PART ONE

RECENT ECONOMIC DEVELOPMENTS AND THE SHORT-RUN OUTLOOK IN THE ECE REGION

CHAPTER 1

THE ECE ECONOMIES IN AUTUMN 2001

1.1 The global context and western Europe

(i) The global context

(a) Increased downside risks and uncertainties

In early autumn 2001, the outlook for the global economy has become very worrisome. The terrorist attacks in New York and Washington on 11 September and the beginning of military reprisals in Afghanistan on 7 October 2001 have amplified the uncertainty that was already considerable in early September about the course of the United States economy and the world economy as a whole. At the time of the attacks, the United States economy and those in other major regions were on the edge of stagnation and short-term prospects appeared to be broadly balanced between the possibility of a moderate upturn and a slide into recession in the final months of 2001. The general effect of the attacks has been to worsen the economic outlook in the short term and possibly in the medium term as well.

It is still not possible to gauge with any reasonable degree of certainty all the short-term economic consequences of these shocks on economic activity let alone their possible longer-term implications. The immediate direct effects of the attacks on the United States economy – the loss of human lives, the destruction of physical assets (buildings, machinery and equipment) can be compared with those inflicted by a natural disaster such as an earthquake, i.e. a loss of productive capacity and a once-for-all reduction of effective demand.[1] To this should be added the adverse secondary consequences on domestic economic activity, especially on the air transport sector, tourism, hotels, restaurants and insurance companies, as well as disruptions to supply chains in manufacturing with subsequent negative multiplier effects throughout the economy. Rough estimates point to a possible total cost of $200 billion or 2 per cent of United States GDP. For comparison, the direct material damage of the Kobe earthquake in Japan in 1995 amounted to $120 billion or 2.5 per cent of Japan's GDP.[2] The upshot is that the magnitude of costs appears to be manageable both in absolute and relative terms given the enormous size of the United States economy.

But unlike an earthquake, the terrorist attacks and their aftermath may have a deeper and longer-lasting psychological effect to the extent that they have eroded people's sense of political and economic security.[3] A central question is therefore whether these attacks will have a sustained effect on consumer and business confidence, and thus on spending habits and on investors' perception of risk.[4] A related question is to what extent these factors can be offset by economic policy measures.

The secondary effects of the events of 11 September were not limited to the United States but spilled over to other countries. This particularly affected the global airline industry, which was faced with a sharp fall of demand and increased costs of security and insurance. It seems unlikely, however, that all the announced job losses[5] are directly related to the attacks: they also reflect long-standing structural problems that had to be addressed anyway.

Similarly, the perception of significantly increased risk by investors, and the associated preference for safe havens, has tended to accentuate a decline in net private capital flows to emerging markets and a rise in financing costs that were already underway in reaction to the crises in Argentina and Turkey and the weakening in global economic prospects.[6] More generally, the unusually large

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[1] It has been estimated that the destruction and damage to property as a result of the attack on the World Trade Center together with the wider economic costs to the economy of New York City (including cleanup, security, business interruption, tax losses, etc.) could amount to $90-$105 billion. This corresponds to some 1 per cent of United States GDP in 2000. The City of New York, Office of the Comptroller, *The Impact of the September 11 WTC Attack on NYC's Economy and City Revenues,* 4 October 2001 (comptroller.nyc.ny.us).

[2] IMF, *World Economic Outlook* (Washington, D.C.), October 2001, p. 17, box 1.3 (www.imf.org).

[3] "In contrast to natural disasters, [the] … events are of a far greater concern because they strike at the roots of our free society, one aspect of which is a market economy". Testimony of Chairman Alan Greenspan, *The Condition of the Financial Markets*, before the Committee on Banking, Housing and Urban Affairs, United States Senate, 20 September 2001 (www.federalreserve.gov).

[4] Peace and security are international public goods. "Where peace and security prevail, everyone can enjoy the fact that there is no war or threat of it, international travel and trade are unimpeded, people can go about their work without fear and the like". R. Mendez, "Peace as a global public good", in I. Kaul et al. (eds.), *Global Public Goods* (New York and Oxford, Oxford University Press, 1999), p. 388.

[5] According to IATA, some 200,000 jobs were shed in the global airline industry as a result of the events of 11 September. *Financial Times*, 10 October 2001.

[6] Institute of International Finance, Inc. (IIF), *Capital Flows to Emerging Market Economies* (Washington, D.C.), 20 September 2001 (www.iif.org).

degree of uncertainty, not least that pertaining to the length and scope of military reprisals and possible responses to them, could lead to an extended period of "wait-and-see" on the part of households and businesses outside the United States.

Another likely consequence of the attacks is an increase in transaction costs not only in the United States but also in the world economy at large due to stricter security measures and higher insurance premiums on cross-border trade and transport services. These could affect business productivity and the volume of international trade although orders of magnitude are difficult to gauge.[7] Also government spending on public security and military defence can be expected to increase. In a context of tight budget deficit targets this would have to be offset by cutbacks of other, mainly discretionary expenditure items, such as public investment, or entail the need to raise taxes.

(b) A simultaneous cyclical downswing

A major feature of economic developments in 2001 (and already apparent before 11 September) has been the simultaneous weakening of economic activity in the major seven industrialized economies (chart 1.1.1), with concomitant adverse repercussions on other countries and regions of the global economy. In the United States and the euro area, real GDP rose by only 0.1 per cent between the first and second quarters of 2001. In western Europe, the increase was only slightly higher, and in Japan there was a sharp fall in economic activity over the same period (table 1.1.1). In the emerging markets of Asia and Latin America economic activity was already increasingly sluggish even before the attacks with several countries in or on the edge of recession. The transition economies of eastern Europe and the CIS remained surprisingly resilient to the general slowdown in the world economy in the first half of 2001, but by mid-year activity was starting to weaken, especially in central Europe.

Against this background, forecasts for world output growth in 2001 had already been lowered before the attacks of 11 September. In its September assessment of the global economic situation the IMF lowered its forecast for global growth to 2.6 per cent in 2001 from the 3.2 per cent expected in the spring.[8] Forecasts for world output growth in 2001 were lowered further in the aftermath of the attacks and now range from 1.5 to 2 per cent. This is very close to the previous lows of 1.4 per cent growth in 1991 and 1.1 per cent in 1982, the two preceding years of global recession. A consequence of the simultaneous cyclical weakening of economic activity across the globe has been a sharp deceleration in world trade. The volume of world trade in goods and services is now expected to increase, at best, by only 2 per cent in 2001, down from a growth rate of some 12.5 per cent in 2000.

With hindsight, it is clear that most economic forecasters underestimated the strength of the forces working towards a prolonged loss of cyclical momentum in the United States economy rather than a short V-shaped slowdown and recovery. This was largely due to a misreading of the implications of the nature of the economic upswing, which was fuelled by an investment boom in information and communications technology (ICT) goods and, related to that, an enormous stock market boom. Both booms ended in the first half of 2000. The ICT boom ended abruptly as companies (and investors) realized that the expansion of their supply capacities had by far outpaced effective demand. In other words, there was massive overinvestment. The stock market boom, long driven by irrational exuberance, collapsed under the pressure of weakening expectations of sales and profits. The economic boom led also to the accumulation of other imbalances such as the fall in personal savings to very low levels, high levels of private sector indebtedness, and a very large current account deficit. What is now underway is a process of capacity, inventory, and corporate and household balance sheet adjustments in the face of drastically changed asset valuations and economic prospects. This combination of circumstances helps to explain the lack of response of private sector spending to the significant easing of monetary policy by the Federal Reserve since the beginning of 2001.[9]

The impact of the abrupt weakening of economic growth in the United States on other parts of the world economy, notably western Europe, was also greatly underestimated. The United States cyclical weakening was not only transmitted via the traditional international trade channel but also via financial links between companies and countries, links which had been intensified by the recent surge of direct investment, much of it consisting of mergers and acquisitions, by west European companies in the United States. In a deteriorating economic situation, these financial links can have adverse spillover effects, via a deterioration of consolidated balance sheets, on investment both at home and abroad. Similarly, the sharp decline of activity in the global information and technology sectors illustrates how intricate supply linkages between companies can have powerful effects on economic activity in many regions of the world economy.[10] This holds especially for many Asian emerging markets and Japan, which have a strong specialization in information and communication technology goods. Furthermore, the increased perception of risk by investors, triggered by the financial crises in Argentina and Turkey and with concomitant reductions in capital flows to many emerging markets, aggravated the situation.

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[7] S. Roach, "Back to borders", *Financial Times*, 28 September 2001.

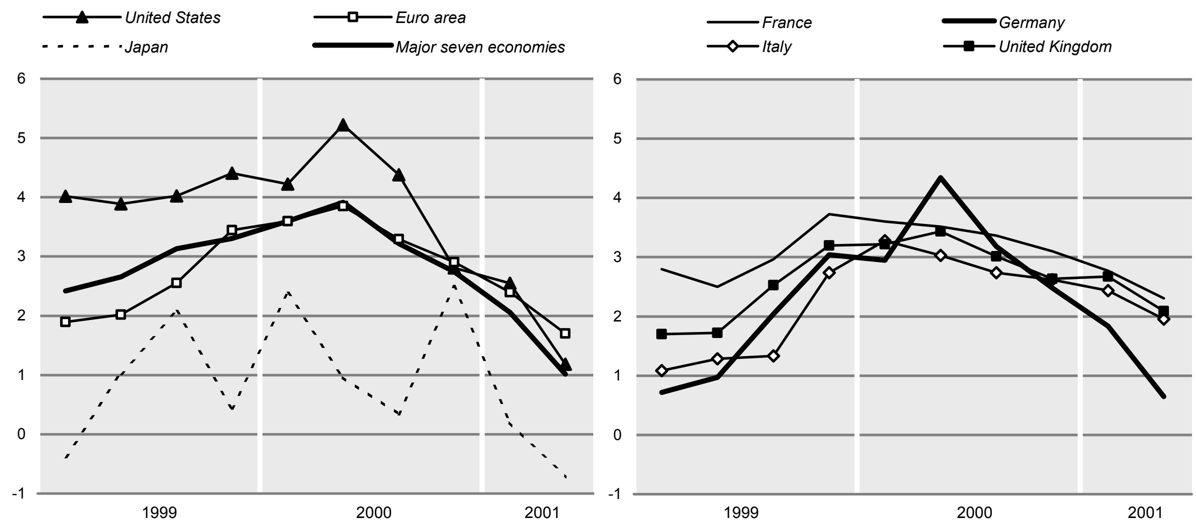
[8] This latest forecast was made before but published after the September events and therefore does not take into account the possible adverse effects of 11 September. IMF, op. cit.

[9] UNECE, *Economic Survey of Europe, 2001 No. 1*, p. 5.

[10] BIS, *71st Annual Report* (Basle), 11 June 2001, p. 143.

CHART 1.1.1

Quarterly changes in real GDP in the developed market economies, 1999 QI-2001 QII
(Percentage change over same period of previous year)



Source: National statistics; Eurostat, New Cronos Database.
Note: Based on seasonally adjusted data. Major seven economies: Canada, France, Germany, Italy, Japan, United Kingdom and United States.

TABLE 1.1.1

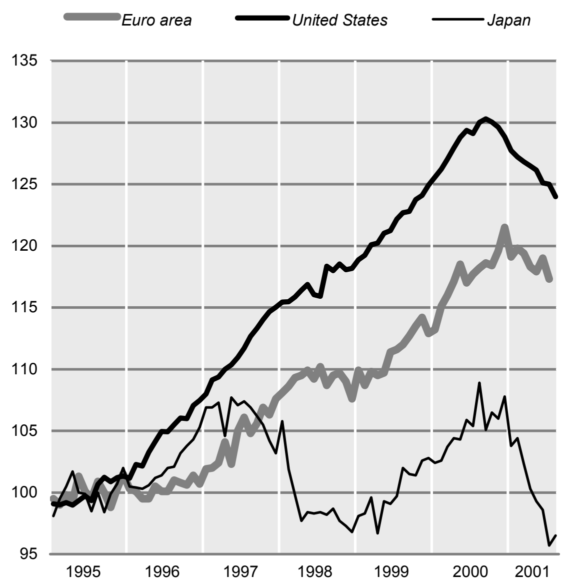
Quarterly changes in real GDP, 2000 QI-2001 QII
(Percentage change over previous quarter)

	2000				*2001*	
	QI	*QII*	*QIII*	*QIV*	*QI*	*QII*
France	0.7	0.7	0.8	0.8	0.4	0.3
Germany	1.0	1.2	0.1	0.2	0.4	–
Italy	0.9	0.5	0.4	0.8	0.8	–
United Kingdom	0.4	0.8	0.7	0.5	0.6	0.4
Canada	1.5	0.5	1.1	0.4	0.5	0.1
United States	0.6	1.4	0.3	0.5	0.3	0.1
Japan	2.4	0.1	-0.7	0.6	0.1	-0.8
7 major economies	1.0	0.9	0.2	0.5	0.4	-0.1
Memorandum items:						
Euro zone	0.9	0.8	0.5	0.6	0.5	0.1
European Union	0.8	0.8	0.5	0.6	0.5	0.1
Western Europe [a]	0.8	0.8	0.5	0.6	0.5	0.2
Western Europe, North America and Japan	1.0	0.9	0.3	0.5	0.4	–

Source: Eurostat, New Cronos Database; national statistics.
Note: Data are seasonally adjusted.
[a] Western Europe: European Union plus Norway and Switzerland.

CHART 1.1.2

Monthly changes in industrial output, January 1995-August 2001
(Indices, 1995=100)



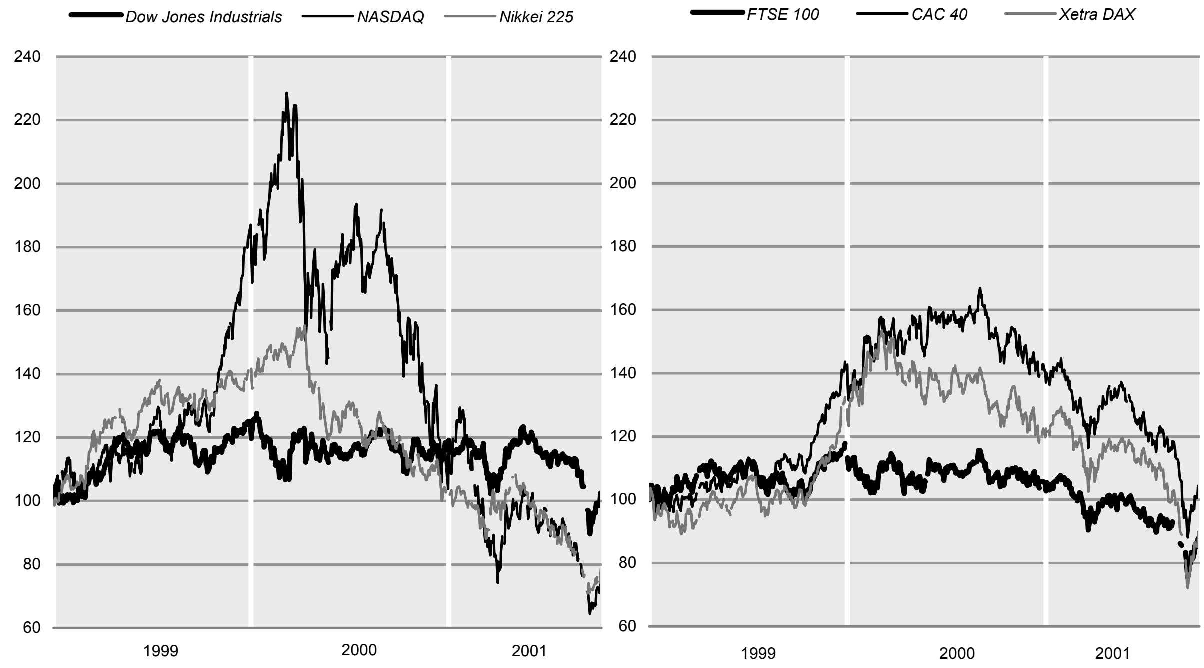
Source: OECD, *Main Economic Indicators* (Paris), various issues; Eurostat, New Cronos Database.

The weakening of cyclical economic growth in the rest of the world, in turn, has had negative feedback effects not only on the United States economy, but also across the major regions themselves, leading to a mutually reinforcing and synchronized downswing. This is most visible in a sharp industrial recession in the developed market economies, which has spilled over to the rest of the world economy (chart 1.1.2). This weakening of industrial activity, largely reflecting the fall in demand for information and communication technology products, was increasingly felt in the services sector and thereby accentuated the cyclical downswing.

Moreover, the sharp fall in international equity prices, already advanced before September 2001 (chart 1.1.3) entailed a sizeable loss of net financial wealth,

CHART 1.1.3

International share prices, 4 January 1999 to 12 October 2001
(Indices, 4 January=100)



Source: Bloomberg L.P. (www.bloomberg.com).
Note: Daily values excluding national holidays.

which dampened private consumption expenditures. By mid-October 2001 the Dow Jones Industrial Average index had lost around 14 per cent compared to its level one year earlier. The NASDAQ fell by about 54 per cent over the same period. On average, European markets fell by around 25 per cent, while the Nikkei 225 lost some 34 per cent.

(c) North America

In the United States, the near stagnation of economic activity in the second quarter of 2001 reflected the combined effect of sharp falls in business investment and the volume of exports, which were offset by the strength of private consumption despite deteriorating prospects in the labour markets. Against a background of low mortgage rates, strong demand for housing continued to buoy residential investment. Higher government spending also supported domestic activity, but all the other major components of domestic demand contracted. Business fixed investment fell sharply in the face of falling corporate profits, large margins of excess capacity in industry and weakening sales prospects. The decline of spending on information processing equipment and software accelerated, but there was also a large cut of investment in non-residential buildings and the process of reducing excess inventories continued to be a drag on economic growth. The weakening of global economic activity was reflected in a marked decline in exports in the second quarter with a further negative impact on manufacturing industry. At the same time, stagnating domestic demand in the United States depressed imports from the rest of the world with the result that changes in real net exports were neutral in their effect on economic growth (table 1.1.2).

Short-term economic indicators, reflecting activity prior to the September attacks, point to continued weakness of economic activity in the third quarter of 2001.[11] Industrial output continued to fall in September for the twelfth consecutive month and capacity utilization rates fell to their lowest level since the end of the 1960s. The Purchasing Managers' Index continued to signal sluggish activity in the manufacturing sector and the economy as a whole. Personal spending turned increasingly sluggish suggesting that a large proportion of private households were unwilling to spend all of their tax rebates. Consumer confidence dropped sharply in September 2001 to its lowest level since September 1995 (chart 1.1.4). In fact, this was the largest monthly decline since October 1990, the time of the Gulf crisis. While the fall was likely to have been influenced by the attacks on 11 September, the survey results were already pointing to a sharp downward trend before then.[12] But the

[11] Federal Reserve Board, *Beige Book* (Washington, D.C.), 19 September 2001 (www.federalreserve.gov).

[12] The Conference Board, *Consumer Confidence Index Drops Sharply*, Press Release, 25 September 2001 (www.conference-board.org).

TABLE 1.1.2

Quarterly changes in real GDP and main expenditure items, 2001 QI-2001 QII

(Percentage change over preceding quarter)

	Western Europe				*United States*		*Japan*		*Western Europe, North America and Japan*	
	Total [a]		*Euro area*							
	QI	*QII*	*QI*	*QII*	*QI*	*QII*	*QI*	*QII*	*QI*	*QII*
Private consumption	0.8	0.5	0.8	0.4	0.7	0.6	0.6	0.5	0.8	0.5
Government consumption	0.5	0.2	0.6	0.2	1.3	1.2	–	0.8	0.8	0.7
Gross fixed investment	-0.3	-0.2	0.1	-0.4	0.5	-2.5	–	-4.0	0.1	-1.7
Final domestic demand	0.5	0.3	0.6	0.2	0.8	0.2	0.3	-0.7	0.6	0.1
Stockbuilding [b]	-0.3	–	-0.6	0.2	-0.8	-0.1	–	–	-0.4	–
Total domestic demand	0.2	0.3	–	0.3	0.1	–	0.3	-0.7	0.2	0.1
Net exports [b]	0.2	-0.2	0.5	-0.2	0.2	–	-0.2	-0.1	0.2	-0.1
Exports	0.4	-1.0	0.2	-0.8	-0.3	-3.1	-3.6	-2.9	-0.6	-2.1
Imports	-0.5	-0.5	-1.2	-0.2	-1.3	-2.2	-2.1	-2.5	-1.1	-1.5
GDP	0.5	0.2	0.5	0.1	0.3	0.1	0.1	-0.8	0.4	–

Source: Eurostat, New Cronos Database; national statistics.

[a] Seventeen countries: EU15 plus Norway and Switzerland.

[b] Growth contribution to change in real GDP (percentage points).

heightened uncertainty and associated psychological stress of households contributed to a slump in retail sales in September.

The number of workers on non-farm payrolls fell by nearly 200,000 between August and September – the largest monthly decline since the recession of 1990-1991. The unemployment rate was 4.9 per cent, the same as in August but up from 4.2 per cent at the beginning of the year (chart 1.1.5). The announcements of massive layoffs in the airline, financial and ICT sectors, together with the worsening economic outlook, are bound to lead to a further rise in unemployment. This will tend to further erode consumer confidence, already weakened by deteriorating economic conditions, including the fall in financial wealth, which will have adverse effects on households' balance sheets and on their ability to service their debts.

Against the backdrop of weak economic activity, easing labour market pressures and falling energy prices, inflation remained weak in the third quarter. The consumer price index in September was 2.7 per cent higher than 12 months earlier, down from a recent peak of 3.6 per cent in May (chart 1.1.6).

In Canada, the economy was also increasingly affected by the global downturn, and especially by the weakness of the United States economy, its main trading partner. Real GDP rose by only 0.1 per cent between the first and second quarters of 2001 reflecting a weaker growth of private household expenditures and a fall in exports. The sharp deceleration in the rate of growth has started to push up the unemployment rate, which rose to 7.2 per cent in August 2001. Inflation peaked at 3.9 per cent in May 2001 but fell back to 2.8 per cent (i.e. below the 3 per cent ceiling of the central bank's target range) in August. This was largely attributed to falls in gasoline and natural gas prices, but it also partly reflects the overall weakening of domestic demand.

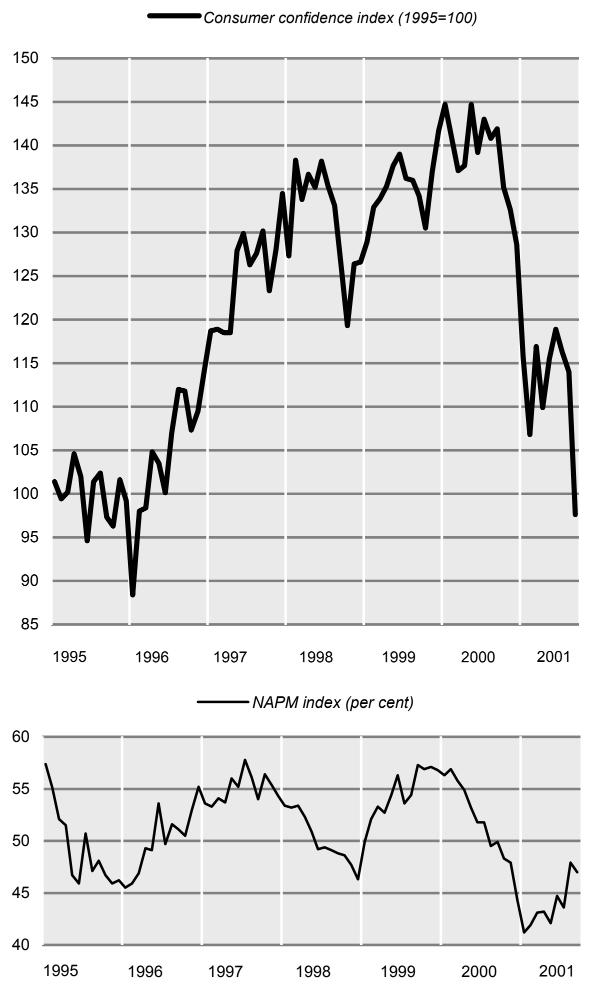
(d) Japan

Real GDP fell sharply in the second quarter of 2001 and the economy probably moved into recession in the third quarter. This would be the fourth recession in a decade. This outcome reflects large falls in business investment and exports, which in turn, reflect the overall deterioration of the global economy (table 1.1.2). Exports were particularly hard hit by the global slump in demand for information and communications technology products. Changes in real net exports have been subtracting from overall economic growth since the third quarter of 2000, while consumer spending has remained lacklustre in the presence of shrinking employment and stagnating real income. Corporate restructuring and an increasing number of bankruptcies raised the unemployment rate to a record 5 per cent in July 2001 (and it remained unchanged in August). Industrial output in August 2001 was nearly 12 per cent lower than a year earlier. Deflationary pressures continued to prevail, with both consumer and producer prices falling. Real estate prices have been declining for 10 years. Share prices (Nikkei 225) in mid-September 2001 reached their lowest level in 18 years.

Monetary policy was eased again in August and September, but as interest rates were already close to zero there were no indications of any expansionary effects (the "liquidity trap"). The Bank of Japan also conducted non-sterilized interventions in the foreign exchange market to stem an appreciation of the yen against the dollar. Faced with the threat of a new recession the government introduced a new fiscal spending package in early October. The worsening of the economic outlook could lead to the postponement of previously announced plans

CHART 1.1.4

Business and consumer surveys in the United States, January 1995-September 2001
(Indices)



Source: The Conference Board (www.conference-board.org) and National Association of Purchasing Management (NAPM) (www.napm.org).

Note: The Purchasing Managers' Index (PMI) is a composite index pertaining to the business situation in manufacturing industry. An index value above (below) 50 per cent indicates that manufacturing industry is generally expanding (contracting). A PMI above (below) 44.5 per cent, over a period of time, indicates that overall economic activity, as measured by real GDP, is generally expanding (contracting).

