it is likely that economic conditions in general will continue to be favourable in the second half of the year for most of them. Among the east European and Baltic countries, some further acceleration of growth can be expected in Hungary and possibly in Slovenia while the Estonian

[1] Since the publication of the UN/ECE, *Economic Survey of Europe, 1998 No. 1,* in April, a number of national statistical offices in the transition countries have revised their previous estimates for some of the economic indicators for 1997. In terms of its impact on aggregate performance, the most important change was the upward revision of the GDP growth rate for Russia from 0.4 per cent to 0.8 per cent (mainly due to a change in methodology). GDP growth for all the Baltic states and Hungary have also been revised upwards, but for the Czech Republic it was lowered. Tables 1.2.1 and 1.2.2 contain the revised and updated 1997 data that were available to the ECE secretariat in mid-June.

[2] It should be noted that this mid-year review can only present a rough assessment of the current economic situation in the transition countries as it is based on preliminary (monthly and quarterly) statistics prepared by the national statistical offices. Some of the short-term economic indicators often differ in methodology and coverage from the annual figures based on national accounts. Due to the lags in statistical reporting, virtually no detailed quarterly national accounts for 1998 were available for the transition countries at the time of writing this *Survey*.

economy is likely to perform above official expectations. In contrast, economic decline is likely to continue in Romania and output performance for the year as a whole may well turn out to be below the official zero growth target. The 10 per cent growth target in Yugoslavia for 1998 is also unlikely to be met. Within the Commonwealth of Independent States, and despite the apparent improvement from previous years, there remain many uncertainties regarding the outlook for all the European CIS countries.

However, the greatest potential risks both for the CIS and for eastern Europe as a whole arise from the considerable uncertainty surrounding the economic situation in Russia. In view of the financial instability observed in the first half of 1998 and the subsequent substantial tightening of monetary and fiscal policy, the short-term growth prospects in Russia have deteriorated considerably. Official forecasts were already being revised downwards in the first quarter, but if instability and policy austerity continue, Russian GDP growth in 1998 may very well fall below these revised targets, and in the second half of the year there could even be a fall in aggregate output. As discussed below, the biggest policy challenge facing the Russian authorities at this point is how to restore financial stability and get the economy onto a path of sustained growth.

4. Financial distress in Russia

At the beginning of 1998 the outlook was relatively promising for the Russian economy. More than two years of steady disinflation and successful exchange rate management (providing a much needed predictability of the exchange rate) set the stage for a relatively stable macroeconomic environment. And, probably most important, after seven years of transitional depression, the economy appeared to be turning the corner: a small but still positive GDP growth was reported for 1997.[3]

However, bad economic news started to emerge and accumulate in the second quarter of 1998. The weak signs of recovery began to fade with the publication of zero growth figures for the first quarter (implying falling output in March). The April figures did not show any improvement and confirmed that GDP had remained flat in the first four months of the year. At the same time the situation with wage arrears – a recurrent problem for the Russian economy – started to worsen. In 1997, the Russian government had managed to reduce the stock of outstanding wage arrears in the final months of the year. However, they began to increase rapidly again in January 1998 and by the end of March the combined stock of public and private sector arrears had reached a record level. Discontent about unpaid wages was behind the wave of coalminers' strikes which escalated in May with the blockade of railroads throughout Russia, including the vital Trans-Siberian route.

The deterioration of the economic situation in 1998 is at least partly due to the sharp fall of commodity prices which has led to a substantial fall in export revenues. The negative impact of this fall is not confined to the corporate sector but also affects Russia's external balances and the public finances. The large negative effect of falling commodity prices highlights a major vulnerability of the Russian economy: due to its narrow specialization in exports of primary commodities and its high degree of dependence on this source of export revenue, Russia is especially prone to external shocks caused by cyclical fluctuations in world market prices and demand.

The obvious lack of progress in coping with the budget deficit has led to mounting tension in relations with the IMF and the accumulation of bad economic news increased the pressure on Russian financial markets where investors were already anxious in the aftermath of the Asian crisis. The totally unexpected change of government at the end of March added further uncertainty to an already deteriorating situation. The manner in which the change was made conveyed to the markets a perception of low predictability of the political process in Russia.

Another setback was the failure of Tokobank, one of the largest Russian banks, which was placed under conservatorship by Russia's central bank on 7 May. Weary foreign investors then started to pull out of the GKO market and out of the rouble. Probably the last straw was the failure of the auction of a 75 per cent stake in the oil giant Rosneft which, if successful, would have provided much needed funds for financing the budget deficit and replenishing the foreign reserves.

Financial turmoil culminated in the last week of May when the Central Bank of the Russian Federation raised its refinancing rate to the crisis level of 150 per cent as a last resort to defend the currency. Subsequently, interest rates began to fall and the pressure on the rouble weakened.

At the time of writing this *Survey*, the outlook is not at all clear. Russian financial markets continue to be characterized by a high degree of volatility, and considerable uncertainties about the future remain. Although this latest crisis was confined to the financial markets, it does reflect a number of persistent and fundamental problems in the Russian economy and these

[3] It should be noted that the accuracy of Russian statistical data has often been questioned by a number of experts both in and outside Russia. For example, in 1995, a comprehensive study under the leadership of the World Bank produced a major upward revision of previous estimates of the output decline in Russia during the first phase of the transition (World Bank-Goskomstat, *Russian Federation: Report on the National Accounts* (Washington, D.C.), October 1995). Subsequently, it has been argued by some observers that the frequent revisions of statistical data by the Russian State Statistics Committee (Goskomstat) are sometimes made in a rather arbitrary and ad hoc manner. The June 1998 corruption scandal at the Goskomstat involving a group of high-ranking statistical officers (who allegedly deliberately distorted statistical data) casts further doubts on the reliability of Russian statistics.

seem to have been the main cause of the turmoil despite an apparent contagion effect from the Asian crisis. At the core of these problems is Russia's chronic fiscal imbalance and the manner in which it is being financed.