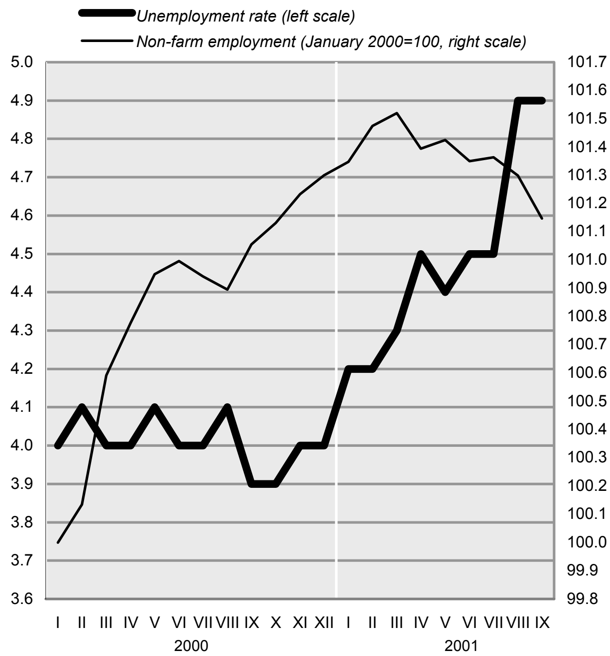
for the fiscal year starting in April 2002 to reverse the rise in government debt which amounted to some 130 per cent of GDP in 2000. The government has also announced a programme of structural reforms designed, *inter alia*, to solve the long-standing problem of non-performing loans accumulated in the banking sector.

(e) Emerging markets of Asia and Latin America

The weakening of world economic activity in 2001 had a negative impact on emerging market economies, mainly through the channels of foreign trade and international capital flows. The economic slowdown accentuated the risk aversion of international investors,

CHART 1.1.5

United States labour market, January 2000-September 2001
(Per cent of civilian labour force, index)



Source: United States Bureau of Labor Statistics (www.bls.gov).

which had already increased after the crises in Argentina and Turkey in the first half of the year. This was reflected in efforts to limit exposure to emerging markets and the repatriation of funds in a search for quality and safety. Both wider yield spreads and reduced private capital inflows signalled more difficult external financing conditions. This was particularly the case for countries more dependent on external financing, such as Argentina, Brazil, the Philippines and Turkey. All these tendencies strengthened considerably in the aftermath of the terrorist attacks of September, further accentuating risk aversion.

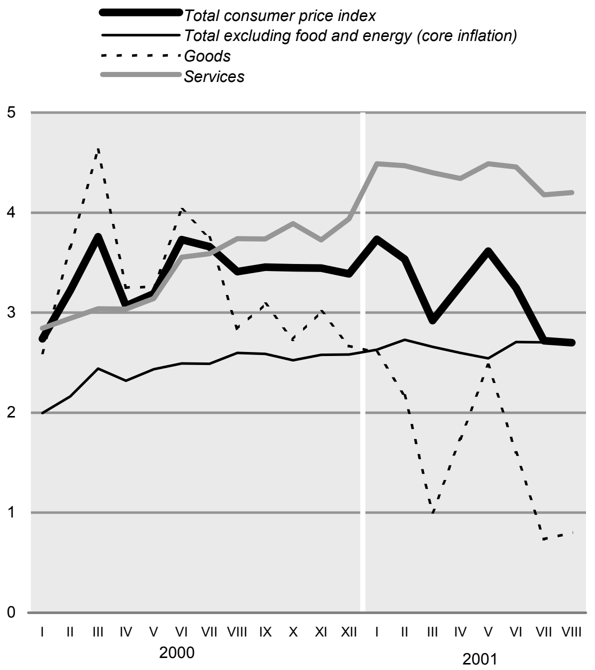
As a result of all these factors, total private capital flows to emerging market economies are forecast to fall from $167 billion in 2000 to $106 billion in 2001. While foreign direct investment (FDI) flows to developing countries are projected to decline only slightly in 2001, private credit is expected to turn from an inflow of about $20 billion to an outflow of a similar magnitude.[13] Most of the shortfall should be offset by public institutions, chiefly the IMF.

The east Asian emerging markets were strongly affected by the global crisis in the information and telecommunication sectors. Falling exports of electronic goods, which account for more than half of total exports from many of these countries, contributed to a sharp slowdown in the rate of economic growth, which in some countries (Singapore, Taiwan) turned into a full-fledged

[13] IIF, op. cit.

CHART 1.1.6

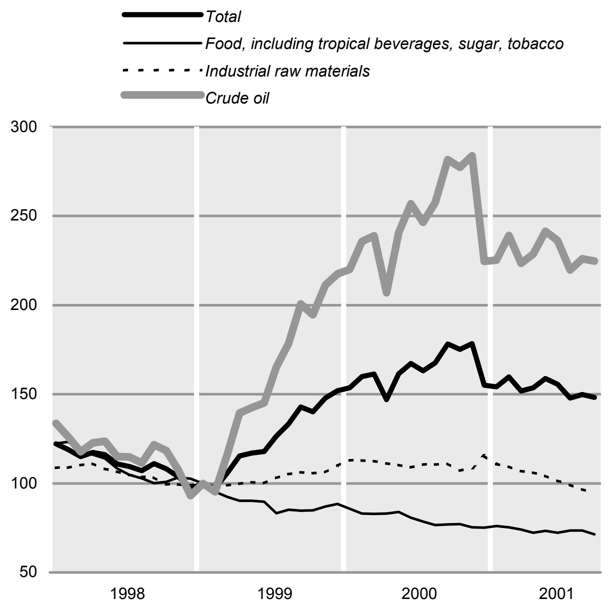
Consumer prices in the United States, January 2000-August 2001
(Percentage change over same month of previous year)



Source: United States Bureau of Labor Statistics (www.bls.gov).

CHART 1.1.7

World commodity prices, January 1998-September 2001
(Indices, 1999=100)



Source: Hamburg Institute for Economic Research (HWWA).
Notes: Indexes calculated on the basis of current dollar prices.

recession that the authorities tried to counter with expansionary monetary and fiscal policies. The deteriorating economic outlook has raised concerns about the resilience of financial systems in the region in view of the large increases in public debt and non-performing loans. In contrast, the two very large and relatively closed economies of China and India appear so far to have been less affected by the downturn in international trade.

Economic growth also slowed sharply in Latin America. A major concern remains the economic and financial situation in Argentina, which is experiencing the third consecutive year of recession brought about largely by depressed domestic demand and an overvalued peso, which has been pegged to the dollar in the framework of a currency board since 1991. Fears of a public debt default and/or exit from the currency board arrangement led to capital flight and the withdrawal of funds by international private creditors. The yield spread over United States treasury bonds has surged to very high levels (nearly 19 percentage points in mid-October 2001), which effectively bars access to international capital markets. Against this backdrop, the IMF has arranged for a new support programme involving stringent fiscal austerity. The principal motive for this is that a debt default could have significant spillover effects in the region and lead to contagion of other emerging markets. The future solvency of the government depends on its capacity to reschedule its existing debt, backed by additional loans from official foreign institutions. The instability in Argentina spilled over to Brazil, given the two countries' strong economic links. A large current account deficit in the face of declining FDI led to tension in the foreign exchange market and a sizeable cumulative depreciation of the national currency. A tight monetary policy, designed to defend the currency, has added to the contractionary effects of a domestic energy crisis and of a restrictive fiscal policy adopted in the context of an IMF-supported programme. The IMF agreed to a new stand-by loan to Brazil in August 2001, designed to limit the adverse financial market spillovers from the crisis in Argentina.

(f) Commodity prices

Primary commodity prices during the first nine months of 2001 came under downward pressure from the strong downturn in world economic activity. The lowering of growth expectations for the world economy after 11 September accentuated the weakness of demand. In the event, average commodity prices in September 2001 were 17 per cent below their recent cyclical peak of one year earlier (chart 1.1.7).

The price of crude oil (OPEC basket) fluctuated within OPEC's target range of $22-$28 between January and August 2001. In order to offset the downward pressure on prices, OPEC reduced its target output three times between February and September, resulting in a cumulative 11 per cent cut in OPEC's oil supply. The effects of the terrorist attacks in September on the global airline sector and the deteriorating global economic outlook led to a sharp fall in oil prices, the price of Brent crude falling from $27 per barrel in August to $21 per barrel in mid-September 2001. OPEC has stated its intention to supply enough oil to prevent a surge in prices, but it is now considering cuts in order to sustain prices. However, if military tensions were to spread to other countries, oil prices might eventually rise steeply.

Prices for industrial raw materials (essentially base metals and agricultural raw materials) fell by 15 per cent in the 12 months to September 2001. Even before 11 September, it was projected that world consumption of base metals in 2001 would experience its largest fall since 1982[14] with prices dropping to levels not seen in many years. Thus, the price of rubber in September reached its lowest level in over 15 years. Although the markets for temperate-zone food commodities are more balanced, prices for tropical products (particularly coffee and sugar) were squeezed by oversupply and high levels of stocks.

(ii) Western Europe

In the euro area, economic growth virtually came to a halt in the second quarter of 2001. The slight rise in GDP conceals falling activity in industry, which was only just offset by continued growth in the service sector. Viewed from the demand side, the slowdown mainly reflected a pronounced weakening of the growth of private consumption and the effects of the deteriorating external environment on exports, which declined markedly between the first and second quarters (table 1.1.2). Fixed investment also fell against a background of weakening industrial confidence, increased margins of idle capacity and a bleaker outlook for sales and profits. The general deterioration in economic performance also depressed consumer confidence (chart 1.1.8).

Although there continued to be considerable differences between individual countries, there was a general weakening in the second quarter of 2001. Quarterly growth rates ranged from 0.5 per cent in Spain to a sharp fall by 1.7 per cent in Finland. (This was the second consecutive fall in quarterly GDP in Finland, the technical definition of recession.) Among the three largest economies, economic activity stagnated in Germany and Italy, and rose only slightly in France (table 1.1.1 above). In Germany and Italy, income tax cuts continued to support private consumption, but fixed investment fell and changes in real net exports also depressed domestic activity. Growth in Germany continued to be restrained by the persistent crisis in the construction sector, which is now in the process of reducing capacity after the post-unification boom.[15] In France, the growth of private consumption slowed markedly between the first and second quarters of 2001, while fixed investment stagnated. Government consumption and changes in stockbuilding also supported domestic demand but, as in Germany and Italy, the change in real net exports was a drag on overall economic growth.

The available short-term economic indicators suggest that economic activity in the euro area remained weak in the third quarter of 2001. The service sector appears to be increasingly affected by the recession in industry. Consumer and business confidence have continued to fall, although the latest figures for September do not provide any indication of the impact of the terrorist attacks on the United States since most of the survey data were collected before 11 September.

Weakening economic activity and the fading of temporary special factors (such as the effects of animal diseases on food prices and the temporary surge in oil prices) led to a fall in the headline inflation rate from 3.4 per cent in May to 2.5 per cent in August. Core inflation has levelled off at 2.1 per cent since May (chart 1.1.9) and labour costs have continued to rise moderately. In view of the weak cyclical conditions, inflation is expected to approach the 2 per cent ceiling of the ECB's inflation target in the coming months. Conditions in the labour markets – a lagging cyclical indicator – were also increasingly influenced by the sharp deceleration of economic growth. The fall in the unemployment rate appears to have bottomed out in the summer at 8.3 per cent, its lowest level in almost a decade. The preceding cyclical upswing led to a marked fall in the unemployment rate in France to 8.5 per cent in August, down from 11.7 per cent in January 1999 (chart 1.1.10). In Spain, the rate fell from 17.2 per cent to 13 per cent over the same period.

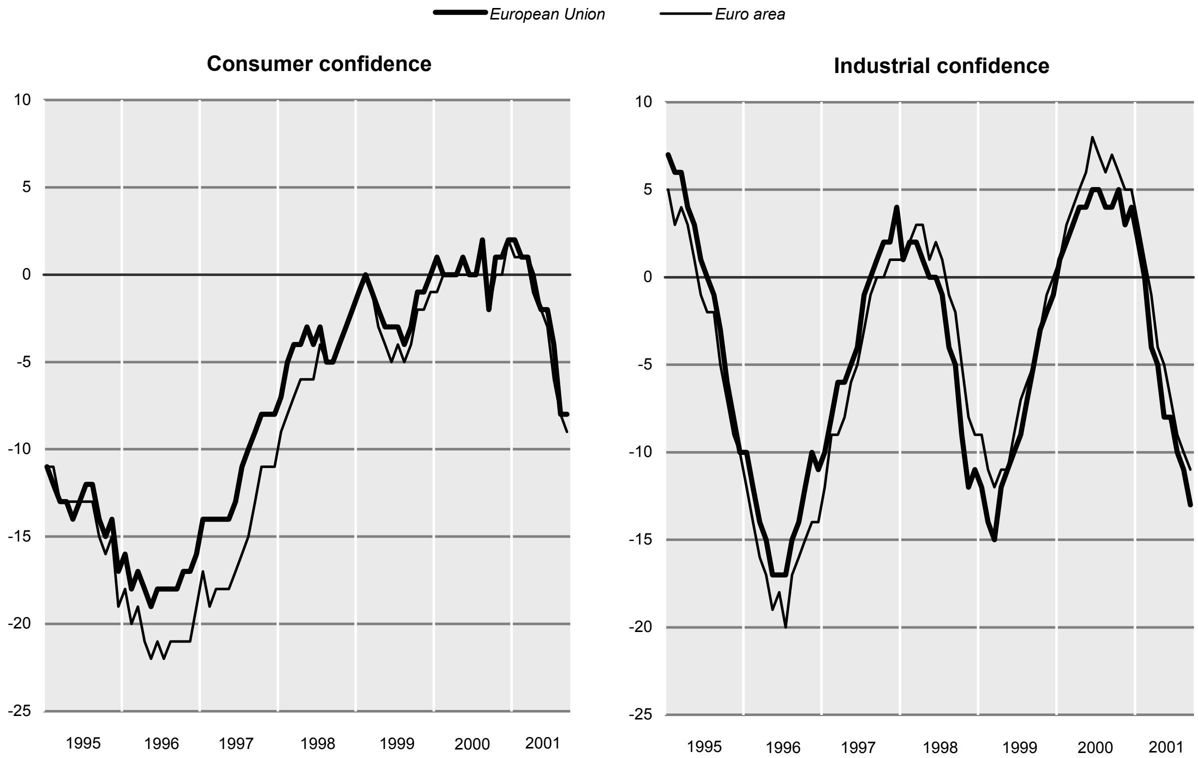
West European economies outside the euro area could not entirely escape from the dampening effects of the global economic slowdown. Nevertheless, the growth of real GDP held up better in the United Kingdom than in the euro area. The growth of real GDP slowed to 0.4 per cent in the second quarter (table 1.1.1) to attain a level 2.3 per cent higher than in the same period of 2000. The private consumption boom, underway since 1998, remained the mainstay of economic growth. Household spending was supported by further gains in real disposable incomes associated with higher levels of employment. In addition, consumer demand was stimulated by a conducive environment for personal borrowing created by soaring house prices and low interest rates. Business investment picked up after a decline in the first quarter. Economic activity was also supported by strong growth in government spending. The strength of domestic demand contrasts with the sluggishness of the tradeables sector, which was hit by the strong exchange rate of sterling and the global cyclical downturn (the "two-speed economy"). Exports fell sharply, but the effect on aggregate domestic output was offset by a contraction of imports. Inflation (RPIX) has remained moderate but, due to special factors, edged slightly above the government's target of 2.5 per cent in August 2001. Inflation has been below the central

[14] E. Fam, "Les marchés mondiaux de matières premières au deuxième trimestre 2001", *Bulletin de la Banque de France*, No. 92, (Paris), August 2001.

[15] Construction investment fell by 55 per cent in the first half of 2001 compared with the same period of 1995.

CHART 1.1.8

Business and consumer surveys in the European Union and the euro area, January 1995-September 2001



Source: Commission of the European Communities, *European Economy*, Supplement B (Luxembourg), various issues and direct communications.

Note: European Union data show net balances between the percentages of respondents giving positive and negative answers to specific questions. For details see any edition of the source.

bank's target of 2.5 per cent for more than two years. Developments in the labour markets remained favourable, with further gains in employment and unemployment falling to its lowest level for over a quarter of a century.

In Turkey, the economy is currently in deep recession. The financial-cum-exchange rate crisis of February 2001 and the subsequent free floating of the currency have led to a sharp depreciation, which amounted to some 55 per cent in early October. The resulting stimulus to net exports, however, was more than offset by the erosion of consumer and business confidence, which not only depressed domestic demand but also limited the ability of the government to borrow at the very high interest rates resulting from the increased risk aversion of domestic and international investors. The government is therefore dependent on financial support from the international financial institutions, notably the IMF. Real GDP is forecast to decline by 6 per cent in 2001, but the outcome could very well be worse.

Macroeconomic policy stances

The drastic change in the economic outlook, especially since 11 September, has led in general to a more expansionary stance of monetary and fiscal policies. In the United States, monetary policy had already been eased significantly before 11 September 2001.[16] Also the federal income tax rebate was expected to support private consumption in the final months of 2001.[17] More or less in tandem with the Federal Reserve, there was also a progressive easing of monetary policy in Canada.

In the euro area, the ECB reacted more hesitantly to the increasing signs of cyclical weakening having assumed for too long that the euro area would be largely immune to developments in the United States. The ECB also felt constrained by the fact that headline inflation was significantly above target, although this was largely acknowledged to reflect transitory factors.[18] But in the face of increasingly sluggish economic activity in the euro area and forecasts of declining inflation, the ECB decided to lower the minimum bid rate on its main refinancing operations in two steps by half a percentage point to 4.25 per cent between early May and late August 2001.

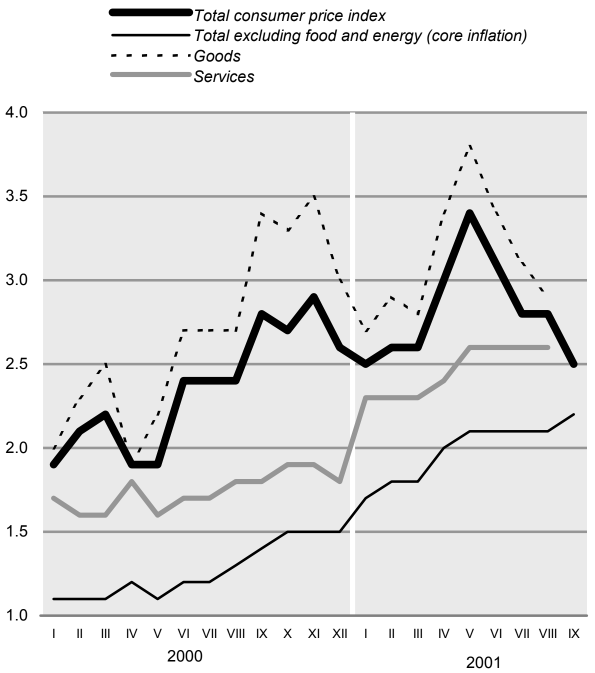
[16] The Federal Reserve lowered the target for the federal funds rate in seven steps from 6.5 per cent at the beginning of January 2001 to 3.5 per cent in August 2001.

[17] Households received cheques ranging from $300 to $600 between late July and late September 2001, totalling some $40 billion or slightly less than 0.5 per cent of GDP in 2000.

[18] UNECE, *Economic Survey of Europe, 2001 No. 1*, chap. 1.

CHART 1.1.9

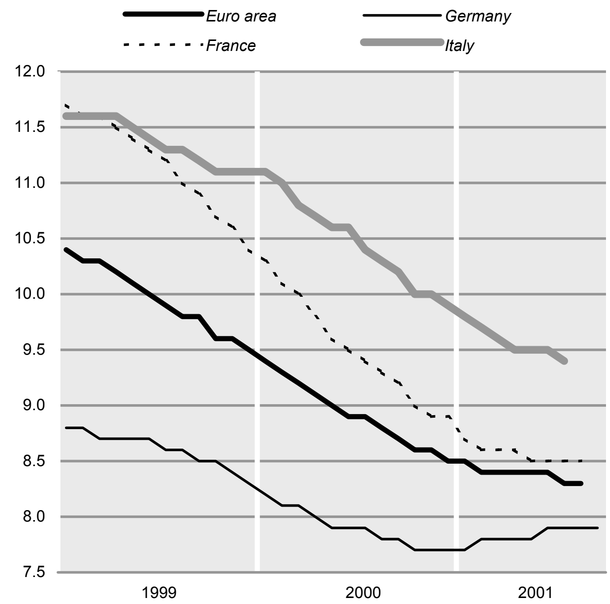
Consumer prices in the euro area, January 2000-September 2001
(Percentage change over same month of previous year)



Source: Eurostat, New Cronos Database.
Note: September data for goods and services not yet available.

CHART 1.1.10

Standardized unemployment rates in the euro area and selected countries, January 1999-September 2001
(Per cent of civilian labour force, seasonally adjusted)



Source: OECD, *Main Economic Indicators* (Paris), various issues.
Note: Data for the euro area and France only available until August 2001; for Italy only until July 2001.

In the spring of 2001, the average fiscal policy stance in the euro area was projected to be mildly expansionary in 2001. Several countries enacted tax cuts (France, Germany, Italy, the Netherlands), but sizeable fiscal easing was projected only in Finland, Germany, Ireland and the Netherlands.[19] Weaker than expected economic growth and the working of the automatic stabilizers has undermined the ability of countries to achieve their budgetary targets for this year which were set in line with the requirements of the Stability and Growth Pact. This has created problems for France, Germany, Italy and Portugal where even under the optimistic growth assumptions of earlier in the year government budgets were not expected to be "close to balance or in surplus" over the medium term as required by the rules of the Stability and Growth Pact. In principle, therefore, these countries were expected to limit the deviations of the actual deficit from the target fixed in their stability programmes or, in other words, to prevent the automatic stabilizers from operating freely in view of the risk that the deficits could approach the 3 per cent ceiling.[20] But this has created a dilemma for policy since restricting the automatic fiscal stabilizers would have a procyclical effect and therefore risk accentuating the downturn.[21]

In the United Kingdom, against a background of concern about the effects of deteriorating economic conditions in the United States and continental Europe on the domestic economy, the Bank of England lowered its key interest rate in four steps from 6 per cent in early February 2001 to 5 per cent in early August. Economic activity was also supported by an expansionary fiscal policy.

In the immediate aftermath of the attacks on 11 September, the Federal Reserve together with the ECB and other major central banks ensured the normal functioning of the banking system by injecting additional liquidity into the money markets and by conducting foreign exchange swaps. On 17 September, when United States stock markets reopened after a closure of four days, and against lingering concerns about the stability of international financial markets and the increased cyclical downside risks, the Federal Reserve cut the target for the federal funds rate by a further half a percentage point to 3 per cent. The move was rapidly followed, possibly as a sign of solidarity, by the ECB, which lowered its key

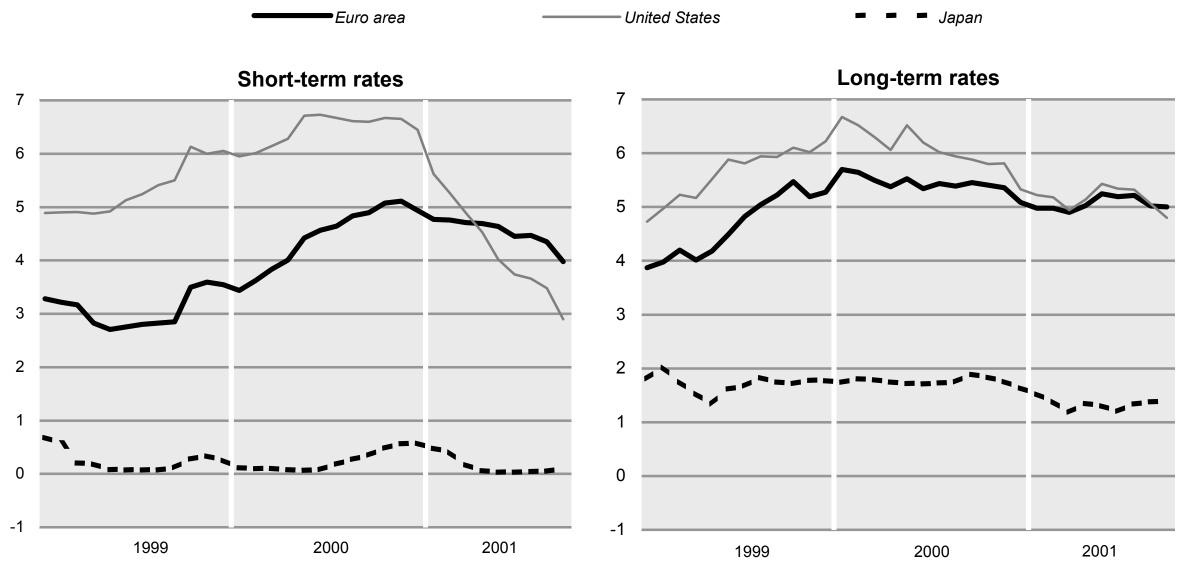
[19] Commission of the European Communities, "Public finances in EMU – 2001", *European Economy*, Reports and Studies, No. 3 (Luxembourg), 2001, pp. 16-19.

[20] European Central Bank, *Monthly Bulletin* (Frankfurt am Main), September 2001, p. 6.

[21] In Germany, the government decided to raise taxes on tobacco and insurance premiums to finance anti-terrorist spending, arguing that the increases were the only option given the commitment to reduce net borrowing in 2002 and to balance the budget by 2006. *Financial Times*, 21 September 2001.

CHART 1.1.11

Short-term and long-term interest rates in the euro area, Japan and the United States, January 1999-September 2001
(Per cent per annum)



Source: OECD, *Main Economic Indicators* (Paris), various issues; European Central Bank (www.ecb.int); United States Federal Reserve (www.federalreserve.gov).
Note: Short-term interest rates: three-month money market rates. Long-term interest rates: yields on 10-year government bonds.

interest rate by the same amount to 3.75 per cent. But the ECB was also concerned about the rapid loss of cyclical momentum in the euro area. The central banks of Canada, Japan, Sweden, Switzerland and the United Kingdom also reduced their official interest rates in the wake of the decision by the Federal Reserve.[22] In the United Kingdom, the main refinancing rate was reduced to its lowest level since 1964. In Switzerland, the cut in interest rates was also intended to arrest the rapid appreciation of the Swiss franc, which had been triggered by the strong inflow of capital in search of a safe haven after 11 September. Concerns about the dampening effect of increased uncertainty on business and consumer spending led the Federal Reserve to lower the target for the federal funds rate by a further half a percentage point to 2.5 per cent on 2 October 2001. At the time of writing the ECB's main refinancing rate was unchanged at 3.75 per cent.

As a result of these monetary policy measures, short-term interest rates fell sharply in the United States; they fell also in the euro area, but given the differential degree of monetary easing the decline has been less pronounced (chart 1.1.11). Real short-term interest rates in the United States were negative (about -0.5 per cent) and around 1 per cent in the euro area in early October 2001. United States long-term interest rates (yields on 10-year government bonds) fell below those in the euro area in September. By mid-October the differential amounted to about half a percentage point. The combined effect of the differential changes in short- and long-term interest rates was a significant steepening of the yield curve in the United States. This reflected not only the sizeable monetary stimulus in the pipeline but also some upward pressure on long-term yields resulting from expectations of future fiscal imbalances. Longer-term inflationary expectations, however, have remained moderate.

In the United States, the response of fiscal policy to the disruptions caused by the September attacks has also been swift. The federal government quickly announced a $40 billion emergency relief package designed, *inter alia*, to assist in the rescue of victims and rebuilding. This package was supplemented by $15 billion of support for the airline industry. The combined package of $55 billion corresponds to 0.5 per cent of GDP in 2000. In early October, the administration proposed a further package of tax cuts and spending increases totalling some $60-$75 billion or 0.6-0.7 per cent of GDP to strengthen domestic demand. This package, which has yet to be adopted by Congress, would put the total post-attack fiscal stimulus at some 1¼ per cent of GDP. This comes on top of the fiscal stimulus from the tax rebate in the second half of 2001, which was already equivalent to some 0.5 per cent of GDP, and the income tax cuts to be enacted in the context of the tax reforms in 2002. The total fiscal stimulus could therefore amount to some 2 per cent of GDP. The deteriorating economic performance and weaker growth prospects are reflected in projections of a significantly reduced budget surplus (if any) in 2002 and the medium term.

[22] Central banks in some of the emerging markets of Asia (Hong Kong, Taiwan) also lowered their official interest rates.

1.2 The transition economies

(i) Introduction

In the first half of 2001, the ECE transition economies generally showed some resilience in the face of a deteriorating international environment. The immediate impact of the global slowdown on eastern Europe and the CIS has so far been much less pronounced than on western Europe where output weakened considerably in the first half of the year. In contrast, output remained relatively robust in many transition economies and growth even accelerated in some countries, especially in the CIS. During the first six months of the year the aggregate GDP of the transition economies increased by 5 per cent (year-on-year) largely a reflection of a 6.1 per cent increase in the CIS (table 1.2.1). Growth also remained strong in all three of the Baltic states (their aggregate GDP growing 6.3 per cent, year-on-year). In eastern Europe the growth of GDP decelerated (to 3.1 per cent in the first half of 2001 from 4.5 per cent in the same period of 2000) but this was mostly due to the sharp slowdown in Poland. It should be added that there are marked differences in the current sources of growth – and hence in the short-run growth prospects – between the different subgroups of transition economies, notably, between the countries of eastern Europe (including the Baltic area) and the CIS (sections (1.2(ii) and 1.3).

Although these figures look impressive against the background of a general slowdown in the world economy, their significance should not be overstated. All the ECE transition economies are highly dependent on their international markets and the sharp deterioration in world market conditions will, sooner or later, start to take its toll – the varying lags depending on the specific transmission channels. In fact, all the indications are that by mid-year economic activity was rapidly weakening in most transition economies (with the possible exception of a few CIS countries).

The Russian economy has been the main support of the continuing recovery in the CIS. Much of Russia's present economic strength is due to the effects of the ongoing restructuring of the economy after the 1998 financial crisis and, especially, the comprehensive reforms initiated by the current administration. The presently prevailing sense of political stability – after a decade of volatility and frequent changes of government – has also contributed to an improving business climate in the country. In addition, the Russian authorities have adopted a more forward-looking approach to policy, which has had a positive effect on business and consumer confidence and expectations in general.

However, it should also be borne in mind that the main source of growth in Russia – and, indirectly, in much of the CIS as a whole – is the continuing strong recovery in Russian final domestic demand, in particular, private consumption. In turn, this has been largely driven by the windfall revenue gains due to the relatively high world oil prices in 2000 and part of 2001. Thus, in assessing Russia's short-term economic prospects, the main issue is whether and to what extent this domestic demand-led growth is sustainable. If world oil prices were to follow the downward trend in the global economy (as suggested by their direction in early autumn), a key stimulus to growth in Russia and the CIS could soon peter out. In addition, the continuing real appreciation of the Russian rouble has already eroded much of the post-1998 competitive gains – acquired from the sharp real depreciation that followed the August 1998 financial collapse – which had given an additional boost to the economy (mainly through its stimulus to import substitution). In these circumstances, Russia's currently good economic fundamentals would be unable to continue to support the growth of real incomes and private consumption at their present pace; or, to put it differently, if such a pattern of demand-led growth were to continue, it would probably be at the expense of macroeconomic stability.

The situation on the labour markets of the transition economies is mixed and in view of the relatively strong output growth in the first half of the year, the outcomes are less favourable than could have been expected: in June 2001 the average unemployment rates in eastern Europe and the Baltic states (14.9 per cent and 9.8 per cent, respectively) were higher than a year earlier and only a handful of countries (Hungary, Slovenia and partly the Czech Republic) have reported more lasting reductions in joblessness. Within the CIS, there was a notable easing in Russia's labour market and some improvement in Ukraine, but the situation in the other countries is difficult to assess due to the unreliability of their statistics.

Most transition economies made further progress in reducing inflation in the period to August 2001. Both internal (prudent macroeconomic policies but also, in some cases, the exchange rate regime and lower food prices due to better harvests) and external factors (especially the easing of oil prices) contributed to this development. Countries with double-digit inflation rates are now a minority among the transition economies and their number is falling steadily (table 1.2.1). Nonetheless, as indicated by several crises in the past, it cannot be taken for granted that this process is irreversible: sustaining macroeconomic stability requires constant effort by policy makers.

The merchandise trade of the transition economies weakened somewhat but still remained quite buoyant in the first half of the year: in dollar terms, both their aggregate exports and imports were increasing at double-digit rates (table 1.2.2). However, in eastern Europe and in the Baltic region, their growth has been rapidly decelerating and the outcome for the second half of the year is likely to be considerably worse than in the first. The continuing recovery in Russia has given a strong boost to intra-CIS trade: this, together with the strong real appreciation of the rouble, has benefited exporters in neighbouring CIS countries.

TABLE 1.2.1

Basic economic indicators for the ECE transition economies, 1999-2002
(Rates of change and shares, per cent)

	GDP (growth rates)						*Industrial output (growth rates)*			*Inflation (per cent change, Dec./Dec.)*			*Unemployment rate (end of period, per cent)*		
			2001												
	1999	*2000*	*Apr. official forecast*	*Jan.-Jun. actual* [a]	*Oct. official forecast*	*2002 official forecast*	*1999*	*2000*	*Jan.-Jun. 2001* [a]	*1999*	*2000*	*2001* [b]	*Jun. 1999*	*Jun. 2000*	*Jun. 2001*
Eastern Europe	1.5	3.7	4.2	3.1	3.1	3½	-0.4	8.3	4.8	..	..	..	13.6	14.7	14.9*
Albania [c]	7.3	7.8	5-7	..	7	7	16.0	12	-20*	-1.0	4.2	4.0	18.0	17.6	15.1
Bosnia and Herzegovina [d]	..	9.1	7-9	..	7-9	..	10.6	8.8	14.6	-0.4	3.4	3.3	39.1	39.1	39.3
Bulgaria	2.4	5.8	5	4.8	4.5	4	-9.3	5.8	1.7	6.9	11.2	9.3	12.8	18.2	17.1
Croatia	-0.4	3.7	3-4	4.5	4	3-4.2	-1.4	1.7	5.9	4.6	7.5	5.0	18.9	20.5	21.5
Czech Republic	-0.4	2.9	3	4.0	3.6-3.8	3.8	-3.1	5.4	8.6	2.5	4.1	5.5	8.4	8.7	8.1
Hungary	4.2	5.2	4.5-5	4.2	4.3	3.7-4.2	10.4	18.3	7.4	11.3	10.1	10.6	9.4	8.9	8.4
Poland	4.1	4.0	4.5	1.6	1.5	2.0-2.5	3.6	6.8	1.6	9.9	8.6	6.1	11.6	13.6	15.9
Romania	-2.3	1.6	4.1	4.9	4.5	5.1	-7.9	8.2	10.4	54.9	40.7	35.8	11.4	10.8	8.8
Slovakia	1.9	2.2	3.2	2.9	2.8-3.0	3.6	-3.1	9.0	6.2	14.2	8.3	7.9	17.7	19.1	17.8
Slovenia	5.2	4.6	4.5	2.9	3.7	3.6	-0.5	6.2	3.2	8.1	9.0	9.6	13.4	11.8	11.1
The former Yugoslav Republic of Macedonia	4.3	4.3	6	-5.0	-5	4	-2.6	3.5	-8.8	2.3	10.8	6.3	42.3	43.6	..
Yugoslavia [e]	-17.7	7.0	5	..	5	..	-23.1	10.9	-2.4	54.0	115.1	125.1	26.7	26.5	27.1
Baltic states	-1.7	5.4	4.7	6.3	5.7	4¾	-8.0	7.6	11.7	..	..	..	8.1	9.3	9.8
Estonia	-0.7	6.9	6	5.4	4.8	4	-3.4	12.8	5.9	3.9	4.9	6.9	6.4	6.2	7.5
Latvia	1.1	6.6	5-6	8.8	8	5-5.5	-5.4	3.2	7.9	3.3	1.9	3.1	10.0	8.4	7.8
Lithuania	-3.9	3.9	3.7	5.1	4.5-5.1	4.7	-11.2	7.0	16.4	0.3	1.5	1.7	7.5	11.1	12.1
CIS	4.5	7.8	4.2	6.1	6.1	5	9.2	11.6	7.6	..	..	..	8.1	7.2	6.4
Armenia	3.3	6.0	6.5	6.6	6.5	6	5.2	6.4	2.7	2.1	0.4	4.1	10.4	11.9	10.4
Azerbaijan	7.4	11.1	8.5	8.4	8.5	8.5	3.6	6.9	5.1	-0.5	2.1	2.1	1.2	1.1	1.3
Belarus	3.4	5.8	3-4	3.7	3-4	4-5	10.3	7.8	4.1	251.3	108.0	65.3	2.1	2.0	2.2
Georgia	3.0	2.0	3-4	5.5	3-4	3.5	7.4	6.1	-3.1	11.1	4.6	6.0	5.5	..	..
Kazakhstan	2.7	9.8	4	14.0	10	7	2.7	15.5	13.6	18.1	10.0	9.1	3.5	4.2	3.3
Kyrgyzstan	3.7	5.0	5	6.7	5.6	4	-4.3	6.0	6.0	39.8	9.5	8.4	3.1	3.2	3.2
Republic of Moldova [f]	-3.4	1.9	5	3.1	5	6	-11.6	2.3	12.1	43.8	18.5	9.1	2.3	2.0	2.0
Russian Federation	5.4	8.3	4	5.1	5.5-6.0	4.3	11.0	11.9	5.5	36.6	20.1	23.7	12.1	10.1	8.4
Tajikistan	3.7	8.3	6.7	10.3	6.7	8	5.6	10.3	13.0	30.1	60.6	49.3	3.2	3.1	2.5
Turkmenistan [g]	16.0	17.6	16	15.0	16	18	15.0	28.6	8.5	..	..	..	..	..	..
Ukraine	-0.4	5.8	3-4	9.1	7.3	6	4.3	12.9	18.5	19.2	25.8	11.6	4.0	4.3	3.8
Uzbekistan	4.4	4.0	4.4	4.2	4.4	4.5	6.1	6.4	7.5	26.0	28.2	28.0	0.6	0.7	..
Total above	3.2	6.2	4.2	5.0	5.1	4½	4.6	10.2	6.5	..	..	..	..	..	..
Memorandum items:															
CETE-5	3.0	3.8	4.1	2.7	2.6	3	2.4	8.7	4.7	..	..	..	11.4	12.6	13.8
SETE-7	-2.3	3.4	4.5	4.4*	4.2	4½	-9.4	7.2	5.2	..	..	..	16.2	17.1	16.6*

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat.

Note: Aggregates are UNECE secretariat calculations, using PPPs obtained from the 1996 European Comparison Programme. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index. Unemployment generally refers to registered unemployment at the end of the period (with the exceptions of the Russian Federation, where it is the Goskomstat estimate according to the ILO definition, and Estonia where until October 2000 it refers to job seekers). Aggregates shown are: *Eastern Europe* (the 12 countries below that line), with sub-aggregates *CETE-5* (central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and *SETE-7* (south-east European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and Yugoslavia); *Baltic states* (Estonia, Latvia, Lithuania); and *CIS* (12 member countries of the Commonwealth of Independent States).

a January-June 2001 over January-June 2000.

b June 2001 over June 2000.

c Industrial output covers state sector only.

d Data reported by the Statistical Office of the Federation; these exclude the area of Republika Srpska.

e Gross material product instead of GDP. Data for 1999, 2000 and 2001 exclude Kosovo and Metohia.

f Excluding Transdniestria.

g Officially reported growth rates are of dubious reliability.

TABLE 1.2.2

International trade and external balances of the ECE transition economies, 1999-2001

(Rates of change and shares, per cent)

	Merchandise exports in dollars (growth rates)			Merchandise imports in dollars (growth rates)			Trade balances (per cent of GDP)			Current account (per cent of GDP)		
	1999	2000	2001 [a]	1999	2000	2001 [a]	1999	2000	2001 [a]	1999	2000	2001 [a]
Eastern Europe	-1.2	12.9	12.8	-2.5	11.0	11.2	-9.7	-10.5	-9.9	-5.8	-5.0	-5.7
Albania	28.3	-10.0	26.2	11.3	14.0	25.8	-16.9	-20.6	-22.0	-3.6	-4.4	-7.2
Bosnia and Herzegovina	47.3	30.2	20.1	14.7	-5.8	-4.9	-42.1	-38.3	-27.1	-21.4	-21.6	-17.1
Bulgaria	-4.5	20.0	8.9	11.3	17.6	12.6	-12.2	-14.0	-17.1	-5.3	-5.9	-4.8
Croatia	-5.3	3.0	0.7	-7.0	1.6	22.9	-17.4	-18.3	-23.7	-6.9	-2.1	-14.7
Czech Republic	-0.4	10.4	16.2	-2.5	14.9	16.9	-3.4	-6.4	-5.3	-2.9	-4.5	-4.3
Hungary	8.7	12.3	11.8	9.0	14.5	11.4	-6.2	-8.7	-7.7	-4.3	-3.3	-3.0
Poland	-2.9	15.5	16.7	-2.4	6.6	2.9	-11.9	-11.0	-8.4	-7.4	-6.3	-5.2
Romania	2.4	21.9	16.0	-12.2	25.6	32.4	-5.4	-7.3	-12.4	-4.2	-3.7	-8.1
Slovakia	-4.6	15.8	8.6	-13.4	12.5	18.5	-5.0	-4.0	-8.3	-5.0	-3.7	-8.1
Slovenia	-5.6	2.2	6.5	-0.2	0.3	0.6	-7.7	-7.6	-5.1	-3.9	-3.4	-0.6
The former Yugoslav Republic of Macedonia	-9.1	11.3	-10.9	-7.2	16.3	-25.5	-15.9	-20.7	-13.2	-3.1	-3.2	-11.0
Yugoslavia	-47.6	15.1	3.0	-31.8	12.6	9.0	-17.7	-24.6	-26.1	-7.5	-4.2	-9.0
Baltic states	-12.5	24.9	18.9	-13.7	15.0	13.1	-18.8	-17.2	-15.0	-9.3	-6.3	-5.2
Estonia	-9.2	33.2	19.7	-14.2	23.7	13.4	-22.5	-21.9	-17.7	-4.7	-6.3	-5.6
Latvia	-4.9	8.1	7.9	-7.6	8.1	9.3	-18.4	-18.5	-17.3	-9.8	-6.9	-5.3
Lithuania	-19.0	28.1	24.0	-16.6	13.0	15.2	-17.2	-14.3	-12.4	-11.2	-6.0	-5.0
CIS [b]	-0.5	38.0	7.5	-24.1	14.0	15.9	14.8	21.3	18.1	8.3	13.9	11.4
Armenia	5.1	29.7	9.3	-10.1	9.0	-9.2	-31.4	-30.5	-34.2	-16.6	-14.5	-14.2
Azerbaijan	53.3	87.8	57.1	-3.8	13.1	-3.9	-2.3	10.9	27.6	-13.0	-3.2	4.3
Belarus	-16.4	24.9	4.2	-21.9	27.0	-12.5	-6.9	-10.6	-0.1	-1.8	-2.1	4.6
Georgia	23.7	38.5	-2.5	-31.9	20.7	24.6	-12.9	-13.2	-15.0	-6.9	-8.7	-12.4
Kazakhstan	2.9	63.4	5.8	-15.2	37.0	45.6	11.3	22.3	12.7	-1.4	4.1	-5.5
Kyrgyzstan	-11.6	11.2	-4.0	-28.7	-7.6	-16.9	-11.9	-3.8	2.6	-14.7	-5.9	–
Republic of Moldova	-26.6	1.6	30.4	-42.7	32.5	16.7	-10.5	-23.8	-21.4	-4.0	-9.4	-6.4
Russian Federation	1.0	39.5	5.4	-30.5	8.9	24.2	22.1	27.5	22.5	12.8	18.4	15.2
Tajikistan	15.4	13.9	-14.4	-6.7	1.8	11.6	2.4	11.1	-10.2	-3.3	-6.3	-21.2
Turkmenistan	100.4	110.1	12.2	48.9	18.7	38.4	-9.5	16.3	0.8	-23.0	2.3	-9.6
Ukraine	-8.4	25.8	21.7	-19.3	17.8	7.4	-0.8	1.9	3.5	5.3	4.7	5.0
Uzbekistan	-0.6	0.9	0.7	-4.0	-5.0	8.0	1.2	2.8	1.1	-1.0	1.4	-0.6
Total above	-1.3	24.7	10.4	-10.1	12.0	12.5	–	3.9	3.0	-0.1	3.6	2.3
Memorandum items:												
CETE-5	0.1	12.2	13.6	-1.0	10.3	9.4	-8.7	-9.2	-7.6	-5.7	-5.2	-4.6
SETE-7	-6.8	16.2	9.3	-7.9	13.8	18.0	-13.2	-14.9	-18.5	-6.1	-4.6	-9.8

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat; UNECE secretariat calculations.

Note: Foreign trade growth is measured in current dollar values. Trade and current account balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. Current price GDP values are in some cases estimated from reported real growth rates and consumer price indices. On regional aggregates, see the note to table 1.2.1.

a January-June. Change over the same period of previous year.

b Including intra-CIS trade.

Most of the east European and Baltic economies have been able to easily finance their current account deficits – even when they have been growing – mainly with the continuing inflow of FDI. There has been, however, a worrying escalation in the external imbalances of some countries (Croatia, Romania, Slovakia), which may soon be faced with the need to take policy measures to arrest this process. The external financial positions of the CIS countries varied considerably in the first half of 2001. Russia's current account remained in large surplus (although less than in 2000) and the balances of about one half of the other CIS members benefited from buoyant Russian demand. However, a majority of energy exporters saw their current account balances deteriorate due to rapid import growth (for example Kazakhstan, Turkmenistan and Uzbekistan). Many CIS countries face various degrees of financing constraints because of their inability to attract private capital (virtually all the small CIS countries and Ukraine) and, in some cases, multilateral funds as well (Belarus).

(ii) Output and demand

During the first six months of 2001 output remained relatively strong in the ECE transition economies but, compared with the previous year, activity weakened somewhat in some countries, especially in eastern Europe. The main reason for the deceleration of growth

TABLE 1.2.3

GDP and industrial output in the ECE transition economies, 2000-2001
(Percentage change over the same period of the preceding year)

	GDP							Industrial output						
	2000				2001			2000				2001		
	Jan.-Mar.	Jan.-Jun.	Jan.-Sept.	Jan.-Dec.	Jan.-Mar.	Jan.-Jun.	Jan.-Sept.	Jan.-Mar.	Jan.-Jun.	Jan.-Sept.	Jan.-Dec.	Jan.-Mar.	Jan.-Jun.	Jan.-Sept.
Eastern Europe	4.7	4.5	4.1	3.7	3.4	3.1	..	8.6	9.8	9.7	8.5	6.7	4.8	..
Albania	..	..	..	7.8	..	..	..	8.8	7.6	18.4	12.0	-15*	-20*	..
Bosnia and Herzegovina	..	..	..	9.1	..	..	..	17.8	15.3	10.1	8.8	14.4	14.6	14.3
Bulgaria	4.5	5.1	5.5	5.8	4.5	4.8	..	5.2	3.2	3.3	2.3	5.6	1.7	2.6[a]
Croatia	3.7	4.1	4.1	3.7	4.2	4.5	..	3.7	2.8	2.7	1.7	5.6	5.9	5.9
Czech Republic	3.2	2.8	2.7	2.9	4.1	4.0	..	4.8	5.0	5.5	5.4	10.0	8.6	7.9[a]
Hungary	6.5	6.0	5.5	5.2	4.4	4.2	..	20.9	20.7	20.4	18.7	10.2	7.4	6.2[a]
Poland	5.9	5.4	4.6	4.0	2.3	1.6	..	10.1	10.2	9.2	7.5	4.2	1.6	0.7
Romania	1.2	..	..	1.6	4.8	4.9	..	0.5	5.0	7.7	8.2	10.8	10.4	9.0[a]
Slovakia	1.5	1.7	2.0	2.2	3.0	2.9	..	7.0	7.6	8.2	9.0	6.2	6.2	6.0[a]
Slovenia	6.2	4.8	5.0	4.6	3.2	2.9	..	7.2	8.4	7.7	6.2	4.7	3.2	3.6[a]
The former Yugoslav Republic of Macedonia	13.3	10.4	7.0	4.3	-5.1	-5.0	..	10.3	10.7	5.3	3.4	-8.7	-8.8	-9.6[a]
Yugoslavia	..	..	..	7.0	..	..	..	-5.0	19.9	18.8	10.9	-0.7	-2.4	-3.5
Baltic states	5.5	4.5	5.3	5.4	5.9	6.3	..	9.5	7.1	7.7	7.6	9.6	11.7	11.9[a]
Estonia	6.5	7.2	7.2	6.9	5.8	5.4	..	13.2	14.3	13.8	12.9	6.4	5.9	6.5
Latvia	6.1	5.5	5.9	6.6	8.3	8.8	..	4.4	4.2	3.2	3.2	7.5	7.9	8.1[a]
Lithuania	4.6	2.6	3.9	3.9	4.4	5.1	5.1	10.1	4.8	6.8	7.0	12.2	16.4	15.1
CIS	8.1	7.9	8.1	7.8	5.4	6.1	..	12.6	12.0	12.0	11.6	7.0	7.6	7.2
Armenia	0.3	2.4	2.7	6.0	12.3	6.6	9.9	0.3	2.9	3.9	6.4	9.2	2.7	3.8
Azerbaijan	6.7	8.5	9.9	11.1	8.0	8.4	9.3	3.5	4.7	5.8	6.9	6.1	5.1	5.4
Belarus	6.5	4.3	5.1	5.8	2.2	3.7	2.9	7.5	5.5	8.1	7.8	2.2	4.1	4.6
Georgia	8.1	0.8	0.1	2.0	1.7	5.5	4.8	14.1	9.1	7.2	6.1	-10.6	-3.1	-0.7
Kazakhstan	9.4	10.6	10.8	9.8	11.2	14.0	12.3	12.2	16.0	15.4	15.5	11.1	13.6	13.8
Kyrgyzstan	0.6	6.5	5.7	5.0	5.6	6.7	6.7	-4.8	3.3	6.7	6.0	11.0	6.0	7.1
Republic of Moldova	1.0	1.7	1.0	1.9	2.6	3.1	..	3.3	3.6	2.0	2.3	3.1	12.1	12.2
Russian Federation	9.0	8.8	8.8	8.3	4.9	5.1	..	14.3	13.1	12.7	11.9	5.2	5.5	5.2
Tajikistan	3.8	6.5	10.8	8.3	7.6	10.3	12.1	8.7	9.0	10.1	10.3	13.9	13.0	16.0
Turkmenistan	12.0	14.0	17.0	17.6	..	15.0	18.1	14.0	14.0	21.0	28.6	4.5	8.5	9.3
Ukraine	5.5	5.0	5.2	5.8	7.7	9.1	9.3	9.7	10.8	11.6	12.9	17.4	18.5	16.6
Uzbekistan	3.0	3.8	4.2	4.0	2.8	4.2	4.5	5.1	6.2	6.4	6.4	7.0	7.5	7.6
Total above	6.8	6.6	6.5	6.2	4.7	5.0	..	10.8	10.9	10.9	10.2	6.9	6.5	..
Memorandum items:														
CETE-5	5.1	4.6	4.2	3.8	3.1	2.7	..	10.5	10.6	10.2	9.1	6.8	4.7	..
SETE-7	3.6*	4.1*	4.0*	3.4	4.1*	4.4*	..	1.5	6.7	7.9	6.5	6.5	5.2	..