At present, Russia's total public debt (foreign plus domestic debt, excluding public sector wage arrears and overdue payables to government suppliers) is estimated at around 50-55 per cent of GDP. Although by international standards this ratio of debt to GDP is not very high, its actual impact needs to be judged in relation to other macroeconomic variables.

Russia's public debt is already 4-5 times larger than the annual budget revenue, and domestic debt alone is some 2-2.5 times higher than the annual revenue of the federal budget. In turn, the level of Russia's gross foreign debt is some 1.5 times higher than the value of total annual export earnings. Obviously the strain on the federal budget stemming from the servicing of this debt is already considerable: interest expenditure in the revised 1998 budget was estimated at 4.8 per cent of GDP (a share which is likely to become higher if the pressure on the securities markets persists). The great danger is that if public debt continues to grow at its present rate, it may soon snowball out of government control.

The second major structural weakness related to the fiscal imbalance arises from the financing of the budget deficit. Due to the very low level of monetization in Russia and the persistent flight of capital abroad (resulting in a low level of savings deposited in the banking system), the domestic funds available to finance the fiscal deficit are rather limited. Consequently, the Russian authorities have been forced to attract increasing amounts of foreign funds to finance the deficit: by selling treasury bills to foreigners and by borrowing directly from the international financial markets. This has resulted in an increase in the exposure of Russia to volatile short-term foreign capital: the size of these inflows has already reached alarming proportions in terms of their potential to disrupt the domestic financial markets. The vulnerability of the Russian economy to an abrupt reversal in the capital flow is increased by the relatively low level of official reserves. Consequently, a sudden capital outflow carries potential threats both to fiscal policy (by draining a major source of finance of the budget deficit) and to monetary stability (by triggering a speculative attack on the currency). These risks became tangible, albeit to a limited degree, during the financial turmoil in May.

The causes of the fiscal crisis in Russia are numerous, but a few of them can be mentioned here. The current tax code in Russia is notoriously complicated: tax-related issues are subject to tens of different pieces of legislation, often giving rise to confusing contradictions. Tax legislation allows for numerous exemptions which lead to abuse and evasion. In addition, tax collection procedures are inefficient and allow companies to defer tax payments on a large scale (the accumulation of huge tax arrears by a few large corporate entities has had an especially negative fiscal impact). According to anecdotal evidence, tax evasion in general (both by individuals and by companies) has been widespread since the start of economic transformation. Moreover, the Russian Duma has often voted legislative amendments implying increases in budgetary expenditure (especially as regards wages and pensions) which are not consistent with the budget that it had previously approved. The revenue projections incorporated in successive budgets have been persistently overoptimistic and actual revenue has been chronically below expectations.

The Russian authorities now face the major challenge of designing and implementing a wide-ranging and comprehensive fiscal reform to restore order in the public finances and to prevent a further widening of the deficit. This seems to be the central requirement of the considerable policy effort which is needed in order to improve financial and macroeconomic stability in the country.

Closely related to this problem is the broader issue of institutional reforms, the implementation of which are fundamental for laying the foundations of a sustained economic recovery. Progress in building an appropriate institutional infrastructure for a market economy has been very slow and modest, especially in areas related to tax and corporate law as well as bankruptcy. The rule of law is still somewhat spasmodic and in some important areas of social life is being crowded out by rules and practices dictated by the interests of the newly born financial oligarchy, often in conjunction with organized crime and a bureaucracy which is often highly inefficient and lacking in transparency. These obvious institutional deficiencies underline the weakness of the state in its efforts to promote economic recovery. This crucial institutional hiatus cannot be closed by simply declaring policy goals or by the provision of emergency assistance; the creation of an effective institutional framework is a long-term process, which requires a long-term policy commitment by the domestic political class to a credible programme of reform.

The Russian authorities do not have sufficient resources to cope with a major run on the currency in the event of a loss of credibility by foreign portfolio investors. Technically this problem can be overcome if the international financial institutions and western governments are willing to provide Russia with sufficient resources to defend the currency. However, the implied moral hazard problem and the suggestion that such assistance might delay the implementation of much needed reforms has led many commentators to question the wisdom of such a move. However, the current situation in Russia presents a major policy dilemma both for the Russian government and not least for the international financial institutions and for western governments. Withholding international assistance might provide the incentive for a much stronger domestic commitment to the process of institutional and economic transformation; but, on the other hand, such a course might exacerbate the considerable economic and social problems in Russia with unpredictable consequences for the rest of Europe.

The only sustainable policy course towards financial – and thus macroeconomic and political – stabilization in Russia is to move ahead with a coherent and comprehensive programme of institutional reform in which the reorganization of the fiscal system should be the top priority. A firm and irrevocable commitment of the authorities to sound and predictable economic policies, and the creation or strengthening of credible and transparent institutions through which such policies can be implemented, are basic requirements for economic stability and sustained growth. What is most needed to restore calm and stability to Russian financial markets is for such a programme to be seen to be put in place and for the authorities to be seen to be carrying it out.