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat.

Note: Industrial output figures are based on monthly statistical reports. Because of differences in coverage, monthly cumulative figures for 2000 as a whole differ slightly from reported annual figures for some countries. For these countries reported annual figures have been used. On coverage of indicators and regional aggregates see the note to table 1.2.1.

[a] January-August.

seems to be the weakening of external demand, especially in western Europe, but real exchange rate appreciation may have also affected exports and output in some east European and Baltic economies.[23] As a result of these developments, a shift from external to domestic sources of growth has been taking place in 2001 in a number of countries in the region. This can be traced in the preliminary reports of their quarterly national accounts and also in the strengthening of retail sales volumes (table 1.2.4). Industrial output showed signs of weakening in 2001 in some transition economies but the picture varied considerably across countries (tables 1.2.1 and 1.2.3). While the growth of industrial production in the CIS as a whole also decelerated from 2000, the average rate of growth remained remarkably high, at 7.6 per cent (year-on-year) during the first half of 2001.

[23] Most east European and Baltic currencies have appreciated considerably in real terms since early 1999; while a broad-based real appreciation against the euro has also been prevalent among CIS currencies, these economies are far less integrated with the euro area for this to matter much. In contrast, the significant depreciation of CIS currencies against the Russian rouble during the first half of this year has had a strong impact on intra-CIS trade (see section 1.2(v)).

(a) Eastern Europe and the Baltic states

During the first half of 2001, central Europe was the slowest growing subregion among the ECE transition economies, the weak performance of the Polish economy weighing heavily on the aggregate figures. The deceleration of growth in Hungary has been perceptible since mid-2000 and GDP growth in the first half of 2001 was 4.2 per cent. So far, the slowdown has not given rise to any significant macroeconomic imbalance.[24] However, during the first half of 2001, the growth of exports slowed down and domestic demand, while rising steadily, has been unable to fully offset it. In this period growth was boosted by a 7.7 per cent, year-on-year, increase in construction output (real value added), with industry growing at a similar rate to GDP; agriculture and services made only small contributions to growth.[25] In Slovenia, weakening domestic demand (fixed capital formation fell by 3.8 per cent, year-on-year, in the first six months and consumption growth weakened due to modest increases in real household incomes) contributed to the deceleration of GDP growth. The curbing of domestic demand was partly policy-driven (fiscal restraint helped curb investment and imports while the central bank intervened on the foreign exchange market to prevent real exchange rate appreciation); through the course of the year, weakening external demand also added to the slowdown in domestic output. However, as import restraint was set in before the weakening of exports, the slowdown in Slovenian growth may not lead to the emergence of serious imbalances.

Slovakia's quarterly growth rate has been positive since the end of 1993 and this continued in 2001 as well. Unlike Hungary, however, the country has repeatedly gone through cycles of domestic versus external demand-led developments: after two years of export-driven recovery after the Russian crisis, preliminary data for the first half of 2001 suggest a strengthening of domestic demand (almost exclusively driven by a surge in investment) combined with an increasingly negative net trade contribution to GDP growth. During the first six months, the growth of industrial output decelerated to 6.2 per cent, while the volume of retail sales picked up only moderately (tables 1.2.3 and 1.2.4). Following nine consecutive quarters of uninterrupted growth, the Czech Republic was one of the few countries in the region to have raised its growth forecast for this year. The 4 per cent rate of GDP growth in the first half of 2001 was underpinned by continuing recovery in industry and in the trade and transport sectors. Stronger than expected domestic demand – contributing 6.2 percentage points to GDP growth in the first half of the year – largely offset a weakening, negative net trade position, in spite of a 9.8 per cent increase in the heavily export-oriented manufacturing output. The surge in domestic demand was partly due to rising real wages (giving a lift to household consumption) and large inflows of FDI (driving investment demand), but there was also some loosening of monetary and fiscal policies. However, given the current external environment, this policy mix is hardly sustainable: a further acceleration of domestic demand at a time when external demand is slowing down may give rise to macroeconomic imbalances.

In contrast to its neighbours, GDP growth in Poland has been slowing since the fourth quarter of 1999 when the quarterly rate peaked at 6.2 per cent, year-on-year. Restrictive monetary policy, aimed at meeting a medium-term inflation objective of 4 per cent by the end of 2003, has since contributed to curbing domestic demand. In the first half of 2001 aggregate domestic absorption fell by 1.3 per cent, year-on-year, largely due to sluggish

TABLE 1.2.4

Volume of retail trade in selected transition economies, 2000-2001
(Percentage change over same period of preceding year)

	2000				2001		
	Jan.-Mar.	*Jan.-Jun.*	*Jan.-Sept.*	*Jan.-Dec.*	*Jan.-Mar.*	*Jan.-Jun.*	*Jan.-Sept.*
Albania	..	..	..	..	3.1	..	..
Bosnia and Herzegovina	23.4	36.1	35.5	59.4	40.7	27.6	..
Bulgaria	6.7	3.7	3.1	0.6	1.1	3.3	4.6[a]
Croatia	10.9	10.7	10.7	9.9	11.0	11.6	10.8[a]
Czech Republic	6.6	5.8	4.8	4.3	3.6	3.8	4.0[a]
Hungary	4.2	3.4	2.2	1.9	6.7	5.3	4.7[a]
Poland	10.6	8.1	5.2	3.0	-2.2	-1.8	-1.2
Romania	-11.2	-7.8	-5.9	-4.0	-0.5	-2.5	-1.5[b]
Slovakia	-1.7	-1.4	0.4	2.3	3.7	3.0	3.3[a]
Slovenia	17.5	5.5	7.0	7.4	5.5	6.2	7.2[b]
The former Yugoslav Republic of Macedonia	4.2	8.8	10.4	10.6	..	6.9	4.7
Yugoslavia	-13.6	3.8	9.0	8.3	2.0	5.0	8.0[a]
Estonia	9.9	12.4	13.0	12.9	13.4	13.7	13.7[a]
Latvia	5.6	4.6	7.4	9.0	13.9	13.7	11.8[a]
Lithuania	12.6	12.4	13.2	13.9	9.9	6.5	7.1[a]
Armenia	7.4	6.3	6.9	8.5	14.2	14.0	15.2
Azerbaijan	9.3	10.0	10.1	9.8	9.4	9.3	9.8
Belarus	18.8	10.7	6.1	8.5	18.0	16.8	18.7
Georgia	9.7	13.2	11.4	11.0	..	3.3	4.3
Kazakhstan	..	0.3	..	4.8	11.7	13.3	12.9
Kyrgyzstan	2.6	6.2	5.5	7.7	6.4	6.3	6.2
Republic of Moldova[c]	-3.0	5.1	6.4	0.1	20.6	10.8	14.2
Russian Federation	8.1	8.4	8.7	8.7	7.3	9.5	10.1
Tajikistan	-28.8	-27.0	-22.1	-21.2	..	-5.7	-3.6
Turkmenistan	38.0	31.0	33.0	30.0	..	..	..
Ukraine	9.2	6.5	6.2	5.6	..	8.8	8.9
Uzbekistan	5.1	5.3	5.0	7.8	7.9	..	8.7

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat.

Note: Retail trade covers mainly goods in eastern Europe, the Baltic states, the Russian Federation, Kazakhstan and Ukraine (for 2000), goods and catering in other CIS countries. The coverage in the monthly statistics is based on current reporting and may differ from the coverage in the annual statistics.

a January-August.

b January-July.

c Registered enterprises for 2000.

[24] Since 1996 Hungary has largely maintained a balanced GDP growth path based on expanding external and, to a lesser extent, domestic demand. The exception was in 1998 when net trade contributed negatively to GDP growth.

[25] Hungarian Central Statistical Office, most recent data, GDP (http://test999.ksh.hu/pls/ksh/docs/index_eng.html).

investment.[26] Industrial production has been decelerating in line with aggregate output, its rate of growth dropping to 0.7 per cent in the three quarters of 2001, while the volume of retail sales was declining (table 1.2.4). The rapid weakening of output contributed to the deterioration of the Polish fiscal balance, which, in turn, triggered a dramatic reassessment of the budget deficit projections (see box 1.2.1). This combination of external consolidation and an unfolding fiscal imbalance may be, at least in part, the consequence of a lack of consistency between monetary policy, aimed at curbing domestic demand, and fiscal policy, which assumed and/or targeted a higher rate of growth than was feasible given the monetary policy stance. At the same time, the pace of external consolidation has so far remained unimpressive: the "containing" effect of monetary policy on the current account position has probably been counterbalanced by a real appreciation of the exchange rate, partly resulting from the recent fiscal expansion. In the short run, with domestic demand curbed and an unpromising external environment, the Polish economy is virtually at a standstill. Poland's medium-term macroeconomic stability will depend on the government pressing ahead with structural reforms and privatization, the latter helping both the financing of the public budget as well as increasing FDI inflows to cover current account deficits accompanying higher rates of economic growth.

In the first half of 2001 there was unexpectedly strong growth in the Baltic states; however, closer inspection reveals some country-specific patterns and suggests that this trend may not last for too long. While GDP grew by 5.4 per cent in Estonia, a notable slowdown of output has been taking place since mid-2000. The same was true for industrial sales whose rate of growth halved compared with the first six months of 2000. The principal supply-side contribution to industrial output came from metal processing, textiles and food processing. The communications equipment industry, one of the fast-growing manufacturing branches, suffered from the decision by the Finnish electronic parts maker Elcoteq to phase out the production of components for mobile phone producer Ericsson (see box 1.2.2). Uncertainty about the future is already well reflected on the demand side: the main contribution to GDP growth during the first half of 2001 was the reported build-up of stocks, while total final consumption and gross fixed capital formation jointly contributed only slightly more to GDP growth than was subtracted by the change in net exports.

While Estonia's production and export structure did not allow for terms of trade gains to be reaped from the recent rise in energy prices, a slight real appreciation of the currency and the weakening of demand from western Europe led to some trade diversion to the CIS. In contrast, Latvia and Lithuania, thanks to their involvement in the transit and/or refining of Russian oil, benefited from the energy price increases. At the same time, however, they experienced a larger real currency appreciation due to the pegging of their exchange rates to currencies other than the euro,[27] and this may be adversely affecting their cost competitiveness on European manufacturing markets.

The fastest growing Baltic economy in the first half of 2001 was Latvia with GDP increasing by 8.8 per cent. The most significant source of growth was the important services sector (with a share in GDP of more than 70 per cent): real value added in all the major service branches grew by more than 10 per cent.[28] The growth of manufacturing output also accelerated, led by wood processing, textiles and food processing, primarily due to robust domestic demand as well as growth in exports to CIS countries. Expectations in the economy remained positive, as construction activity remained buoyant (with real value added increasing 5.5 per cent, year-on-year, in the first half of 2001), while private sector investment grew by about 20 per cent.[29]

In addition to strong consumption growth, a 5.1 per cent, year-on-year, increase in Lithuanian gross fixed capital formation during the first half of 2001 was another positive outcome after two years of declining investment. Growth in the first half of the year was largely driven by industry, particularly by a 56 per cent increase in oil refining, which now represents roughly 20 per cent of industrial activity.[30] According to the quarterly national accounts, real value added in services grew by only 1.7 per cent (year-on-year), while in agriculture and construction output declined. The exchange rate peg to the dollar has turned out to be a mixed blessing recently. While benefiting the refining and export of Russian oil, it has proved rather burdensome for the international competitiveness of the rest of the manufacturing sector, since the dollar strengthened considerably against the currencies of Lithuania's mostly European trading partners (see section 1.2(v)).

[26] Gross fixed capital formation dropped by 8.4 per cent, year-on-year, in the second quarter of 2001.

[27] The Lithuanian litas is fixed to the United States dollar, but will switch to the euro in February 2002. Latvia's lats is pegged to the IMF's SDR.

[28] In particular, the amount of oil and oil products transported by pipelines increased by 21 per cent.

[29] Bank of Finland, *Russian & Baltic Economies. The Week in Review*, No. 39 (Helsinki), 28 September 2001. Due to the recent growth of investment in Latvia the share of gross fixed capital formation in GDP in nominal terms increased from 15.1 per cent in 1995 to about 21 per cent in the first half of 2001. UNECE Macroeconomic Statistical Database.

[30] UNECE Statistical Database. While the numbers given refer to NACE category DF (manufacture of coke, refined petroleum products and nuclear fuel), there is almost no other activity except oil refining in Lithuania.

Box 1.2.1

Fiscal turmoil in Poland

The policy debates accompanying the revision of the Polish 2001 budget in July and especially those during the deliberations on the 2002 budget brought to the surface a problem whose existence was long suspected by some analysts: Poland was facing an escalating fiscal gap which was approaching dangerous proportions. The draft 2002 budget prepared by the Ministry of Finance contained a laconic but alarming message: unless radical fiscal reforms were immediately undertaken, and under conservative growth assumptions, next year's budget deficit could reach some zloty 90 billion, or more than 11 per cent of GDP. Ringing the alarm bell cost the Minister of Finance his post but the re-evaluation of these projections by independent analysts only confirmed this outlook. Although there had been doubts about the actual state of Polish public finances for quite some time (the Monetary Policy Council has repeatedly pointed out that its discontent with the lax fiscal policy stance was one of the main reasons for the tightening of monetary policy since the last quarter of 1999), the sheer proportions of the looming fiscal crisis came as a surprise both to policy makers and to the public. Moreover, during the last several years the reported fiscal deficit in Poland was never considered as a major source of concern.[1]

Although the exact causes of this abrupt deterioration in Poland's fiscal position still need to be analysed in more depth, the academic and policy debate that followed this disclosure has focused on several key factors. An important reason for the emergence of such a large fiscal gap appears to be an ill-fated overlap of structural and cyclical factors in 2001, which had a negative impact on the economy in general and on the fiscal position in particular. These negative effects were compounded by misjudgement and mismanagement that led to a belated response to a looming problem.

In the course of the past several years Poland embarked on an ambitious reform programme including a complete overhaul of the pension system, a reorganization of local government structures, a health care reform and a restructuring of the education system. It has now been acknowledged that the full fiscal implications of these far-reaching reforms – especially given their simultaneous implementation – were not properly assessed at the time they were launched. In addition, it appears that the fiscal coordination of the legislative process during recent years was inadequate: numerous laws were adopted that affected (directly or indirectly) public revenue and expenditure without a comprehensive assessment of their immediate and, especially, their longer-term effects on net revenue.[2] Another structural factor that might have also aggravated the fiscal gap was the automatic adjustment (indexation) of various income-related payments (in particular pensions and various social benefits) for inflation.

The escalation of fiscal liabilities generated by these structural factors coincided with a notable weakening of the Polish economy: in the first half of 2001, the rate of GDP growth slowed to 1.6 per cent, year-on-year. Thus, the official assumption of 4.5 per cent annual GDP growth incorporated in the 2001 budget turned out to be grossly optimistic, with grave consequences for the country's fiscal position. As a large number of expenditure items were fixed in nominal terms, the budget deficit was already starting to rise in the early months of the year: by the end of March it had reached zloty 15.05 billion, or 73.3 per cent of the projected annual figure, and by the end of May it had almost reached the annual target.[3]

Much attention – indeed, not only during the latest debates but already since the first signs of the economy weakening in 2000 – has been focused on the role of the Monetary Policy Council, which sets the course of monetary policy in Poland. There was sharp criticism of what was seen as a too rigid policy stance by the Council, which was responsible for monetary policy being unnecessarily tight. The critics also argued that the monetary authorities were unduly preoccupied with meeting their ambitious disinflation targets while neglecting other serious problems in the economy. The main counter argument of the Council is that in the face of fiscal looseness, cooling down the economy through monetary restraint was the only available option to prevent a further deterioration in the current account and to avoid an exchange rate crisis. Another argument in support of its pursuit of a rapid rate of disinflation was the existence of automatic inflation adjustment mechanisms in a number of public expenditure items (such as pensions and social benefits); given such indexation, a higher inflation rate would imply an even further widening of the fiscal gap.

However, while monetary austerity might have prevented a further deterioration in Poland's external imbalance, in all likelihood it also contributed to the sluggish performance of the Polish economy in 2000-2001 and, in turn, to the cyclical deterioration in the fiscal balance. In terms of the general macroeconomic stance during this period the Polish economy probably received the wrong treatment, which eliminated some of the symptoms but did not address the core problems, namely, the above-mentioned structural factors. These problems cannot be solved with the instruments of monetary policy, or for that matter, of macroeconomic policy alone. They require a wider and more comprehensive policy approach and call for a much greater focus on policy coordination, on the one hand, between the monetary and the fiscal authorities, but on the other, between the legislative and the executive arms of the government as well.

Given the magnitude of the fiscal imbalance and the sluggishness of the Polish economy, Poland's new government, which took office in October, faces formidable problems in searching for ways and means to avert a fiscal and economic crisis. The situation is aggravated by the sharp slowdown in the global and west European economies and the likelihood of negative repercussions for the Polish economy. Time is pressing because a further deterioration in the international environment will cause a further enlargement of the fiscal gap. However, there are no easy solutions and the policy adjustments will inevitably include some highly unpopular measures such as cutting public spending and raising taxes.

Box 1.2.1 (concluded)

Fiscal turmoil in Poland

Despite its present problems, Poland's macroeconomic fundamentals appear to be generally sound and the long-run fiscal solvency of the economy has not been questioned. It should also be borne in mind that some of the structural components of the present fiscal imbalance, namely those generated by systemic changes such as the transition to new health care and pension systems, are likely to disappear when the new systems become fully operational. On the other hand, tolerating such a large fiscal deficit as that projected, even if only for a short period, could be an embarrassment as it would send unfavourable signals to the financial markets and could become an obstacle in Poland's accession negotiations with the EU. Thus, if Poland's image as a front-runner in the transition process is to be sustained, the new government will need to initiate and implement a number of painful policy adjustments.

[1] In the period 1997-2000, the consolidated general government deficit varied in the range between 2.7 to 3.8 per cent of GDP. UNECE, *Economic Survey of Europe, 2001 No. 1*, p. 84.

[2] According to the Ministry of Finance, during the 1997-2001 term of the Polish Sejm (which ended in September 2001), some 50 bills were passed with significant effects on the budget. W. Orlowski, "Ways can still be found to avert the present crisis", *Polish News Bulletin Company*, 4 September 2001, quoted in *Reuters Business Briefing*, 4 September 2001.

[3] *Reuters Business Briefing*, 5 May 2001 and PlanEcon, *Monthly Report*, Vol. XVII, No. 15, 24 August 2001.

Developments in the south-east European transition economies were dominated by post-conflict reconstruction in Yugoslavia, the rising tensions in The former Yugoslav Republic of Macedonia and the fallout from the recent Turkish financial crisis. After three years of recession, the Romanian economy started to recover early in 2000, led by industry. Increases in GDP of 4.9 per cent and of industrial production by over 10 per cent during the first half of 2001 largely reflected a strong, broad-based recovery in domestic demand.[31] At the same time, there was an increasingly negative contribution of net exports to GDP growth, raising concerns about a potentially dangerous external imbalance (table 1.2.2). Bulgaria's GDP rose 4.8 per cent during the first half of 2001, the main impetus coming from the continuing strong recovery in fixed investment. Following the general pattern since 1998, gross industrial output was again lagging behind GDP growth, with a mere 1.7 per cent increase during the first six months of this year. The new government has come up with policy measures aimed at invigorating the economy, including a plan to set up a fund for small- and medium-sized enterprises, a lowering of some taxes, as well as a cut in public administration staff, coupled with a rise in electricity and heating prices and increases in various social benefits. Economic growth in Croatia improved in the first half of the year led by a strong performance in manufacturing industry.[32] On the demand side, GDP was driven by consumer spending and investment, largely inventory building, while net trade subtracted 6.7 points from the rate of growth of GDP in the first half of the year due to a surge in imports in the face of a still rather poor export performance.[33] Worsening external conditions and the need for further fiscal tightening, however, point to a slowdown of output in the short term.[34]

Apart from the general worsening of external conditions, The former Yugoslav Republic of Macedonia currently faces a number of additional problems. The beginning of 2001 brought escalating ethnic tensions and political uncertainty, which led to the outburst of an internal military conflict. Although a ceasefire was negotiated in July, the existing tensions are a constant threat to political and economic stability. This uncertainty, as well as the disruption of a number of business activities due to the internal conflict, has had a highly detrimental impact on economic performance. Industrial output – which has been on a downward trend since mid-2000 – fell sharply (by 8.8 per cent, year-on-year) in the first half of this year. The incoming international aid inflow – which so far has been substantial – has been essential for protecting the country from the worst consequences of the past and present conflicts in its region and within its own borders.

[31] As a word of caution, the available preliminary Romanian statistics for the first half of 2001 contain some discrepancies. Thus, according to the quarterly national accounts, private consumption in the first half of 2001 increased by more than 7 per cent, year-on-year, while according to the monthly retail trade statistics the volume of retail sales during the same period declined by 2.5 per cent from the same period of the previous year (table 1.2.4).

[32] The output of machinery and equipment was up 13.2 per cent, year-on-year, in this period.

[33] As in the case of Estonia, if the increase in stocks were deducted from total final demand, Croatian GDP would in fact have shrunk during the first half of 2001. However, in contrast to Estonia where statistical discrepancies are explicitly reported in the national accounts, in Croatia these are lumped together with the "changes in stocks".

[34] In accordance with the recommendations of the IMF, the share of consolidated central government spending in GDP will have to be gradually reduced, from 50.2 per cent in 1999 to 37.6 per cent in 2003. IMF Staff Country Report No. 01/50, *Republic of Croatia: 2000 Article IV Consultation and Request for a Stand-By Arrangement. Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Authorities of Croatia* (Washington, D.C.), 23 March 2001, p. 14.

Box 1.2.2

The Elcoteq case

Thanks to the rapid expansion of a local subsidiary of the Finnish Elcoteq company during recent years, by the beginning of 2001 Estonia had become one of the largest third-country suppliers to the EU of transmission apparatus for radio-telephony (mobile phones, group 8525 of HS) and parts thereof (group 8529 of HS): it ranked 4th and 5th for the two groups, respectively, accounting for 11 and 5 per cent of the corresponding EU markets. These two product groups together made up nearly 40 per cent of Estonia's exports to the EU, which, in turn, accounted for about three quarters of its total exports in the first quarter of 2001. The major export destinations were Finland and Sweden: in 2000 the two countries absorbed 59 and 30 per cent of these exports, respectively. In turn, supplies from Estonia accounted for 40 and 33 per cent of Finland's and Sweden's imports of these goods from the non-EU area.

Recently, however, after losing orders from its major customer Ericsson (which in January decided to outsource the manufacture of its mobile phones to other manufacturers), Elcoteq had to scale down its output and, during the first quarter of 2001, discontinued Ericsson mobile phone production in Estonia and Hungary but continued production for Ericsson in China and Mexico. In May 2001, Elcoteq began production in Tallinn of electronics for base station antennas for a United States company; however, this requires only a small proportion of the available capacity in one of its two Tallinn plants. During the spring of 2001, Elcoteq reduced the workforce in its Tallinn subsidiary from 3,200 to 2,400 people, and it plans to lay off another 400 people by the end of the year.[1]

As a result, according to Eurostat data, in January-May 2001, Swedish imports from Estonia in these two product groups dropped by 65 per cent (year-on-year) in euro value. However, Finnish imports reportedly nearly tripled in value, although the volume growth decelerated noticeably.[2] This helped to contain the deterioration in the year-on-year growth rate of total Estonian export earnings in the second quarter, but in July and August 2001 they fell by 7 and 17 per cent in dollar value, respectively. In volume, Estonia's total exports have been declining since April 2001. With the global economy slowing down and with uncertain prospects for this industry, Estonia's export sector may suffer even more blows in the months to come.

The decision of Elcoteq to close down mobile phone production in its Hungarian plant by mid-year, in addition to ending its manufacture of computer monitors in December 2000, took its toll on Hungarian exports as well, although the impact was not as drastic as that on Estonia owing to the larger size of Hungarian exports and their more diversified structure. Faced with the global weakening of demand and especially of demand for communications equipment, the Elcoteq management has also been considering whether to pull out from Poland by the end of the year, terminating operations at the Wroclaw plant (240 employees) and transferring its manufacturing operations to Hungary. If these plans were to materialize, the new plant currently under construction in Wroclaw would be sold when completed.

[1] "Details of Elcoteq adjustment program specified – annual cost savings estimated to total 16 MEUR", *Press Release*, 27 August 2001 and "Elcoteq Network Corporation's Interim Report for January-June 2001", *Press Release*, 3 August 2001 (http://www.elcoteq.fi).

[2] An equally startling discrepancy emerges in the development of export unit values. According to the Estonian Statistics Office, while export unit values for communication network products in group 8525 of the HS rose on average by only 6 per cent between the first and fourth quarters of 2000, they increased nearly threefold between the last quarter of 2000 and the first quarter of 2001. They then dropped by a third in July-August. The exact causes of these fluctuations remain a puzzle but it is most probable that in the wake of the decision to shut down production of mobile phones for Ericsson in March, Elcoteq inflated the transfer prices of these products for strategic reasons before moving the remaining stocks back to its headquarters in Finland.

Similarly, neighbouring Yugoslavia is still best described as a postwar economy preoccupied with reconstruction. Recovery is expected to continue from last year, albeit at a reduced rate, especially as industrial output has not proved able to keep up last year's pace. Rebuilding the infrastructure and restructuring industry still require substantial foreign assistance, before private foreign investment will be willing to enter the country.

In Bosnia and Herzegovina, the emphasis is gradually shifting from reconstruction to structural reform. In the first six months of 2001, output development was uneven in the two entities that form the country: while industrial production grew by some 14.6 per cent in the Muslim-Croat Federation, it fell by 9.3 per cent (year-on-year) in Republika Srpska, widening the income disparity between the two.[35] The country still has rather weak export capacities, which result in persistent and sizeable external deficits (table 1.2.2). Private sector activity – now dominating construction, services and the production of foodstuffs and industrial consumption goods – has been the main source of economic growth in still mostly agrarian Albania during the first six months of the year. In contrast, production in state owned industrial firms fell by 20 per cent during the same period (table 1.2.1). Recently, inflows of foreign loans and foreign investment, attracted by the privatization of state owned companies, have joined cash remittances from abroad in financing the

[35] According to some estimates, at mid-2001 the average monthly income in Republika Srpska was one third less than that in the Federation. *RFE/RL Newsline*, Vol. 5, No. 186, Part II (Prague), 16 August.

country's chronic external imbalance, adding further impetus to domestic demand.

(b) Commonwealth of Independent States

Thanks to a rebound in domestic demand, the CIS as a whole was one of the fastest growing regions in the world in the first half of 2001. At the same time, there are signs that growth is decelerating, partly because of the particular nature of the initial export-driven recovery after the 1998 Russian crisis, which was largely due to subsequent large terms of trade gains. These gains were particularly favourable (at least until mid-2001) for energy and commodity exporters as well as for exporters of some price sensitive bulk commodities (such as chemicals and metals), while all the CIS countries (including net energy importers) benefited from the increase in Russian import demand.[36] Among the energy exporting countries, however, there are signs that the positive terms of trade shock has started to feed into a real appreciation of the exchange rate which threatens to undermine the competitiveness of the non-energy sectors and thus the diversification of their economies. Policy makers seem to be aware of these dangers and have been reacting accordingly, although with varying success.[37]

While GDP growth in Russia remained high (5.1 per cent, year-on-year, during the first half of 2001), it was less than in 2000. With real appreciation of the rouble having gained ground and oil prices having passed their peak, the external stimuli have been gradually weakening. At the same time, strong internal demand has been mostly due to the continuing strength of private consumption, which increased by 9.6 per cent in the first half of 2001. Retail sales were up by 9.5 per cent during the first half but there were signs that the import substitution effect, prompted by the 1998 rouble devaluation, was losing some of its force. The growth of industrial production was broadly based but it also slowed down from the preceding year.[38] Despite its continuing growth, there are some disturbing aspects of fixed capital formation: most of the net increase of investment since 1998 has been concentrated in the energy and transportation sectors, while real investment in the rest of the economy has in fact been declining.[39]

After positive growth was recorded for the first time in a decade in Ukraine in 2000, it strengthened further in 2001: during the first six months GDP increased by 9.1 per cent, year-on-year. However, much of the stimulus so far has been due to a rather narrow export base: in 2000, about a third of manufacturing output consisted of basic metals and fabricated metal products, while exports of steel accounted for roughly 40 per cent of the total value of exports.[40] Reducing the risks from such a narrow specialization in price sensitive products requires the development of a more diversified industrial structure and there were some encouraging signs of that in 2001: during the first six months the growth of manufacturing output was not only very high (up by 23.3 per cent over the same period of 2000) but it was also broadly based.

Belarus – which has not been part of the terms of trade-led expansion – performed significantly below the CIS average in the first half of 2001: GDP rose 3.7 per cent and industrial output by 4.1 per cent. On the demand side, the picture was mixed: investment outlays are reported to have fallen by 3.2 per cent (year-on-year) but private consumption was probably rising.[41] While a recent tightening of monetary policy may have had a negative effect on economic activity, this relatively weak performance in Belarus stems at least partly from the chronic structural problems of its economy. The situation was similar in the Republic of Moldova where GDP increased by 3.1 per cent in the first half of 2001. While preliminary statistics indicate increasing household consumption, falling gross fixed capital formation jeopardizes the potential for stable growth and restructuring.[42]

The relatively high rate of GDP growth in Armenia (6.6 per cent, year-on-year, in the first half of 2001) was largely driven by an upturn in the services sector. Retail trade and personal consumption also picked up strongly.[43] However, as Armenia is a large exporter of processed jewellery and precious stones, it is vulnerable to the effects of the global economic slowdown on the external demand for these items. Georgia's economy grew by 5.5 per cent, year-on-year, in the first half of 2001, having performed worst of all the CIS economies last year. However, its economic situation remains precarious as evidenced by the fact that Georgia was the only CIS economy to report declining industrial output during the

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[36] Rising energy prices, however, resulted in serious external imbalances in Armenia, Georgia, Kyrgyzstan, the Republic of Moldova and Tajikistan, and may also have been responsible for declining production and distribution of electricity during the first half of this year notably in Armenia and Georgia.

[37] While Azerbaijan has succeeded in avoiding real appreciation by bringing down inflation, Kazakhstan has chosen to subsidize the non-oil industries by channeling part of the increasing investment there.

[38] Oil extraction led the fuels industry with a 6.9 per cent increase (year-on-year) during the first half of 2001. Engineering branches grew above average, while non-ferrous metals output increased by 5.6 per cent during the first six months of this year. There was some stagnation in the production of ferrous metals. Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii*, January-June 2001 (Moscow), pp. 15-22.

[39] According to some estimates, while real gross fixed investment in fuels and transportation (the latter often related to the former) in the first half of 2001 grew by 132 per cent, compared to the same period of 1998, in the rest of the economy it declined by 10 per cent. Russian-European Center for Economic Policy, *Russian Economic Trends* (Moscow), September 2001, p. 3.

[40] Ukrainian-European Policy and Legal Advice Center, *Ukrainian Economic Trends* (Kiev), June 2001, p. 7.

[41] During the first six months the volume of retail sales was reportedly growing at double-digit rates (table 1.2.4)

[42] TACIS, *Moldova Economic Trends* (Chisinau), April-June 2001, p. 21 (www.economic-trends.org) and *Reuters Business Briefing*, 3 October 2001.

[43] The country has steadily reported levels of aggregate consumption in excess of GDP in recent years. The ratio of consumption to GDP in Armenia reached 107.4 per cent in 2000 and obviously, this does not provide a healthy basis for long-term capital investment and growth. Other low-income transition economies such as Albania, Georgia, Kyrgyzstan, the Republic of Moldova and Tajikistan, also suffer from similar disproportions.

first half of 2001.[44] During most of the past decade, Azerbaijan's economy has been shaped by expanding oil extraction and related activities in construction and transport. The capacity build-up in these areas (so far boosted by FDI) has now come to a temporary halt due to the lack of feasible projects. The continuing strong growth of GDP, which grew 8.4 per cent in the first half of 2001, is now being driven by increasing oil production and, at least until mid-year, relatively high oil prices.[45] Agriculture, which still employs almost half of the total workforce, also contributed to the high rate of GDP growth in 2001, gross agricultural output increasing by 8.2 per cent during the first six months. Consumer demand also remained strong with significant increases in real wages supporting an increase in retail sales of 9.3 per cent.

At 14 per cent and 15 per cent, respectively, the two central Asian oil and gas exporters, Kazakhstan and Turkmenistan, reported the highest GDP growth rates in the ECE region for the first half of 2001.[46] In contrast to Azerbaijan, capacity building in Kazakhstan's energy sector continues to proceed without interruption: while industrial production grew in line with GDP in the first six months of 2001, construction output increased by some 31 per cent, with agriculture lagging far behind the rest of the economy.[47] Real wage increases allowed retail sales to grow by 13.3 per cent – a significant acceleration if compared to the rates of growth in 1999 and 2000 – indicating a surge in private consumption. The rise in imports of machinery and equipment (section 1.2(v)) suggests buoyant investment activity as well, particularly in oil-related sectors. The economy of Turkmenistan is dominated by resource extraction,[48] although strong performance in the textile and food industries also contributed to output growth in 2001. Turkmenistan's export earnings remain constrained by the lack of an independent pipeline network to transport gas to markets outside the CIS.[49]

In the course of 2001 the central Asian commodity exporters, Kyrgyzstan, Tajikistan and Uzbekistan, were already experiencing the negative impact of falling commodity prices. Kyrgyzstan remains dependent on just a few sectors, mainly gold extraction and the related metallurgy as well as agriculture. According to some estimates, almost 2 percentage points of the 6.7 per cent GDP growth during the first half of 2001 are directly attributable to the exploitation and development of the Kumtor gold field;[50] the rest of industrial production has in fact declined. Gross agricultural production in Kyrgyzstan increased by 14.6 per cent, year-on-year, in the first half of 2001 adding to the strength of aggregate output.[51] Uzbekistan, although self-sufficient in oil and gas, exports little of either and has consequently been unable to benefit from the recent terms of trade gains. However, modest but steady growth continued into the first half of 2001. Industrial production was driven by a surge in metal processing and machinery building, largely thanks to increasing capacity utilization and exports by a foreign owned car plant.[52] Tajikistan has a large agricultural sector while its industry is dominated by aluminium and electricity; consequently, its economy is largely dependent on the fluctuating world prices of its main export items, aluminium and cotton. The strong economic upturn, which started in 2000, continued during the first half of 2001 and was broadly-based in the key sectors of the economy.[53] Despite these positive developments, chronic under-investment continues to hamper restructuring in both agriculture and industry.[54] The recent slump in aluminium prices is also likely to have a negative impact on Tajikistan's economy.

(iii) Costs and prices

Inflationary pressures weakened in the first eight months of 2001 in most of the transition economies and, by and large, inflation was not a major policy concern in these countries. Imported inflation, a key cause of the setback in the overall disinflationary process in the last two years, subsided significantly as a result of weaker

[44] This is due to a large extent to the persistent energy supply disruptions in the country, another indication of its economic fragility.

[45] In the first half of 2001, the share of oil extraction and refining in GDP amounted to 36.9 per cent, while non-oil industry accounted for 6.1 per cent. In 1998, these shares were 13.5 and 9.5 per cent, respectively. TACIS, *Azerbaijan Economic Trends* (Baku), April-June 2001, p. 25 (www.economic-trends.org).

[46] As a word of caution, the reliability of Turkmenistan's official growth statistics, as well as that of the official growth projections (table 1.2.1) have often been questioned by independent analysts due to doubts about the proper deflation of nominal figures.

[47] Statistical Office of Kazakhstan, Sotsial'no-ekonomicheskoe razvitie respubliki Kazakhstan (Almaty), July 2001, p. 8.

[48] Gas, cotton and to a lesser degree oil, together accounted for 83 per cent of export earnings in 2000, while gas alone accounted for over 50 per cent of government revenue and almost 60 per cent of foreign exchange earnings. *Reuters Business Briefing*, 13 September 2001, quoting *Walden Publishing*.

[49] In addition, Ukraine, the largest market for Turkmen gas, owed some $600 million in unpaid gas bills by mid-2001. "Turkmenistan – Review", *Reuters Business Briefing*, 13 September 2001.

[50] *Reuters Business Briefing*, 21 August 2001. The country is the tenth largest gold producer in the world while the Kumtor gold field is responsible for about half of its industrial output.

[51] Interstate Statistical Committee of the CIS, *Main Macroeconomic Indicators, Kyrgyzstan* (http://www.cisstat.com/kir.htm).

[52] TACIS, *Uzbek Economic Trends* (Tashkent), April-June 2001, p. 31 (www.economic-trends.org).

[53] Preliminary data for the first quarter suggest that apart from aluminium there was strong growth in other sectors such as construction, transport and agriculture. IMF Staff Country Report No. 01/115, *Tajikistan: Second Review Under the Third Annual Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of a Performance Criterion. Staff Report and News Brief on the Executive Board Discussion* (Washington, D.C.), 27 July 2001, p. 6.

[54] In order to assist at least basic infrastructure development in this, the poorest ECE economy, the EBRD approved in September 2001 a $13 million loan to modernize the telecommunications networks in Dushanbe, Khujand and Qurghon Teppa. *RFE/RL Newsline* Vol. 5, No. 187, Part I (Prague), 3 October 2001, quoting *Interfax News Agency*.

world energy prices and falling prices for other commodities.[55] Import price pressures were further moderated by falling world market prices for manufactures[56] in the face of the global economic slowdown. In addition, in many countries there was real exchange rate appreciation, particularly against the euro, which further reduced the domestic prices of imports.

On the domestic side, food prices, which were an important inflationary factor in 2000 in many transition economies, weakened substantially in 2001 thanks mainly to better than average harvests. As food prices fell considerably faster than usual during the summer, and given their still large weight in the consumption basket of households in these economies, the rate of consumer price disinflation gained further momentum over the summer months. Within the consumer price index, the major upward pressure came from service prices (particularly in Croatia, the Czech Republic, Yugoslavia, Kyrgyzstan and Russia).

Over January-August 2001, consumer price inflation was higher than in the same period of 2000 only in the Czech Republic, the three Baltic states and Russia (table 1.2.5); nevertheless, in Latvia and Lithuania the eight-month cumulative inflation rate remained below 2 per cent. The acceleration in the Czech Republic was mainly due to robust household demand, in turn the result of a combination of expansionary fiscal and income policies and a somewhat loose monetary policy. Relatively large gains in labour productivity, however, partly offset the effect of cost-push factors such as wage growth. In all the other east European countries, inflation rates fell and were even negative in Albania and Bosnia and Herzegovina. In Romania, the rate fell but still remained high at just below 20 per cent, the third highest among all the transition economies after Yugoslavia (32.5 per cent) and Belarus (25.4 per cent). In Poland, household demand weakened significantly as a result of further slowdown in real wage growth and soaring unemployment. This subdued consumer demand combined with the strong zloty and dwindling food prices during summer, lowered the eight-month cumulative inflation rate to 2.6 per cent in August, one of the lowest rates in the region and well below the expectations of the authorities at the beginning of the year. In contrast, in Hungary, a strong recovery in household consumption due to a large rise in real wages, substantial increases in agricultural and tourism incomes, and rapid growth of household credit were the major sources of inflationary pressure. Nevertheless, the strong forint, falling food prices and continuing (although smaller than in previous years) gains in productivity kept the slow rate of disinflation on trend. Recovery or a further strengthening of household demand was also one of the major sources of inflationary pressure in Bulgaria, Slovakia, Slovenia, the Baltic states and most of the CIS economies.

Industrial producer price inflation over January-August 2001 decelerated sharply and was even negative in several countries (table 1.2.5). Slovenia, Latvia and Armenia were exceptions to this pattern but even in these countries, increases in producer prices were not a source of concern. Inflation measured by the producer price index was much lower than that measured by the consumer price index in most transition economies, except Romania, Slovenia and a few small CIS economies. As mentioned above, service prices were the major component of the increase in the consumer price index in 2001. The smaller increase in producer prices than consumer prices may be explained to a large extent by two factors. First, real wages tend to increase not only in sectors with rapid productivity growth (mainly cost-efficient, export-oriented manufacturing branches) but also in less productive sectors (most of the non-tradeable service branches which are much less prone to competition), a phenomenon known as the "Balassa-Samuelson" effect.[57] Second, and probably more important, the experience of most east European countries indicates that consumer prices are usually more sensitive than producer prices to adjustments (usually increases) in administered or controlled prices.

Wage inflation in industry in the first half of 2001 remained relatively strong, rising faster than producer prices except in Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia, Latvia and Lithuania (table 1.2.5). In the two Baltic countries, in fact, nominal wages were nearly 2 per cent lower than in the same period of 2000. In the CIS countries, real product wages, which were shrinking in the previous two years or so, recovered strongly in the first half of 2001 and rose at double-digit rates in most of them. On the other hand, industrial labour productivity grew strongly in the first half of 2001, although less vigorously than in 2000, largely mirroring the slower output growth in many transition economies. Among the east European and the Baltic countries, labour productivity fell only in The former Yugoslav Republic of Macedonia, stagnated in Yugoslavia, and rose at relatively low rates in Slovenia and Estonia. Productivity growth decelerated in the first half of 2001 in Bulgaria, Hungary and Slovakia even though its rate still remained between 5 and 6 per cent (year-on-year). In Russia, the slowdown was considerable, its rate falling from more than 9 per cent in 2000 to less than 4 per cent in the first half of 2001. The best performers, with increases in labour productivity of

[55] Over the first nine months of 2001, world market prices for energy commodities (in dollars) increased by only 1.1 per cent, while those for industrial raw materials fell by more than 18 per cent. Over the same period of 2000, these prices had risen by 28 per cent and 1 per cent, respectively.

[56] Developed market economies' export unit values, in dollar terms, for manufactured goods declined by 3-4 per cent, year-on-year, in the first half of 2001. See section 1.2(v) below.

[57] The experience of the transition economies since 1990 provides relatively strong evidence of the presence of the "Balassa-Samuelson" effect. UNECE, "Economic transformation and real exchange rates in the 2000s: the Balassa-Samuelson connection", *Economic Survey of Europe, 2000 No. 1*, chap. 6, pp. 227-239.

TABLE 1.2.5

Consumer prices, industrial producer prices and labour costs in industry[a] in the ECE transition economies, 2000-2001

(Percentage change)

	August over previous December				*Annual average percentage change*							
	Consumer price index		*Producer price index*		*Nominal gross wages[b]*		*Real product wages[c]*		*Labour productivity[d]*		*Unit labour costs[e]*	
	2000	*2001*	*2000*	*2001*	*2000*	*2001[f]*	*2000*	*2001[f]*	*2000*	*2001[f]*	*2000*	*2001[f]*
Albania	-4.1	-4.1	..	..	..	..	..	..	57.0	..	..	..
Bosnia and Herzegovina	-0.2	-2.4	-11.0	-8.6	12.3	7.4	11.3	6.0	8.6	20.2	3.3	-10.6
Bulgaria[g]	6.2	0.9	6.0	0.8	10.9	7.5	-5.2	-3.1	18.4	5.8	-6.3	1.6
Croatia[h]	5.4	3.6	5.2	-2.5	6.0	9.0	-3.2	2.8	3.8	8.5	2.2	0.4
Czech Republic	3.4	4.9	3.3	0.8	7.0	7.5	1.9	3.2	8.5	7.9	-1.3	-0.4
Hungary	7.2	5.8	8.4	0.5	15.0	14.9	3.2	5.2	19.7	5.8	-4.0	8.6
Poland	6.0	2.6	5.1	0.4	10.9	7.2	2.9	3.7	9.5	6.7	1.3	0.5
Romania	26.4	18.9	31.2	21.5	41.7	54.1	-7.6	3.7	15.5	13.6	22.7	35.7
Slovakia	6.6	6.0	6.6	3.6	9.1	10.3	-0.6	1.7	12.5	5.0	-3.0	5.0
Slovenia	5.6	5.1	5.5	5.9	11.7	12.4	3.8	1.0	6.9	2.1	4.5	10.0
The former Yugoslav Republic of Macedonia[h i]	7.2	2.9	5.0	2.3	5.5	5.0	-3.2	-0.5	8.4	-2.3	-2.7	7.5
Yugoslavia	36.2	32.5	55.5	22.9	97.8	128.1	-3.7	4.6	14.8	0.2	72.3	127.6
Estonia	2.7	3.7	3.5	2.1	10.6	13.9	5.4	7.6	9.0	1.0	1.5	12.8
Latvia	0.7	1.7	0.4	1.5	15.1	-1.8	14.2	-2.9	1.0	8.2	14.0	-9.2
Lithuania	0.7	1.7	2.2	-1.9	1.2	-1.7	-14.1	-2.6	9.2	21.8	-7.3	-19.3
Armenia	-3.1	0.3	-1.0	4.1	14.1	12.5	14.5	12.7	15.6	3.3	-1.3	8.9
Azerbaijan	-0.2	-0.8	6.4	-2.7	15.0	24.4	5.1	28.4	11.0	20.0	3.6	3.6
Belarus	67.1	25.4	107.1	20.4	201.9	119.5	5.7	3.9	8.2	5.6	179.1	107.9
Georgia	0.4	0.5	4.6	2.1	..	..	..	..	..	..	..	..
Kazakhstan	5.2	3.4	8.5	-10.1	25.9	25.4	-8.8	17.6	22.2	23.2	3.0	1.8
Kyrgyzstan	4.7	1.6	14.9	5.9	21.7	24.5	-7.6	8.6	14.2	6.7	6.6	16.6
Republic of Moldova	13.9	1.1	19.4	4.6	32.3	28.5	-1.0	9.1	-2.0	11.4	35.0	15.4
Russian Federation	12.6	13.4	23.0	9.7	42.5	45.3	-2.7	16.6	9.2	3.7	30.6	40.1
Tajikistan	23.8	7.3	14.6	5.0	30.7	42.8	-6.0	3.8	20.9	14.9	8.0	24.3
Turkmenistan	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine	18.6	3.3	14.1	1.3	30.2	39.0	7.8	23.2	19.6	21.0	8.9	14.8
Uzbekistan[i]	9.1	9.0	31.6	6.6	39.0	54.6	-13.8	2.6	..	..	..	..

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

a Industry = mining + manufacturing + utilities.

b Average gross wages in industry except in Bosnia and Herzegovina – net wages in industry; in Bulgaria, Estonia, Lithuania and all CIS economies – gross wages in total economy; in The former Yugoslav Republic of Macedonia and Yugoslavia – net wages in total economy.

c Nominal gross wages deflated by producer price index.

d Gross industrial output deflated by industrial employment.

e Nominal wages deflated by productivity.

f January-June 2001 over January-June 2000.

g June over previous December for purchasing price index.

h Retail price index for consumer prices.

i June over previous December for consumer and producer prices.

20 per cent or more, were Bosnia and Herzegovina, Lithuania, Azerbaijan, Kazakhstan and Ukraine. As a result of these developments, industrial unit labour costs, with few exceptions, remained broadly in check and in real terms they increased only in The former Yugoslav Republic of Macedonia, Yugoslavia, Estonia and some CIS countries, particularly in Russia. This suggests that producers' operating profits in most transition economies were subject to only mild downward pressures during the first half of 2001.

Preliminary quarterly national accounts data indicate that household consumption growth continued to be weak or had lost steam in the first half of 2001 in some of the east European countries (Bulgaria, Poland and Slovenia) and Estonia. On the other hand, significantly higher real household incomes, due to rising real wages and some easing of the situation on the labour markets, boosted private consumption throughout the CIS except Tajikistan and, probably also, Georgia, as suggested by the retail trade data.[58]

In the short term, unless another external shock raises input costs, a further slowdown in core inflation

[58] See table 1.2.4 above. In the absence of national accounts data for the CIS economies except Russia, retail trade data were used as a proxy for developments in private consumption in the first half of 2001.

rates (that is, excluding increases in administrative prices) can be expected. The major source of domestic pressure on industrial producer prices in the rest of 2001 may come from unit labour costs due to the expected slowdown in export-led growth in output and productivity. However, this may be partly offset by the expected deterioration in the labour markets, which is likely to ease wage pressures. At the same time, the increase in global economic uncertainties and the weakening growth in household incomes can be expected to check consumption demand in the near future. Consequently, the inflation forecasts and targets incorporated in the budgets for 2001, some of which seemed to be rather ambitious when they were set, now seem to be within reach, and in a few cases, the outturn can be expected to be even lower.

(iv) Labour markets

In the first half of 2001 there were some signs of improvement in the labour markets of some transition economies but, with the deepening of the global economic downturn, these appear to be coming to an end. The decline in employment decelerated in eastern Europe, with several countries reporting actual increases. For the first time, employment increased in the CIS region as a whole. Nevertheless, in many cases the demand for labour continued to be weak and, on average, rates of unemployment remained very high. One possible reason for the relatively weak response of employment to output growth is the specific pattern of industrial restructuring which combines rationalization of labour in existing firms with the adoption of modern, highly productive technologies in newly emerging ones. On balance this results in a sluggish demand for labour despite the robust output growth. However, the effect of changes in output on labour demand is asymmetric: thus if growth in the transition economies starts to weaken due to the global slowdown, there is a risk that employment will continue to fall and at an accelerating rate in late 2001 and 2002.

Unemployment declined in many countries during the first eight months of the year, and has done so on the largest scale since mid-1998, when in most transition economies it rose sharply in the wake of the Russian financial crisis. Nevertheless, the situation on the labour markets is rather heterogeneous among countries and subregions and several economies still have high and persistent rates of unemployment, which present a major challenge for economic and social policy. Moreover, in some cases (Bulgaria, the Czech Republic and Romania) a fall in unemployment in the first eight months of 2001 occurred in tandem with falling employment, suggesting departures from the labour force. It should also be mentioned that the negative social consequences of the tense situation on the labour markets in some countries are further exacerbated by the continued decline in the numbers eligible for unemployment benefits[59] as well as the regional distribution of unemployment. Average levels of unemployment mask considerable regional disparities in a number of countries.[60]

In eastern Europe, the decline in employment which started in 1999 and continued throughout 2000, decelerated in the first half of 2001 in the region as a whole (to 1 per cent from about 2 per cent in the same period of 2000) (table 1.2.6). In addition to Hungary and Slovenia, where relatively large increases in employment (around 1 per cent) were maintained for a fourth consecutive year, employment increased also in Albania and Slovakia. Employment was basically stagnant in Romania and Yugoslavia, but elsewhere it continued to fall, although in Bulgaria and the Czech Republic at a much slower rate than in the recent past. In the former this reflected higher labour demand in small businesses, while in the latter it was mainly due to net job creation in manufacturing.

In the 12 months to August 2001, unemployment in the region declined in the majority of countries for the first time since the second half of 1998 (table 1.2.6). There were large falls in Albania, Romania and Bulgaria[61] and further improvement in the Czech Republic, Hungary and Slovenia. After peaking at nearly 20 per cent in January 2001, the unemployment rate in Slovakia fell substantially during the following months. Nevertheless, at close to 18 per cent in August, it was still slightly higher than a year earlier and the highest among the EU accession candidates. In the rest of the region joblessness continued to rise. In Croatia, a persistently high and rising unemployment rate reached a new record of just below 23 per cent in March.[62] Although the rate declined somewhat in the summer, in August it was nearly one percentage point higher than a year earlier.

59 In countries such as Albania, Bulgaria, Poland and Slovakia where unemployment rates were 15 per cent and higher in August 2001, some two thirds or more of the unemployed were no longer eligible for unemployment benefits.

60 Interregional disparities in unemployment within individual transition economies largely reflect the countries' inherited industrial structures, which under central planning were, geographically, highly concentrated. The spatial patterns that emerged were sometimes quite irrational, paying little attention either to transport cost (for industry) or to natural conditions (for agriculture). As a result, the whole of central and eastern Europe faces serious problems with regional unemployment: for example, in Poland, the former state farms in the north have given rise to very high regional unemployment rates. As an illustration of the existing regional disparities, the numbers below indicate the ranges between the lowest unemployment rates (usually located in capital districts), the average national rates and the highest rates (located in depressed regions) in selected countries (the countries are listed in the order of their average national rates, all numbers are in per cent and refer to August 2001): Latvia: 3.6-7.8-26.8; the Czech Republic: 2.4-8.5-21.4; Lithuania: 5.5-12.1-26.2; Poland: 4.3-16.0-35.7; Bulgaria: 4.5-16.7-53; Slovakia: 6.1-17.8-24.9.

61 As in Romania employment was somewhat stagnant and in Bulgaria it continued to decline; these falls suggest, *inter alia,* departures from the labour force.

62 The statistics of registered unemployment in Croatia appear to be biased upwards. Thus, in the second half of 2000, the unemployment rate according to the labour force survey stood at 17 per cent as opposed to 21.3 per cent according to the unemployment register. Similar caution is advised when interpreting the unemployment data in all the successor states of the former SFR of Yugoslavia. For a more detailed discussion of the reasons for this discrepancy see UNECE, *Economic Survey of Europe, 2001 No. 1*, pp. 134, 136.

TABLE 1.2.6

Total employment and registered unemployment in the transition economies, 1998-2001
(Percentage change over the same period of preceding year, per cent of labour force, end of period)

	Employment [a]					*Unemployment*			
				QI-QII		*August*			
	1998	*1999*	*2000*	*2000*	*2001*	*1998*	*1999*	*2000*	*2001*
Eastern Europe	0.4	-1.9	-0.9	-2.0	-1.0	11.7	13.8	14.6	14.9*
Albania	-2.0	-1.8	0.3	-1.7	1.2	16.8	18.1	17.4	15.1
Bosnia and Herzegovina [b]	5.9	3.1	1.1	1.1	-0.8	37.9	39.3	39.4	39.7
Bulgaria	-0.2	-2.1	-4.7	-10.0	-4.6	10.8	13.6	18.0	16.7
Croatia	6.6	-0.4	-1.8	-0.8	-1.0	17.0	19.1	20.8	21.5
Czech Republic	-1.6	-3.6	-2.3	-2.3	-0.6	6.4	9.0	9.0	8.5
Hungary	1.4	3.1	1.0	0.7	1.0	9.0	9.4	8.8	8.1
Poland	2.3	-2.7	-0.5	-3.6	-3.1	9.5	11.9	13.9	16.2
Romania [c]	-1.9	-0.6	-0.1	-0.5	-0.3	8.7	10.9	10.1	8.1
Slovakia [c]	-0.3	-3.0	-1.4	-2.5	1.5	13.8	18.2	17.4	17.8
Slovenia	0.2	1.8	1.3	2.0	1.1	14.2	13.3	11.7	11.1
The former Yugoslav Republic of Macedonia	-2.9	1.8	-1.3	0.4	-3.4	41*	43*	44*	..
Yugoslavia [d]	-0.1	-8.2	-2.7	..	-0.2	27.0	27.2	26.8	27.8
Baltic states	-0.5	-1.2	-2.0	-1.7	-2.6	5.8	8.3	9.5	9.8
Estonia [e]	-1.3	-4.1	-0.9	-2.1	0.7	4.2	6.3	6.0	7.3*
Latvia	0.6	-0.5	–	0.6	-0.1	7.4	9.8	8.1	7.7
Lithuania	-0.8	-0.5	-3.7	-3.0	-5.4	5.4	8.1	11.8	12.1
CIS	-1.1	-0.4	..	-0.2	0.6	8.4	8.6	7.0	6.2
Armenia	-2.5	-2.9	-1.6	-1.0	-0.6	8.7	11.3	11.4	10.0
Azerbaijan	0.2	–	–	–	0.1	1.4	1.2	1.1	1.3
Belarus	1.1	0.6	–	0.1	-2.6	2.3	2.1	2.1	2.5
Georgia	2.2	..	..	..	..	3.6	5.3	..	..
Kazakhstan	-5.3	-0.4	1.6	-3.3	8.1	4.0	3.6	4.0	2.8
Kyrgyzstan	0.9	3.5	0.2	0.2	-0.1	3.7	3.1	3.1	3.2
Republic of Moldova	-0.2	-9.0	1.3	3.0	-1.0	2.0	2.4	2.1	1.9
Russian Federation [f]	-1.5	0.5	0.6	0.7	1.1	11.6	11.9	9.8	8.2
Tajikistan	0.3	-3.3	0.5	-0.7	-3.4	3.5	3.3	3.0	2.6
Turkmenistan	1.3	3.8	..	..	..	..	..	..	..
Ukraine	-1.1	-2.3	-2.5	-2.4	-1.6	3.6	4.1	4.2	3.7
Uzbekistan	1.4	1.0	1.1	1.0	..	0.4	0.5	0.5	..
Memorandum items:									
CETE-5	1.2	-2.0	-0.6	-2.1	-1.1	9.4	11.7	12.6	13.8
SETE-7	-0.7	-1.8	-1.2	-1.7	-0.8	15.0	16.8	17.5	16.5*
Russian Federation [g]	..	..	..	..	..	2.4	1.9	1.4	1.4
Former-GDR	..	..	..	..	..	17.2	17.6	17.0	17.1

Source: National statistics; direct communications from national statistical offices to UNECE secretariat.

a Annual average unless otherwise stated. Regional quarterly aggregates of employment exclude Yugoslavia, Georgia, Turkmenistan and Uzbekistan.

b Figures cover only the Muslim-Croat Federation. Data for Republika Srpska are not available.

c Labour force survey employment data.

d Since 1999 excludes Kosovo and Metohia.

e Unemployment: until October 2000 – job seekers, thereafter – registered unemployed as percentage of the labour force.

f Unemployment figures are based on monthly Russian Goskomstat estimates according to the ILO definition, i.e. including all persons not having employment but actively seeking work.

g Registered unemployment.

Given the expected slowdown of GDP growth and the need to implement austerity measures in order to reduce macroeconomic imbalances, any radical improvement of the situation is unlikely this year. In Poland, an already difficult situation deteriorated further in the first eight months of 2001, reflecting the sharp slowdown in output growth coupled with the ongoing restructuring of unprofitable industries and the continued pressure of newcomers on the labour market. In August, the unemployment rate was 2.3 percentage points higher than a year earlier (the largest increase among all the transition economies) and reached a six-year high at 16.2 per cent of the labour force. As economic growth is expected to remain weak, and with a large influx of baby-boom graduates entering the labour market in the course of the year, national analysts estimate that the unemployment rate could reach a record 17-18 per cent of the labour force by the end of 2001.[63] The highest unemployment rates in the region were again in Bosnia and Herzegovina and probably in The former Yugoslav Republic of Macedonia, in both cases the rates standing at around 40 per cent.

Despite a robust economic performance in the Baltic states in 2000-2001, so far there have been no radical improvements in their labour markets, although the situation differed considerably between the three countries. In Estonia, the fall in employment bottomed out at the end of 2000 and in the first half of 2001 it grew by nearly 1 per cent, the first increase since 1997. The improvement was mainly due to manufacturing industry where employment started to grow rapidly in 2000 and continued to do so in the first two quarters of 2001.[64] In Latvia, where output growth was even stronger than in Estonia, the demand for labour remained weak and employment was actually flat during the first half of the year. This is partly explained by the fact that the growth of the Latvian economy was largely due to the increased transit of oil and oil products. The rapidly growing Lithuanian economy has not invigorated the country's labour market either. On the contrary, the situation has deteriorated considerably: the decline in employment accelerated in the first half of 2001 with a fall of over 5 per cent. Most of the job losses were in manufacturing, energy and agriculture, a reflection of the continuing restructuring of the enterprise sector and the country's specific pattern of growth (see section 1.2(ii)).

In August 2001, the average unemployment rate in the Baltic region stood at nearly 10 per cent,[65] slightly higher than a year earlier (table 1.2.6), although, again, the situation differed considerably among the countries. In Latvia, the downward trend, observable since 1999, continued in the first eight months of 2001. But the situation continued to deteriorate in Lithuania: unemployment there has been rising steadily since August 1998 and reached a record of more than 13 per cent in March 2001. In 1998, unemployment rates were very similar in all three economies but by August 2001 the rate in Lithuania was considerably higher than in the other two Baltic states and more than double what it was in 1998, just before the Russian crisis.[66] The official figures suggest that unemployment also increased in Estonia in the 12 months to August 2001, but this may largely reflect a change introduced in October 2000 to ease the eligibility conditions.[67]

As a result of the widespread and strong economic recovery in the CIS countries, there was some improvement in employment in the region as a whole.[68] In Russia, it rose by more than 1 per cent, reflecting the strength of the continuing recovery. The growth in employment continued for the third consecutive year after the August 1998 financial crisis, although its rate decelerated in the second quarter of 2001. As employment in large and medium-term enterprises – which still account for more than 60 per cent of total employment – broadly stagnated, most of the expansion was concentrated in small enterprises. The main sectors providing new jobs were services, but there was also a substantial increase, of nearly 2 per cent, in industry. In the first two quarters of 2001, there was also a large increase in employment in rapidly growing Kazakhstan with labour demand increasing in construction, and particularly in services. Employment remained flat in Azerbaijan and Kyrgyzstan and in the other countries for which data are available continued to decline, although in some cases at lower rates than in 2000 (except in Belarus and Tajikistan, where the falls were larger than in 2000).

Goskomstat's estimates of unemployment based on data from the labour force survey indicate a marked fall in unemployment in Russia, the rate declining steadily during the first eight months of 2001 to just above 8 per cent in August, 1.6 percentage points less than a year earlier. The situation also improved in Ukraine where according to the latest labour force survey, the unemployment rate fell to 10.5 per cent in June 2001, 0.9 percentage points lower than a year earlier.[69] According to rough estimates for the first half of 2001, the total number of unemployed in the CIS region (i.e. all those who are out of work and searching for a job, not just those who are registered) amounted to some 12 million persons, down from 13.5 million in the same period of 2000.[70] The main

[63] In August some 2,300 enterprises declared that they were planning some 81,000 layoffs in the near future. *Polish News Bulletin Company,* 24 September 2001, as quoted by *Reuters Business Briefing*.

[64] Despite the continued strong growth of manufacturing employment, there were signs of a sharp deceleration in the first half of 2001. The rate of growth declined from 12.9 per cent (year-on-year) in the first quarter to 5.5 per cent in the second. The situation may be further aggravated by the adjustment programme recently announced by Elcoteq Network Corporation (box 1.2.2).

[65] In interpreting the unemployment figures in these countries, one should take into consideration that the official figures for registered unemployment in the Baltic states tend to underestimate the actual levels of unemployment. In the second quarter of 2001, unemployment rates derived from labour force surveys were at 12.4 per cent in Estonia, 13.5 per cent in Latvia (May) and 16.6 per cent in Lithuania (May), whereas the registered rates were 7.5, 7.9 and 12.6 per cent, respectively.

[66] This partly reflects the fact that the Lithuanian economy has taken longer to recover from the effects of the Russian crisis.

[67] Although data from the labour force survey are not yet available for the third quarter of 2001, the data for the first half of the year do not indicate any increase in unemployment. On the contrary, according to the labour force surveys, the unemployment rate declined from 14.2 per cent in the first quarter of 2001 to 12.4 per cent in the second; these rates were also lower than the corresponding rates a year earlier, by 0.6 and 0.8 percentage points, respectively.

[68] Recently there has been a deterioration in the current statistical reporting of the situation on the labour markets of the CIS countries, which was inadequate in the first place. Thus, quarterly employment statistics are no longer available for several CIS countries. As for unemployment, registered unemployment data, often improperly measured, are the only series available for most of the CIS countries. Moreover, several countries (Georgia and Uzbekistan, in addition to Turkmenistan) recently stopped reporting unemployment statistics altogether.

[69] Direct communication to the ECE secretariat from the national statistical office.

[70] CIS Statistical Committee, *Statistika SNG, Statistical Bulletin,* No. 14, July 2000, p. 50 and No. 14, July 2001, p. 68.

contributors to this development were Russia, Ukraine and most likely Kazakhstan, where the labour market has improved since 2000. The average unemployment rate based on these figures was 9.4 per cent (compared with 10 per cent in 2000).

It is increasingly difficult to assess the unemployment situation in the rest of the CIS countries due to the scanty and unreliable statistics. The official figures indicate few changes in the 12 months to August 2001. Although registered unemployment rates remain very low, they do not reflect the true level of unemployment as a large proportion of the jobless, although willing to work, do not register for various reasons.[71]

(v) International trade

(a) Trade of eastern Europe and the Baltic states

Contrary to widespread expectations, the foreign trade of the east European and Baltic countries maintained its momentum throughout the first six months of 2001, expanding at nearly the same rate (11-13 per cent) in current dollar value as in 2000.[72] However, growth in volume, although in double digits, weakened significantly in 2001: the region's exports and imports grew some 13 and 10 per cent in volume, respectively, against 21 and 15 per cent in 2000.[73] The terms of trade slightly worsened for a number of countries in the region, as dollar import prices increased slowly or were stagnant on average, whereas average export dollar prices declined, mainly under the influence of manufactured goods.[74] The region's aggregate merchandise trade deficit increased by one billion dollars in the first half of 2001, widening to $21.4 billion. This was in spite of a noticeable improvement in the Polish and Slovene trade balances.

The 13 per cent rise in the aggregate dollar value of east European and Baltic exports in the first six months of 2001 resulted partly from the diversified product structure and flexibility of the export sector in a number of these countries; the Czech Republic, Poland and Slovenia markedly increased their export earnings over those of 2000 (table 1.2.2). While the growth of exports in 2000 was primarily boosted by buoyant western import demand, in the first half of 2001 the latter faltered; but at the same time some of the transition economies benefited from the ongoing recovery of demand in the Russian, CIS and south-east European markets.[75] In particular, Croatia, Slovenia and the Baltic states were able to increase significantly their exports to the CIS.[76] However, the actual increase in total exports would not have been possible had there not been a steady growth of exports to the developed market economies in spite of the weakening of their overall import demand (table 1.2.7).[77]

The markedly increased presence of east European and Baltic producers on specific western markets is a result of their ongoing integration into the production networks of multinational companies and of improved cost competitiveness (see table 1.2.5 on changes in unit labour costs). According to Eurostat data, the share of the east European and Baltic countries in total EU imports increased from 4 per cent to 4.5 per cent between the first quarters of 2000 and 2001, and their share of EU imports originating from third countries rose to nearly 11 per cent (from 10 per cent in January-March 2000).[78] In the first three months of 2001, there were particularly large gains in EU market share for vehicles, spare parts and components (chapter 87 of HS) produced or assembled in CEFTA-7 countries, which rose from 21 to 28 per cent of extra-EU imports. This development reflects the deepening production fragmentation in major western automotive companies, often based on cheaper unit labour costs, and geographical proximity and other logistical factors. There were similar developments

[71] The proportion of those who do not register varies in different countries between 50 to 80 per cent of total unemployment. For a more detailed discussion see UNECE, *Economic Survey of Europe, 2001 No. 1*, p. 137. Ad hoc estimates suggest that actual unemployment rates in some CIS countries were much higher than those in table 1.2.6. These estimates suggest that the rate of unemployment in Georgia was around 12 per cent on average in the first half of 2001; in Kazakhstan at 12.7 per cent in April; and in the Republic of Moldova 8.8 per cent in the first quarter of 2001. National Bank of Georgia, *Bulletin of Monetary and Banking Statistics*, No. 6 (Tbilisi), 2001, p. 5; *Sotsial'no-economicheskoe razvitie Respubliki Kazakhstan, yanvar'-aprel' 2001 goda* (Alma Aty), May 2001, p. 93, TACIS, *Moldova Economic Trends*, April/June 2001, p. 42 (www.economic-trends.org).

[72] The continued weakness of the euro – in which most of the region's trade is denominated – relative to the dollar depressed export and import values expressed in dollars, but not as much as in 2000: in euros, east European and Baltic trade rose by 19-21 per cent in the first six months of 2001, following a 29-31 per cent rise in 2000.

[73] These are ECE secretariat estimates, based on preliminary data from several east European and Baltic countries (see table 1.2.8).

[74] World market prices in dollars for energy resources stagnated on average in the first six months of 2001 compared with January-June 2000, but starting in June they also dipped down; world commodity prices excluding energy fell markedly at the same time. Export unit values (in dollars) for manufactured goods declined, year-on-year, by 3-4 per cent in developed market countries (United Nations Statistical Division, *Monthly Bulletin of Statistics On-line,* query results for trade-manufactured goods exports, unit value indices in dollars, 1990=100). According to national statistics, export dollar unit values for manufactured goods also declined in Hungary but remained virtually unchanged in the Czech Republic and Poland. On the unprecedented increase in the export prices of Estonia see footnote *d* to table 1.2.8 and box 1.2.2.

[75] Russia's imports from non-CIS countries rose by more than 45 per cent in volume in the first half of 2001. This trend seems to have continued into the second half.

[76] In January-June 2001, Slovenia recorded a rise of 63 per cent, and Croatia and the Baltic states of 40 per cent, year-on-year, in their export dollar values to the CIS region. In contrast, exports from Bulgaria and Romania declined, while those from Hungary remained stagnant.

[77] According to Eurostat data, in January-March 2001 total EU imports rose by 3 per cent in current dollar value and those from third countries by nearly 6 per cent, while imports from east European and Baltic countries surged by more than 15 per cent, year-on-year. The pattern seems to have continued through April-May, when the dollar value of extra-EU imports to 12 EU countries (data for Denmark, Greece and Spain were not yet available at the moment of writing) shrank by 1 per cent, year-on-year, but imports from the east European and Baltic countries grew by 9 per cent. European Commission/Eurostat, *Intra- and Extra-EU Trade Flows*, *Monthly Data*, No. 8, 2001.

[78] European Commission/Eurostat, op. cit.

TABLE 1.2.7

Foreign trade of the ECE transition economies by direction, 1999-2001
(Value in billion dollars, growth rates in per cent) [a]

	Exports				*Imports*			
	Value	*Growth rates*			*Value*	*Growth rates*		
Country or country group [b]	*2000*	*1999*	*2000*	*2001* [c]	*2000*	*1999*	*2000*	*2001* [c]
***Eastern Europe,** to and from:*								
World	132.9	-0.6	12.8	12.8	172.6	-2.1	11.1	11.2
ECE transition economies	26.7	-17.0	13.5	12.3	38.2	-0.8	27.7	12.2
CIS	4.9	-41.2	14.3	8.7	18.0	-3.4	50.5	12.5
Baltic states	1.2	1.3	15.3	26.1	0.5	31.9	50.8	3.1
Eastern Europe	20.5	-9.2	13.2	13.6	19.8	0.6	11.8	11.8
Developed market economies [d]	96.7	4.8	12.2	13.5	115.0	-3.7	6.1	9.3
European Union	88.4	4.6	11.7	13.8	99.7	-3.6	4.8	9.3
Developing economies	8.3	1.8	18.9	10.2	17.3	8.5	13.3	26.5
***Baltic states,** to and from:*								
World	8.9	-11.6	24.5	18.9	13.0	-13.6	15.5	13.1
ECE transition economies	2.5	-34.7	18.7	23.7	4.4	-10.5	23.4	15.3
CIS	0.9	-50.9	0.9	39.7	2.7	-13.9	36.8	14.1
Baltic states	1.2	-12.3	28.2	15.2	0.8	-6.3	7.8	14.3
Developed market economies	6.1	5.6	25.9	15.4	7.7	-15.1	9.5	4.0
European Union	5.5	5.4	26.6	16.1	6.7	-15.4	10.5	3.1
Developing economies	0.3	8.3	50.6	20.2	0.9	-13.6	38.3	105.9
***Russian Federation,** to and from:*								
World	103.0	2.2	41.3	5.4	33.9	-30.5	12.0	24.2
Intra-CIS	13.8	-21.8	28.8	3.7	11.6	-26.3	39.6	18.3
Non-CIS economies	89.2	7.9	43.5	5.7	22.3	-32.0	1.5	27.2
ECE transition economies	17.9	6.3	61.1	..	2.4	-45.3	15.5	..
Baltic states	4.9	26.0	73.7	..	0.3	-56.2	12.2	..
Eastern Europe	12.9	0.9	56.8	..	2.1	-43.0	16.1	..
Developed market economies [d]	49.6	4.2	37.6	..	15.4	-31.9	2.9	..
European Union	36.9	7.1	48.4	..	11.1	-28.9	-0.4	..
Developing economies	21.7	19.4	44.5	..	4.4	-24.5	-9.2	..
***Other CIS economies,** to and from:*								
World	41.0	-4.7	34.4	12.8	36.9	-17.1	34.4	8.5
Intra-CIS	15.1	-21.2	38.0	16.6	20.4	-18.3	38.0	8.8
Non-CIS economies	25.9	7.9	32.4	10.5	16.5	-15.9	32.4	8.1
***ECE transition economies,** to and from:*								
World	285.8	-0.7	25.2	10.4	256.4	-9.8	12.5	12.5

Source: National statistics and direct communications from national statistical offices to UNECE secretariat; for the Russian Federation, State Customs Committee data; for other CIS economies, CIS Statistical Committee.

Note: There were changes in the methodology of foreign trade reporting in several east European and Baltic economies in 1999-2000. In 1999, Poland changed its customs declaration system increasing substantially the coverage. In 2000, Estonia in its basic trade statistics switched to a "special trade" reporting system; this change, however, is not yet reflected in the Baltic states aggregate above. For details on prior-1998 changes see UNECE, *Economic Bulletin for Europe*, Vol. 48, 1996 and Vol. 49, 1997.

a Growth rates are calculated on values expressed in dollars.

b For country groups see table 1.2.1.

c January-June over same period of 2000.

d "Developed market economies" exclude Turkey and include Australia, New Zealand and South Africa.

elsewhere in the machinery and equipment sector, but also in other manufacturing sectors (furniture for instance), leading to marked increases in the presence of the east European and Baltic countries in specific product markets in the EU. Thus, exports of mechanical and electrical machinery and equipment and their parts (chapters 84 and 85 of HS) from east European and Baltic countries currently account for 10 and 12.5 per cent of extra-EU imports, respectively, while furniture, bedding, etc. (chapter 94 of HS) account for 42 per cent of extra-EU imports in that sector. However, some of the east European and Baltic countries, being small open economies, are now increasingly dependent on a limited range of export products and/or markets, which implies a high degree of risk should the industry or market fail. The recent major reshuffling of the Elcoteq production site in Estonia is a case in point (see box 1.2.2).

Export growth in eastern Europe and the Baltic states had slowed down by mid-2001 (chart 1.2.1) as weakening business and consumer confidence in western countries led to a fall in demand for most investment goods and some consumer durables, in particular for electrical machinery and communications network products and new vehicles.

TABLE 1.2.8

Changes in the volume of foreign trade in selected transition economies, 1997-2001

(Per cent)

	Exports						Imports					
					2001 [a]						2001 [a]	
	1997	1998	1999	2000	Jan.-Mar.	Jan.-Jun.	1997	1998	1999	2000	Jan.-Mar.	Jan.-Jun.
Croatia	..	11.6	-2.7	-1.3	0.7	..	..	-4.4	-4.2	3.7	16.6	..
CETE-4	18.4	12.2	8.4	21.5	16.9	14.1	18.4	15.3	7.7	15.0	10.3	8.3
Czech Republic	14.2	14.4	9.7	20.2	17.1	14.9	7.6	8.5	5.8	19.2	16.5	14.7
Hungary	29.9	22.5	15.9	21.7	16.3	14.2	26.4	24.9	14.3	20.8	15.6	13.4
Transition economies	25.2	4.7	-9.3	22.5	17.8	20.4	5.3	12.1	6.0	17.1	16.2	6.6
European Union	33.6	24.1	20.6	21.3	17.8	14.6	29.7	23.8	14.6	14.4	12.3	11.1
Poland	13.7	2.3	2.0	25.3	19.2	15.0	22.0	14.3	4.4	10.8	5.2	2.5
Transition economies	35.8	-5.0	-9.3	25.1	18.9	18.3	13.5	12.6	7.8	16.7	7.9	3.3
European Union	11.9	8.5	5.4	26.8	20.4	15.7	25.2	16.2	4.1	10.5	3.6	2.1
Slovenia [b]	11.9	8.1	3.7	11.4	10.0	7.7	10.5	11.3	9.2	4.1	-1.4	-0.3
Baltic states	20.3	8.7	-7.1	25.9	15.6	12.3	..	13.4	-9.3	15.9	19.2	15.7
Estonia [c d]	29.2	16.7	0.9	41.1	20.4	0.3	..	13.1	-9.0	35.0	27.4	18.8
Latvia	20.3	10.2	-2.1	13.6	9.0	10.9	..	21.3	-3.2	5.1	12.7	10.1
Lithuania	12.8	1.3	-16.3	19.2	14.8	23.0	24.6	9.0	-13.0	7.4	16.6	16.6
Total above	..	11.9	6.8	20.9	16.2	..	..	14.0	5.6	14.5	11.5	..
Russian Federation	1.8	-0.3	9.4	10.2	0.2	1.4	21.1	-11.0	-15.6	29.2	27.2	36.7
Non-CIS	1.8	-0.6	11.3	9.9	1.7	1.9	31.7	-8.4	-19.4	28.6	35.3	47.0
CIS	1.9	0.8	1.5	12.5	-8.0	-0.7	-1.8	-18.4	-4.8	30.6	10.4	16.3

Source: UNECE secretariat calculations, based on national foreign trade statistics.

Note: Dollar values of exports and imports in 2000 used for weights in calculating aggregate growth rates.

a Over same period of 2000.

b Changes in volumes for Slovenia are derived from indices of export and import unit values and changes in trade values as reported in *Statistical Yearbook of the Republic of Slovenia 2000* and *Monthly Statistical Review of the Republic of Slovenia*, Volume L, No. 6 (Ljubljana), 2001.

c Changes in volumes for Estonia are derived from indices of export and import prices and changes in trade values as reported in the monthly bulletin *Estonian Statistics*. Since Estonia switched to the "special trade" reporting system as from 1 January 2000, volume indices in this table were calculated on export and import values under the new reporting system and differ from the previously published trade data for Estonia in the statistical appendix and in other text tables of this *Survey*.

d According to the Estonian statistical office, export prices had risen 13 and 43 per cent year-on-year in the first and second quarters of 2001. For details see box 1.2.2.

Decelerating (year-on-year) growth rates prevailed throughout the region (except for Latvia and Lithuania) in April-June, but in July and August export performance was rather mixed. In July 2001, Croatian, Hungarian and Estonian exports shrank by 2-7 per cent, while Czech and Slovene exports picked up after a slump in June; in August, there was an even larger decline in exports from Estonia (down 17 per cent, year-on-year), while for most other countries, according to preliminary data, there were important increases in the dollar value of their exports (in the range of 9-15 per cent).[79]

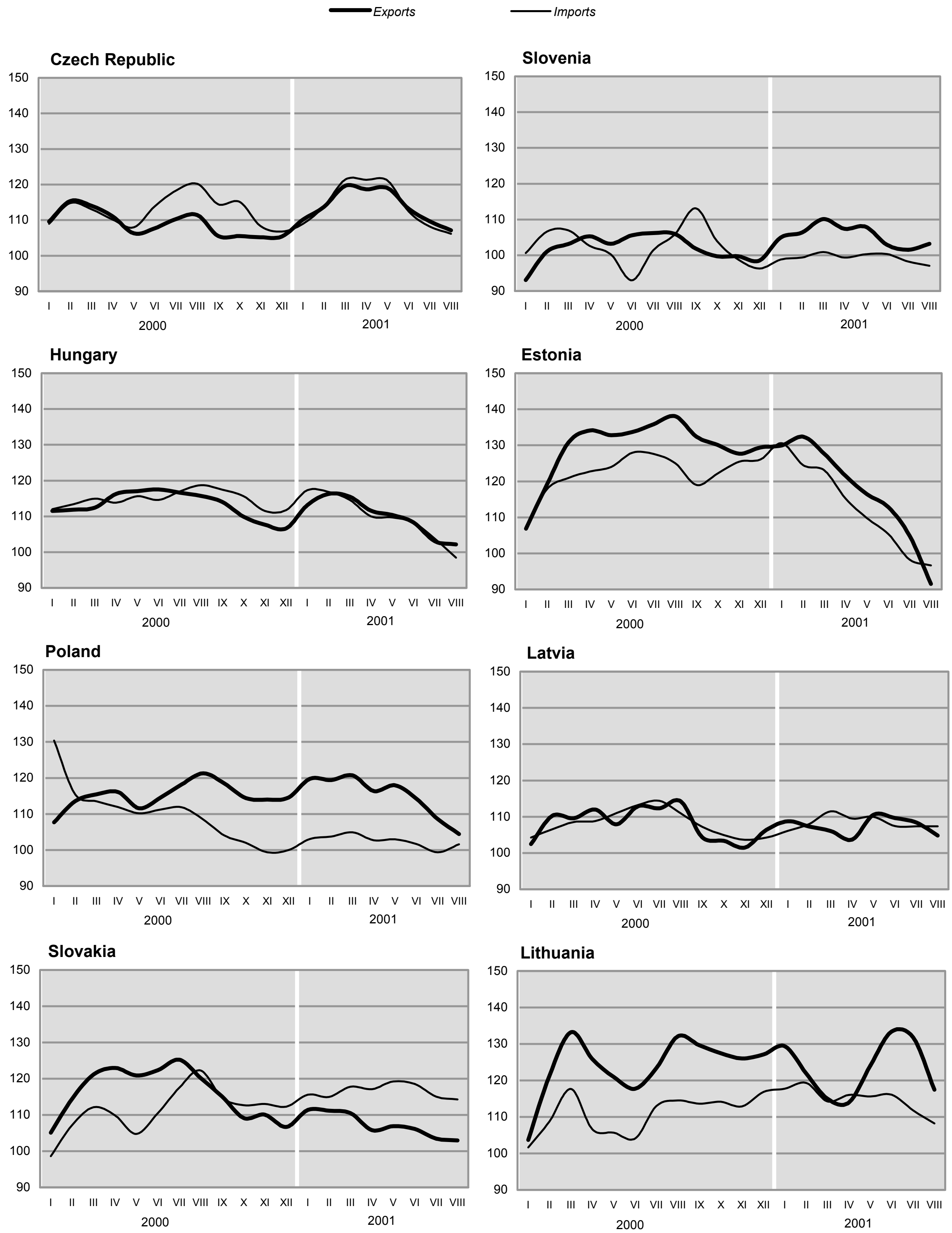
In the first half of 2001 there was also a notable rise in the region's imports, although the aggregate dollar value of east European and Baltic imports increased at a slower pace than exports, mainly reflecting the low rate of growth of Polish imports. In fact, Polish imports, after surging 14 per cent in January, dropped slightly below the previous year's monthly dollar values in February and again in May onwards. This reflected the squeeze on domestic demand by the tight monetary policy, although the strengthening of the zloty in real effective terms probably helped to keep imports afloat. As a result, Poland's merchandise trade deficit shrank to $7.1 billion in January-June 2001 from nearly $9 billion in the first half of 2000. There was also a substantial improvement in the trade balance of Slovenia, where imports remained nearly flat throughout January-August as domestic demand was weak and the tolar depreciated slightly in real effective terms.[80]

[79] The strong export growth in Latvia and Lithuania through the second quarter of 2001 partly reflected continued expansion of their exports to the CIS and other transition economies. Lithuanian exports to the EU also grew rapidly (30 per cent, year-on-year) in the first half of 2001, but this growth was very narrowly based: some three quarters of the increase came from exports of oil and its products from Mazeikiai Nafta, a development which hardly has longer-term prospects. Already in July the export growth rate had decelerated noticeably and in August it was just 7 per cent, year-on-year. At the same time, the growth of exports of mineral products, including oil and electricity, was sharply reduced from over 50 per cent in January-June to below 4 per cent in July-August (year-on-year).

[80] In The former Yugoslav Republic of Macedonia, imports declined by a quarter in the first half of 2001 according to the Macedonian Central Bank, mainly because of the high import values in the base period when there was an influx of goods destined for refugees and for Yugoslavia which was then still under the Milosevic regime.

CHART 1.2.1

Monthly dollar exports and imports in selected transition economies, 2000-2001
(Year-on-year indices)



Source: UNECE secretariat calculations, based on national statistics.

Note: Monthly indices against same month of previous year are based on three-month moving average of monthly values in current dollars.

These were not, however, across-the-board developments: backed by recovering domestic demand and reduced trade protection,[81] import growth in Croatia, Romania and Slovakia, and to a lesser extent in Bulgaria, not only accelerated in the second quarter of 2001, but also exceeded that of exports, resulting in a considerable increase in their merchandise trade deficits.[82] In addition, import growth in these countries continued at double-digit rates throughout the summer. In other countries, however, import demand seemed to be more affected by the dynamics of exports than by domestic absorption – a clear sign of the dependency of the exporting sectors on imported inputs. This could explain the deceleration in import growth in the second quarter and a rather mixed performance in July-August 2001 – in spite of strong domestic demand – in the Czech Republic, Estonia and Hungary (chart 1.2.1), Estonia being a special case.[83]

Although the slackening of west European import demand had no immediate impact on the rise in east European and Baltic export revenues in the first half of 2001, the looming prospects of a global recession will hamper their export growth not only in the second half of this year but probably also in 2002. Import demand from commodity-rich Russia and other CIS countries is also most likely to subside in the short to medium term, mainly under the pressure of diminishing export revenues, although the recent relaxation of trade protection in Russia might boost its imports.[84]

(b) International trade of the CIS countries

The continuing economic rebound in the CIS area – driven by the rising demand for consumer and capital goods in the wake of the recession generated by Russia's 1998 financial crisis – helped to increase regional trade in the first half of 2001. Although internal and external conditions continued to support the trade performance of many CIS countries, growth in export revenues across the CIS slowed markedly following the stabilization of crude oil prices and the weakening of other natural resource prices. In the first half of 2001, the dollar value of aggregate merchandise exports from the CIS increased by 8 per cent (table 1.2.2) down from 49 per cent in the corresponding period of 2000. In most CIS countries (except Georgia, Kyrgyzstan and Tajikistan) total exports rose, with increases of almost 60 per cent in Azerbaijan and 20-30 per cent in the Republic of Moldova and Ukraine. Aggregate imports continued to grow at the same rate as in the first half of 2000 (16 per cent), reflecting higher imports by some of the largest regional economies such as Kazakhstan and Russia. The CIS area's merchandise trade surplus – after doubling to about $33 billion in the first half of 2000 relative to the same period of 1999 – stabilized at this level due to the levelling of natural resource prices, crude oil in particular.

Currency movements also had a notable impact on CIS trade flows in the first half of 2001. The prevailing trend of real appreciation of national currencies in the CIS (most CIS countries' national currencies rose by 2-15 per cent in real terms against the dollar) supported increased imports from non-CIS sources in the first six months of 2001.[85] Currency appreciations in Kazakhstan, Russia and Ukraine represented the continuation of a development that began in the second half of 2000, a dramatic turnaround from the evident weakening of their currencies in the first six months of 2000. On the other hand, there were significant intra-CIS exchange rate movements. Given the substantial real appreciation of the rouble against the dollar, the currencies of all the CIS countries depreciated sharply in real terms against the Russian rouble.[86] This gave a solid boost to the competitiveness of their exports to Russia, reinforcing the effect of the strong Russian domestic demand.

While the robust global economic performance had dramatically improved commodity prices and consequently the export earnings of CIS commodity producers in the first half of 2000, one year later the prices of virtually all natural resources had declined.[87] In the first half of 2001, year-on-year, the dollar prices of all base metals decreased: aluminium and copper were down by 2-3 per cent and the price of nickel by almost a third. The gold price was lower by 7 per cent while cotton sold for 14 per cent less. The price of crude oil – the most important source of export revenue in the CIS – did not change significantly. In contrast, Russia's exports of natural gas – the only major exception to the commodities'

81 For some details on measures undertaken in 2001 to further liberalize trade see UNECE, *Economic Survey for Europe, 2001 No. 1,* p. 148.

82 According to preliminary data, merchandise trade deficits in relation to GDP in the first half of 2001 amounted up to 24 per cent in Croatia, 12 per cent in Romania and 8 per cent in Slovakia, some by 4-5 percentage points more than their 2000 levels.

83 In Estonia, gross fixed capital formation picked up strongly in the second quarter of 2001 (11 per cent, year-on-year) and private consumption also rose. However, Estonian imports, after registering a 21 per cent dollar value growth, year-on-year, in January-April 2001, declined in May and were actually down by 6 and 4 per cent, respectively, in July and August. The major factor behind this was the sharp fall in imports for inward processing, which more than halved in these two months. In Hungary, although domestic demand was strong and the forint appreciated in real effective terms, a slowdown in import growth became obvious after May and in August dollar imports were down by 5 per cent, year-on-year. In the Czech Republic, in contrast, after falling by 3 per cent in June, imports picked up in the months that followed.

84 Russia has announced import tariff reductions and unification for roughly 400 commodities as from 1 October 2001 effective for nine months. The tariff reductions will mainly affect imports of technological equipment. *Interfax News Agency, Weekly Business Report,* 3 October 2001, as reported by *Reuters Business Briefing,* 3 October 2001.

85 The exceptions were Armenia, Azerbaijan and Georgia, where the national currencies depreciated slightly in real dollar terms.

86 In most cases the real depreciation was in the range of 15-25 per cent except for the currencies of the Republic of Moldova and Ukraine, which depreciated slightly less (by 9 and 4 per cent, respectively).

87 In the third quarter of 2001, commodity prices continued to decline reflecting deteriorating world demand and the uncertainty created by the 11 September terrorist attacks on the United States. In the wake of the terrorist attacks, gold benefited from its role as a safe haven. Gold averaged $284 per ounce for the month of September, up by almost $12 from August.

declining price trend, due to the specific pricing mechanisms in the gas sector – fetched over 50 per cent more relative to the first half of 2000.[88]

In general, CIS producers responded to lower metal prices by decreasing the volumes shipped. Oil exporters, however, increased shipments with the additional exports being accommodated by new pipeline capacity. For example, in the first half of 2001 the volume and value of Kazakhstan's oil exports increased by about 20 per cent, year-on-year – owing to accelerated production ahead of the opening of a major new pipeline – but the volumes of the country's major metal exports were either flat (copper and zinc) or declined (aluminium and steel products). As a result, the revenues from exports of metals declined by up to 26 per cent compared to the first half of 2000. Similarly, in Russia, virtually all metals exports declined in volume, but the country continued to ship more crude oil and oil products. In Azerbaijan, despite a modest increase in oil production, which now accounts for about 90 per cent of total exports, the combination of a 50 per cent rise in export volumes and higher prices led to a significant increase in total export revenues.[89] In contrast, Tajikistan's shipments of aluminium increased – the metal accounts for more than half of the country's exports – but much lower exports of electricity reduced the value of its total exports. Overall, as a result of the interplay between export prices and quantities shipped, on average, the earnings that accrued to CIS commodity exporters such as Azerbaijan, Kazakhstan, Russia and Tajikistan in the first six months of 2000 probably remained the same as in 2001.

In some other CIS countries, total exports increased in response to solid CIS-wide economic growth and the resulting increase in import demand. The Russian economy grew by 5.1 per cent in the first half of the year and this growth boosted directly and indirectly the export performance of those countries that rely heavily on CIS trade such as Armenia, the Republic of Moldova, Ukraine and, to a lesser extent, Belarus. Armenia and the Republic of Moldova increased their shipments of agricultural and food products while Ukraine boosted its major exports such as steel and chemicals. In Georgia and Kyrgyzstan total exports fell slightly because of lower demand in Turkey (Georgia's important trade partner) and lower CIS sales of electricity from Kyrgyzstan.

Although total imports into the CIS increased notably in the first half of 2001 (by 16 per cent, year-on-year) performance varied among countries. Compared with the first half of 2000, a number of CIS economies reported large increases in the dollar value of their total imports: 7 to 17 per cent in the Republic of Moldova, Tajikistan, Ukraine and Uzbekistan and between 24 and 46 per cent in Georgia, Kazakhstan, Russia and Turkmenistan. Among the countries with the largest increases in imports – Kazakhstan (46 per cent) and Turkmenistan (38 per cent) – imports of machinery and equipment accounted for most of the rise. These two countries were also the fastest growing CIS economies in the first half of 2001. In Kazakhstan, for example, imports of machinery and equipment, mostly related to investment in infrastructure for the gas and oil industry, increased by 65 per cent to over $900 million, while the value of imported steel pipes doubled. Similarly, the value of Russian imports of machinery and equipment increased by 27 per cent, year-on-year, in the first half of 2001, again almost exclusively due to fixed investment in oil-related sectors (section 1.2(ii)). In contrast, lower imports of machinery and equipment were behind the fall in total imports into Armenia, Azerbaijan and Kyrgyzstan (despite the high GDP growth in these countries) and the same was probably true of Belarus.[90] The falls in the total imports of these countries ranged between 4 and 17 per cent.

In the first half of 2001, the dollar value of CIS exports to non-CIS countries increased by 7 per cent (table 1.2.9). Traditional commodity exporters such as Kazakhstan, Kyrgyzstan, Russia, Tajikistan and Turkmenistan all increased exports in value by between 2 and 6 per cent, the differences reflecting variations in the importance of crude oil and oil products as well as the differential movements of commodity prices. Azerbaijan was the major exception among the natural resource exporters with its non-CIS exports rising by almost three fourths, the result of a 64 per cent increase in the volume of crude oil exports. Turkmenistan also increased its sales of crude oil and oil products – reportedly by 40 and 20 per cent, respectively – its total non-CIS exports increasing by 6 per cent. Similarly, Kyrgyzstan increased its sales of gold by about 15 per cent in value, which contributed to the overall increase in its non-CIS exports of 5 per cent. The Republic of Moldova increased its food and textile exports (to the EU in particular) and Ukraine's steel and chemical sales to non-CIS countries both rose by 15 per cent. Russia's non-CIS exports increased slightly in volume together with a 3 per cent increase in average export prices. In the remaining CIS countries, non-CIS exports were flat, except in Georgia where they fell 10 per cent and Armenia (-2 per cent), mainly because of much lower exports of jewellery and precious stones to the EU.

The dollar value of CIS imports from non-CIS countries rose in the first six months of 2001 by 19 per cent (table 1.2.9). These often consisted of imports of

[88] Russian Federation Goskomstat, *Sotzial'no-ekonomicheskoe polozhenie Rossii* (Moscow), various issues.

[89] The large increase in exports of crude oil from Azerbaijan probably came from inventories. The price for the country's oil exports was also reported to be 16 per cent higher than in the first six months of 2000.

[90] In Armenia total imports fell despite a 13 per cent increase in investment outlays. In Azerbaijan, which has passed a peak in its spending on oil and gas infrastructure, total imports fell. In Kyrgyzstan, total imports also fell as investment expenditures fell by one fifth.

TABLE 1.2.9

CIS countries' trade with CIS and non-CIS countries, 1999-2001
(Value in million dollars, growth rates in per cent)

	Percentage change over the same period of the preceding year				Trade balances		
	Export		Import				
	2000	2001 [a]	2000	2001 [a]	1999	2000	2001 [a]
Armenia							
Non-CIS	29.5	-1.9	13.9	-12.3	-449	-484	-196
CIS	30.1	48.6	-7.3	3.0	-131	-100	-43
Azerbaijan							
Non-CIS	110.3	73.5	12.1	-16.4	8	713	760
CIS	11.4	-27.6	15.4	25.6	-114	-140	-126
Belarus							
Non-CIS	27.9	0.3	3.8	-18.9	-98	450	417
CIS	23.0	6.9	39.9	-9.6	-667	-1 548	-420
Georgia							
Non-CIS	48.0	-10.1	27.0	19.5	-246	-285	-141
CIS	26.9	9.8	10.0	33.7	-118	-111	-76
Kazakhstan							
Non-CIS	64.6	1.8	9.9	43.3	2 011	4 455	1 673
CIS	60.2	16.0	72.6	47.5	-106	-367	-409
Kyrgyzstan							
Non-CIS	9.8	5.3	-24.9	-23.5	-70	42	49
CIS	13.1	-17.6	15.2	-10.4	-76	-91	-36
Republic of Moldova							
Non-CIS	-7.0	15.2	49.9	15.1	-134	-321	-159
CIS	8.7	40.2	7.7	19.6	12	15	34
Tajikistan							
Non-CIS	9.8	2.4	-22.3	43.9	225	295	130
CIS	18.7	-31.6	8.7	5.7	-200	-186	-168
Turkmenistan							
Non-CIS	71.4	5.9	10.0	15.7	-300	100	-200
CIS	165.3	17.8	36.0	100.8	-10	620	220
Ukraine							
Non-CIS	21.0	14.8	15.9	11.3	3 227	4 159	2 286
CIS	38.3	38.5	19.2	4.8	-3 491	-3 542	-1 692
Uzbekistan							
Non-CIS	-7.1	-1.0	-20.0	10.1	–	290	-10
CIS	20.0	3.6	40.0	4.1	200	90	60
Total above							
Non-CIS	32.4	10.5	7.1	8.1	4 174	9 414	4 608
CIS	38.0	16.6	30.8	8.8	-4 701	-5 361	-2 657
Russian Federation							
Non-CIS	43.5	5.7	1.5	27.2	40 244	66 959	30 366
CIS	28.8	3.7	39.6	18.3	2 364	2 137	937
CIS total							
Non-CIS	40.8	6.8	3.8	18.9	44 418	76 373	34 974
CIS	33.4	10.2	33.8	12.1	-2 337	-3 224	-1 720

Source: CIS Statistical Committee; UNECE estimates for Turkmenistan and Uzbekistan.

[a] January-June.

machinery and equipment to upgrade the capital stock in the oil, natural gas and metal sectors. This was the case in varying degrees in Kazakhstan, Russia and Turkmenistan. Russian non-CIS imports also rose in volume by 47 per cent helped by lower unit import values. In addition to increased imports of machinery and equipment, the strong growth in Russian private consumption led to more imports of consumer goods. In contrast, reduced non-CIS imports in Azerbaijan, Kyrgyzstan and probably Belarus were linked to low spending on capital goods in Azerbaijan and negative investment rates in the latter two countries.

In the first half of 2000, the value of intra-CIS trade increased by some 11 per cent. The relatively strong and extended economic recovery in Russia has increased demand for both capital and consumer goods from neighbouring economies. Increased CIS exports to Russia were also helped by the real appreciation of the rouble against the currencies of the other CIS countries. In the first half of 2001, Russia's imports from the CIS increased by 16 per cent in volume, benefiting the many countries that rely on Russia for a large part of their foreign sales. Armenia and the Republic of Moldova increased their sales of agricultural and food products and the solid performance of Ukrainian CIS exports was also due to sales to Russia. Ukraine's key export items, ferrous metals and chemicals, increased by 11 and 6 per cent, respectively, with a large proportion going to Russia. Kazakhstan also benefited from higher demand for raw materials in the CIS, its CIS exports, mainly crude oil and coal, increasing by 16 per cent. Turkmenistan's CIS exports increased by 18 per cent following the resumption of gas sales to Ukraine at the end of 2000 (up by 24 per cent in volume).

(vi) Current accounts and external financing

Despite the deterioration in the international economic climate, the external financial situation of most transition economies remained stable or improved in the first half of 2001. The current account deficits of the east European and Baltic states were generally easily financed by increasing capital inflows, and foreign currency reserves increased (which was the case in many CIS countries as well). The access of creditworthy transition economies to the international financial markets improved and in some cases credit ratings were upgraded. This included the long-term (sub-investment grade) debt rating of Russia, thanks to its better internal and external finances and continuing structural change. However, the current account deficits of a number of countries increased to worrisome levels, particularly as signs of slower export growth became more widespread. Several transition economies continue to face serious financial constraints, generally because foreign investment has been discouraged by slow economic reform, political uncertainty and/or doubts about the sustainability of their debt.

(a) Current account developments

In the first half of 2001, the combined current account of the transition economies was in surplus by $9 billion, down from $12 billion in the comparable period of 2000 (table 1.2.10).[91] This large surplus is due mainly to Russia, which has benefited from relatively high international fuel prices since 1999, while most of the other countries have current account deficits. In general, there are large differences among individual economies in their external performance.

[91] Unless otherwise noted, all comparisons and growth rates for the first half of 2001 are relative to the same period in 2000. All data in this section derive from national balance of payments statistics.

TABLE 1.2.10

Current account balances of the ECE transition economies, 2000-2001

(Million dollars, per cent)

	Million dollars			*Per cent of GDP*	
		January-June			*Jan.-Jun.*
	2000	*2000*	*2001*	*2000*	*2001*
Eastern Europe	-19 024	-10 349	-11 291	-5.0	-5.7
Albania	-163	-81	-147	-4.4	-7.2
Bosnia and Herzegovina	-909	-400*	-400*	-21.6	-17.1
Bulgaria	-702	-432	-270	-5.9	-4.8
Croatia	-399	-677	-1 420	-2.1	-14.7
Czech Republic	-2 273	-690	-1 131	-4.5	-4.3
Hungary	-1 496	-832	-726	-3.3	-3.0
Poland	-9 946	-5 611	-4 375	-6.3	-5.2
Romania	-1 359	-581	-1 337	-3.7	-8.1
Slovakia	-713	-156	-785	-3.7	-8.1
Slovenia	-612	-285	-57	-3.4	-0.6
The former Yugoslav Republic of Macedonia	-113	-124	-194	-3.2	-11.0
Yugoslavia	-339	-480*	-450*	-4.2	-9.0
Baltic states	-1 483	-626	-623	-6.3	-5.2
Estonia	-315	-118	-148	-6.3	-5.6
Latvia	-493	-193	-191	-6.9	-5.3
Lithuania	-675	-315	-283	-6.0	-5.0
CIS	47 638	23 159	21 118	13.9	11.4
Armenia	-278	-155	-100*	-14.5	-14.2
Azerbaijan	-168	-34	100*	-3.2	4.3
Belarus	-220	-258	240	-2.1	4.6
Georgia	-262	-128	-180*	-8.7	-12.4
Kazakhstan	743	609	-551	4.1	-5.5
Kyrgyzstan	-77	-32	–*	-5.9	–
Republic of Moldova	-121	-57	-38	-9.4	-6.4
Russian Federation	46 317	22 843	21 149	18.4	15.2
Tajikistan	-62	-37	-80*	-6.3	-21.2
Turkmenistan	100*	-50*	-240*	2.3	-9.6
Ukraine	1 481	292	845	4.7	5.0
Uzbekistan	184	164	-28	1.4	-0.6
Total above	27 131	12 183	9 205	3.6	2.3
Memorandum items:					
CETE-5	-15 040	-7 574	-7 073	-5.2	-4.6
SETE-7	-3 984	-2 775*	-4 218*	-4.6	-9.9

Source: UNECE secretariat, based on national balance of payments statistics; IMF, *Staff Country Reports,* for Bosnia and Herzegovina, Yugoslavia, Tajikistan and Uzbekistan (www.imf.org); for Azerbaijan: TACIS, *Azerbaijan Economic Trends* (Baku) (www.economic-trends.org).

Note: UNECE secretariat estimates of the current account of Bosnia and Herzegovina and Yugoslavia (January-June 2001) reflect their reported changes in merchandise trade in that period. Estimates for Armenia, Azerbaijan, Georgia, Kyrgyzstan and Tajikistan also incorporate first quarter 2001 current account results. The estimate for Tajikistan are one half of the balance projected for the full year by the IMF. The current account of Turkmenistan has been estimated using the estimated merchandise trade balance (custom basis) and assuming no change in the other current account items since 1998.

In eastern Europe, the combined current account deficit increased to over $11 billion in the first half of 2001, some 5.7 per cent of aggregate GDP. The dollar value of east European exports of goods and services continued to expand at a rate of 11-12 per cent in the first half of 2001, thanks in part to the faster growth of services. As noted above, however, the expansion of merchandise exports slowed as the year progressed, in contrast to what the year-on-year changes suggest. At the same time, the rate of growth of imports of goods and services quickened from 8 to 11 per cent in the first half of the year. The surplus on services continued to recover after the sharp decline in the late 1990s, but this has only partially offset the deterioration of the merchandise trade balance. Current account balances were also adversely affected by moderately larger income outflows and smaller inward transfers.

Despite the general weakening of the external environment, only about one half of the east European and Baltic countries experienced a widening of their current account deficits (although some of these deficits are quite large). Among the latter are Romania and Slovakia where the impact of slowing exports of goods and services has been amplified by an acceleration of domestic demand and imports. Domestic demand was also the dominant factor behind increased deficits in Croatia and the Czech Republic, despite the fact that Czech exports actually accelerated during the first half of the year. Dynamic growth of exports of goods and services were instrumental in reducing the current account deficit of Poland, tight monetary policy having kept import growth in check. A larger surplus on services explains the improvement in the current account balance of Hungary.[92] As a percentage of GDP, the aggregate imbalance of the south-east European transition economies was about twice as large as that of central Europe (table 1.2.10).

On average some 73 per cent of the combined current account deficit of eastern Europe and nearly all of that of the Baltic states was covered by net inflows of FDI (table 1.2.11). There are, however, considerable intercountry differences in the relative importance of this source of financing.

The traditionally large current account surplus of *Russia* declined slightly, to $21 billion in the first half of 2001 (from $22.8 billion in the same period of 2000). Although the growth of exports of goods and services quickened somewhat to 6 per cent, imports increased by 20 per cent, spurred by domestic demand and the real appreciation of the rouble. The same factors also boosted the demand for foreign travel, which accounts for the rise in the services deficit. However, net interest payments declined markedly, chiefly because of higher interest receipts on growing foreign exchange reserves.

The expansion of Russian demand continued to stimulate exports of goods and services from the other CIS countries. Fragmentary data indicate that around one half of them reported an improvement in their current account balances.[93] Belarus and Ukraine were in surplus, but their imports of goods and services remain below the

[92] Although the current account of Hungary moved into surplus in July and August, a deficit is expected for the full year.

[93] UNECE secretariat estimates are explained in table 1.2.10. Balance of payments data are no longer available for Turkmenistan and those for Uzbekistan are only released with a considerable lag.

TABLE 1.2.11

Foreign direct investment in the ECE transition economies, 2000-2001
(Million dollars, per cent)

	FDI inflows [a]			Net FDI/ current account [b]	
		January-June			Jan.-Jun.
	2000	2000	2001	2000	2001
Eastern Europe	20 279	7 532	8 803	102	73
Albania	143	50	101	88	69
Bosnia and Herzegovina	150	70*	80*	17	20
Bulgaria	1 002	286	275	143	101
Croatia	926	678	388	225	27
Czech Republic	4 595	2 242	2 317	197	201
Hungary	1 700	906	1 245	78	123
Poland (cash basis)	8 294	2 737	2 748	82	61
Romania	1 025	274	313	76	25
Slovakia	2 075	130	714	289	84
Slovenia	176	40	189	18	287
The former Yugoslav Republic of Macedonia	170	99	373	149	192
Yugoslavia	25	20*	60*	7	13
Baltic states	1 173	530	729	74	98
Estonia	387	146	260	103	117
Latvia	408	191	128	81	63
Lithuania	379	193	341	56	112
CIS	5 329	2 152	3 464	..	..
Armenia	104	81	90*	37	90
Azerbaijan	129	67	20*	77	..
Belarus	88	52	32	40	..
Georgia	131	63	40*	50	22
Kazakhstan	1 246	369	1 372	..	249
Kyrgyzstan	-2	14	25*	..	..
Republic of Moldova	128	72	104	105	278
Russian Federation	2 714	1 004	1 188	..	..
Tajikistan	22	17	10*	35	13
Turkmenistan	100*	50*	50*	..	14
Ukraine	595	333	515	..	..
Uzbekistan	75	32	17	..	62
Total above	26 782	10 214	12 996	..	..
Memorandum items:					
CETE-5	16 839	6 055	7 213	106	94
SETE-7	3 440	1 477*	1 590*	86	38

Source: UNECE secretariat, based on national balance of payments statistics; IMF, *Staff Country Reports*, for Bosnia and Herzegovina, Yugoslavia, Tajikistan and Uzbekistan (www.imf.org); for Azerbaijan: TACIS, *Azerbaijan Economic Trends* (Baku) (www.economic-trends.org).

Note: Estimates for Bosnia and Herzegovina, Yugoslavia and Tajikistan are one half of the corresponding IMF projections for the full year. Estimates for Armenia, Azerbaijan, Georgia and Kyrgyzstan reflect first quarter 2001 results and quarterly changes in 2000.

a Million dollars. Inflows into the reporting countries.

b Per cent. In this table (..) indicates that the current account balance was positive (and/or net FDI negative).

1997-1998 levels. Both countries have been subject to severe financing constraints in recent years, although for Ukraine these appear to be easing.[94] In Kazakhstan, the faster growth of imports of goods and services (and the shift in the current account to deficit) seems to reflect mainly larger purchases of oil and gas field equipment and services, both of which are associated with a surge in FDI. Concern has been expressed about the sustainability of the debt burdens of five low-income CIS countries – Armenia, Georgia, Kyrgystan, the Republic of Moldova, and Tajikistan.[95] In the first half of 2001, only the Republic of Moldova posted a relatively rapid growth of exports of goods and services (one of the conditions for debt sustainability) of 23 per cent. In Armenia export growth was considerably weaker. In the other countries exports fell, increasing the already large current account deficits of Georgia and Tajikistan.

(b) Capital flows and FDI

Despite increasing signs of a global economic downturn and nervousness about emerging financial markets, net inflows on the capital and financial account into eastern Europe increased by nearly 30 per cent in the first half of 2001 (table 1.2.12). FDI remained the leading source of finance (as it did in the Baltic states), but portfolio investment increased sharply (table 1.2.13). The latter reflects external bond issues (see below) and foreign investments in local securities markets.[96] Net inflows of long-term finance were small, but there was another marked (net) outflow of short-term funds.[97] Inflows of unrecorded capital (the "errors and omissions" item in the balance of payments statistics) rose in the first half of 2001 to \$3.7 billion (about equally divided between central and south-east Europe). Croatia and Romania reported the largest increases in capital inflows, consisting of modest amounts of FDI, external bond issues and, in the case of Romania, large inflows of short-term funds (including unrecorded flows which are often presumed to be short term). In both countries foreign exchange reserves also rose significantly.

Fragmentary data indicate that most CIS countries received less capital in early 2001, or experienced net outflows. In Belarus, Russia and Ukraine outflows were fuelled by current account surpluses (although in Ukraine FDI was a significant source of funds as well). Although the types of transaction underlying these outflows differ

[94] Ukraine has been excluded from the international financial markets but it has continued to service outstanding bonds. In 2001 it obtained a Paris Club rescheduling, regained access to IMF/World Bank funds and, very recently, negotiated a rescheduling of its debt arrears to Russia's Gazprom.

[95] UNECE, *Economic Survey of Europe, 2001 No. 1*, pp. 162-163; IMF and World Bank, "Armenia, Georgia, Kyrgyz Republic, Moldova and Tajikistan: external debt and fiscal sustainability", 7 February 2001, background paper prepared jointly by the European II Department of the IMF and the Europe and central Asia region of the World Bank (www.imf.org/external).

[96] During the course of 2001, foreign investors reduced their exposure to eastern Europe (as they did to emerging markets in general), which partly explains the decline in local stock market prices. However, the Russian stock exchange was one of the best performing in the world.

[97] Virtually all east European countries reported a build-up of short-term assets abroad, the total amounting to over \$4 billion in the first half of 2001.

TABLE 1.2.12

Net capital flows into the ECE transition economies, 2000-2001
(Million dollars, per cent)

	Capital and financial account flows [a]					*Changes in official reserves* [b] *(million dollars)*	
	Million dollars			*Capital flows/GDP*			
		Jan.–Jun.			*Jan.–Jun.*		*Jan.–Jun.*
	2000	*2000*	*2001*	*2000*	*2001*	*2000*	*2001*
Eastern Europe	25 051	12 272	15 775	6.6	8.0	6 028	4 484
Albania	295	93	218	7.9	10.7	132	72
Bosnia and Herzegovina	923	450*	410*	21.9	17.5	14	10*
Bulgaria	1 111	488	106	9.3	1.9	409	-164
Croatia	981	958	1 946	5.2	20.1	582	527
Czech Republic	3 092	1 420	1 644	6.1	6.2	819	513
Hungary	2 557	982	1 794	5.6	7.5	1 060	1 068
Poland	10 565	4 846	5 041	6.7	6.0	619	666
Romania	2 287	943	2 496	6.2	15.2	928	1 159
Slovakia	1 537	948	578	8.0	6.0	824	-206
Slovenia	790	362	662	4.4	7.2	178	605
The former Yugoslav Republic of Macedonia	349	223	279	10.6	17.1	236	85
Yugoslavia	566	560*	600*	7.0	12.0	227	150*
Baltic states	1 754	815	667	7.5	5.6	271	44
Estonia	437	117	41	8.7	1.6	122	-107
Latvia	511	196	224	7.2	6.2	18	33
Lithuania	806	503	402	7.1	7.1	131	118
CIS	-30 313	-13 994	-13 299	-8.8	-7.2	17 325	7 759
Armenia	298	140	69*	15.5	9.9	19	-30*
Azerbaijan	442	-20	-29*	8.4	-1.3	274	70*
Belarus	295	336	-176	2.9	-3.3	76	64
Georgia	242	105	190*	8.0	13.1	-20	10*
Kazakhstan	-602	-673	777	-3.3	7.8	141	226
Kyrgyzstan	98	42	-10*	7.5	-1.9	21	-10*
Republic of Moldova	167	72	35	13.0	5.9	46	-3
Russian Federation	-30 307	-13 522	-13 980	-12.1	-10.1	16 010	7 170
Tajikistan	91	35	69*	9.2	18.3	29	-11*
Turkmenistan	..	..	..	..	..	..	..
Ukraine	-1 083	-465	-463	-3.4	-2.7	398	382
Uzbekistan	-153	-274	-2	-1.1	–	31	-30
Total above	-3 508	-908	3 143	-0.5	0.8	23 624	12 288
Memorandum items:							
CETE-5	18 540	8 557	9 719	6.4	6.3	3 500	2 646
SETE-7	6 512	3 715	6 056	7.5	14.2	2 528	1 839
Russian Federation [c]	-21 040	-10 687	-9 996	-8.4	-7.2	16 010	7 170

Source: UNECE secretariat, based on national balance of payments statistics; IMF, *Staff Country Reports,* for Bosnia and Herzegovina, Yugoslavia, Tajikistan and Uzbekistan (www.imf.org); for Azerbaijan: TACIS, *Azerbaijan Economic Trends* (Baku) (www.economic-trends.org).

Note: Estimates for Bosnia and Herzegovina, Yugoslavia and Tajikistan are one half of the relevant IMF projections for the full year. Estimates for Armenia, Azerbaijan, Georgia and Kyrgyzstan reflect first quarter 2001 results and quarterly changes in 2000.

a Includes errors and omissions; excludes changes in official reserves.

b A negative sign indicates a decrease in reserves.

c Excluding errors and omissions.

among countries, it appears that in all three there were various degrees of capital flight. This was particularly true of Russia, but its official reserves rose sharply nonetheless, to nearly $38 billion in September (about $34 billion excluding gold).

A decline in FDI inflows into the transition economies has been expected because investors tend to postpone new investment when the global economy weakens. Although this scenario remains likely, data for the first half of 2001 show FDI inflows continuing to rise (table 1.2.11). This growth presumably reflects the long-term nature of FDI and projects in the pipeline. Also, large privatizations involving foreign strategic investors have continued in a number of countries. Such deals, often involving national monopolies, seem to be less subject to the business cycle than greenfield investments. Inflows of FDI increased in most countries – the large energy-related investment in Kazakhstan is noteworthy – but in some they fell short of initial expectations due to delays or postponements of privatizations. FDI inflows have remained relatively small in Russia, and steadily increasing outflows have made the country a net exporter of FDI since 2000.

International bond issues by the transition economies were modest in the first three quarters of 2001, remaining at around $5 billion. The creditworthy countries in the area had only a limited need for such funds thanks to FDI inflows (over one half of the transition economies, mainly the CIS, remain excluded from the bond markets). Although investor sentiment towards emerging markets was generally negative, lenders were willing to discriminate among countries according to their perceived credit quality. In fact the Czech Republic, Hungary, Poland and Slovenia are no longer viewed by bond investors as emerging market risks.[98] Sovereign borrowers accounted for the bulk of the euro-denominated bonds that were issued, mainly in the first half of the year. Hungary borrowed €1 billion to refinance maturing debt, while Poland issued a €750 million bond largely for benchmarking purposes. However, in Croatia (a €750 million emission) and Lithuania (€200 million) the funds were intended to finance budget deficits. Romania, which had acute financial difficulties in 1999, consolidated its access to the international markets with a €600 million bond. Corporate borrowing remains far below the pre-rouble crisis levels and has been largely limited to blue chip companies.[99] The transition economies benefited from investors seeking to diversify their portfolios and, as a result, all of the issuing countries successfully broadened their investor bases. Following the terrorist attacks in the United States on 11 September, several sovereign bonds and initial public equity offerings (IPOs) planned by the transition economies (and other issuers as well) have been postponed. However, the city of Moscow was able to issue a bond in late October suggesting that the international market remains receptive to the debt issues of some of these countries.

[98] These countries' long-term bonds are also attractive because they offer the possibility of a so-called "convergence play": the holders of the bond hope to profit from the expected convergence of the bond yield to the lower yields prevailing in the euro area.

[99] For example, bonds were issued by Poland's telecommunications company TSPA (€500 million) and gas monopoly PFNiG (€800 million in October) and by Kazakstan's oil transport firm KazTransOil ($150 million).

TABLE 1.2.13

Net capital flows into eastern Europe, the Baltic states and selected members of the CIS, by type of capital, 1999-2001
(Billion dollars)

	Eastern Europe [a]				*Baltic states*				*Three European CIS* [b]			
			Jan.-Jun.				*Jan.-Jun.*				*Jan.-Jun.*	
	1999	*2000*	*2000*	*2001*	*1999*	*2000*	*2000*	*2001*	*1999*	*2000*	*2000*	*2001*
Capital and financial account	24.4	21.9	9.1	12.1	2.2	1.6	0.7	0.6	0.1	-0.6	-0.4	-0.2
Capital and financial account [c]	28.7	25.1	12.3	15.8	2.2	1.8	0.8	0.7	-1.1	-0.6	-0.1	-0.6
of which:												
FDI	18.8	19.4	7.4	8.3	1.0	1.1	0.5	0.6	1.0	0.8	0.5	0.6
Portfolio investment	2.6	2.3	2.2	5.5	0.8	0.1	0.4	0.1	-0.2	-0.1	–	-0.2
Medium-, long-term funds	4.9	4.8	2.9	0.6	0.5	–	–	-0.1	1.0[d]	-1.2[d]	-1.4[d]	-0.4[d]
Short-term funds	-2.9	-5.4	-3.7	-3.1	-0.1	0.5	-0.2	-0.1	-1.8	-0.2	0.5	-0.2
Errors and omissions	4.3	3.1	3.1	3.7	–	0.1	0.1	0.1	-1.2	–	0.3	-0.4
Memorandum item:												
Short-term investment [e]	4.1	–	1.6	6.1	0.6	0.6	0.3	0.1	-3.3	-0.3	0.8	-0.8

Source: UNECE secretariat estimates, based on national balance of payments statistics.

[a] Excludes Bosnia and Herzegovina and Yugoslavia.

[b] Belarus, Republic of Moldova and Ukraine.

[c] Including errors and omissions.

[d] Includes short-term funds for Belarus.

[e] Portfolio investment, short-term funds and errors and omissions.

1.3 The short-term outlook

(i) The western market economies

The short-term economic outlook for the ECE region, and indeed for the world economy as a whole, has become exceptionally uncertain since the terrorist attacks in New York and Washington on 11 September. At the time of writing this *Survey* it is impossible to know how long the military action in Afghanistan will last, what kind of responses it will trigger and whether the conflict can be contained. The current public fears of anthrax in the United States have, moreover, raised the spectre of "bio-terrorism" that risks accentuating the sense of insecurity caused by the events in September and further depressing business and consumer confidence. But all this remains to be seen.

The current trends in the world economy are pointing to a worst-case scenario in which the simultaneous weakening of economic activity in the major economies and all major regions has strengthened deflationary forces which, if allowed to continue, could push the global economy into deep recession.

Predictions of a quick recovery from the cyclical downturn in the United States have so far proved to be wrong. Although many forecasts now assume that a recovery will start in the second half of 2002, there are no definite signs that this will indeed be the case. The main reasons for scepticism about this are the considerable internal and external imbalances that have accumulated in the United States economy in the period 1995-2000 (see section 1.1 above). The orderly unwinding of these imbalances will take time and their presence will tend to reduce the effectiveness of the considerable stimulus from monetary and fiscal policy.[100]

The corporate sector needs to eliminate a large amount of spare capacity before business investment can be expected to respond to the lower interest rates and assume its traditional role of supporting economic recovery. In a similar vein, private households need to restructure their balance sheets and to reduce high debt levels in view of deteriorating prospects in labour markets and significant stock market losses. As a result, the outlook for fixed investment and private consumption is not clear and this leaves the prospects for a recovery in 2002 in doubt.

As the United States was the main engine of global economic growth in 1995-2000, it is clear that a prolonged weakness of the United States economy will have serious consequences for other regions, notably the developing countries. This is particularly so for its major trading partners in Asia and Latin America and also Canada. In Japan, real GDP is expected to decline not only in 2001 but also next year as well. These developments will, in turn, weaken further the growth prospects for the European economies.

Against this background, there has been a marked lowering of growth forecasts for the United States, Japan and the euro area for both this year and next compared with those made before the attacks in early September (table 1.3.1). The figures for 2002 should, of course, be regarded with great caution – they reflect inevitably rough estimates of the impact that the attacks and the

[100] UNECE, *Economic Survey of Europe, 2001 No. 1,* chap. 1.

TABLE 1.3.1

Changes in the consensus forecasts of economic growth in 2001 and 2002

(Percentage change over previous year)

	Survey data				*Change* [a]	
	10 Sept. 2001		*8 Oct. 2001*			
	2001	*2002*	*2001*	*2002*	*2001*	*2002*
United States	1.6	2.7	1.0	1.2	-0.6	-1.5
Canada	1.8	2.7	1.4	1.7	-0.4	-1.0
Euro area	1.9	2.4	1.7	1.8	-0.2	-0.6
France	2.4	2.5	2.0	1.8	-0.4	-0.7
Germany	1.1	2.1	0.9	1.5	-0.2	-0.6
Italy	2.1	2.4	1.9	1.5	-0.2	-0.9
United Kingdom	2.1	2.6	2.1	2.1	–	-0.5
Japan	0.1	0.5	-0.5	-0.4	-0.4	-0.9

Source: Consensus Economics Inc., *Consensus Forecasts* (London), various issues.

a Percentage points.

steeper downturn in the global economy might have on expectations and confidence, and hence on the spending behaviour of households and enterprises. At the same time, however, they illustrate the considerable downside risks facing the global economy given the possibility of a simultaneous contraction of output in the euro area, Japan and the United States and the ensuing negative multiplier effects.

By far the largest reductions in the forecasts of economic growth are those for the United States, especially for 2002, but expectations have also been reduced substantially for other countries and the euro area as a whole. Although many forecasts now assume that a recovery will start in the second half of 2002, the overall strength of economic activity is seen to remain rather weak for the year as a whole. In the United States, the consensus is for a continued decline of business investment and a marked slowdown of consumer spending, which had been the main source of growth until the second quarter of 2001. Business investment has collapsed against a background of deteriorating prospects for sales and profits. Private consumption expenditures can be expected to weaken under the impact of a deteriorating labour market and increasing strains in households' balance sheets. Both business and consumer confidence will be depressed by the heightened uncertainty and this may lead to a postponement of spending plans. Real GDP in the United States is now expected to increase by only 1 per cent in 2001 followed by only 1¼ per cent in 2002.

In the euro area, the rate of economic growth is likely to be only some 1¾ per cent this year, down from 3.4 per cent in 2000 and a full percentage point less than the European Commission's forecasts in the spring 2001.[101] On current forecasts, the average growth rate of the euro area in 2002 is unlikely to be much better than this year. The same holds for the aggregate of the 15 European Union countries (table 1.3.2). The average outcome is strongly influenced by the pronounced cyclical weakness in Germany, the largest western European economy. The German government now expects an annual rate of economic growth of only ¾ of a percentage point in 2001, down from 3 per cent in 2000. Growth is expected to strengthen only slightly in 2002, largely a reflection of the continued modest growth of the global economy.

In the euro area the virtual stagnation of economic activity in the second quarter of 2001 increases the probability of a contraction in the third quarter. The sharp fall of the *ifo* business climate index, a key cyclical indicator, in September 2001 signalled a rapid deterioration of business prospects in Germany. This is likely to be the case in other member countries as well. Given the weak economic conditions in the euro area and the global economy at large and forecasts of rapidly declining rates of inflation, the ECB now has room for a further loosening of monetary policy. As regards fiscal policy, at minimum the automatic stabilizers should be allowed to operate fully in order to avoid procyclical effects. The ECB has argued in favour of continued fiscal discipline in the three larger economies of the euro area in line with the letter of the Stability and Growth Pact. But it is difficult to reconcile the two policies: demanding fiscal discipline in a cyclical downturn and at the same time pursuing an overly cautious monetary policy – either with each other or with the current needs of the European economy.[102]

It was accepted in the early years of EMU, that countries with large budget deficits – i.e. close to 3 per cent or above – would need time to achieve the desired medium-term fiscal position of "close-to-balance or in surplus" and that in the event of a severe cyclical downturn in the early years of EMU they could therefore be forced into a procyclical fiscal stance by the rules of the Stability and Growth Pact. The probability of such a risk was, of course, unknown but it was assumed that a sustained cyclical upturn would enable the medium-term fiscal targets to be reached. But actual developments have not turned out that way. The euro area is now on the edge of recession in a very worrisome global context. One of the major principles of the Pact, namely that fiscal discipline is a precondition for eventual fiscal flexibility,[103] is therefore hardly adequate for the current economic situation, which was not envisaged when the Pact was designed. It can, of course, be argued that countries have not done enough to consolidate their fiscal positions, although this is not only a matter of choice but also of economic circumstance. But there is no point in crying over spilt milk. What is required now in view of European and global economic conditions is a more flexible interpretation of the Pact (e.g. in the form of a temporary derogation). The reasons for this should and must be explained to the general public and the

[101] Commission of the European Communities, *European Economy*, Supplement A, No. 3-4 (Luxembourg), March/April 2001.

[102] UNECE, *Economic Survey of Europe, 2001 No. 1,* chap. 1.

[103] M. Artis and M. Buti, "'Close-to-balance or in surplus': a policy makers guide to the implementation of the Stability and Growth Pact", *Journal of Common Market Studies*, Vol. 38, No. 4, November 2000, pp. 563-591.

TABLE 1.3.2

Real GDP in the ECE market economies, 1999-2002
(Percentage change over previous year)

	1999	*2000*	*2001 [a]*	*2002 [a]*
France	2.9	3.1	2.0	1.8
Germany	1.8	3.0	0.8	1.5
Italy	1.6	2.9	1.9	1.5
Austria	2.8	3.3	1.8	2.3
Belgium	2.7	4.0	1.8	2.2
Finland	4.0	5.7	2.1	2.7
Greece	3.4	4.1	3.7	3.7
Ireland	10.8	11.5	5.5	4.8
Luxembourg	7.5	8.5	5.6	4.2
Netherlands	3.7	3.5	1.3	1.6
Portugal	3.3	3.2	1.9	2.1
Spain	4.0	4.1	2.7	2.3
Euro area	2.6	3.4	1.7	1.8
United Kingdom	2.3	3.0	2.1	2.1
Denmark	2.1	3.2	1.1	2.1
Sweden	4.1	3.6	1.6	2.0
European Union	2.6	3.3	1.8	1.9
Cyprus	4.5	4.9	4.5	4.6
Iceland	4.3	3.6	1.5	1.7
Israel	2.6	6.2	1.0	3.0
Malta	4.0	4.3	4.3	4.3
Norway	1.1	2.3	1.2	1.9
Switzerland	1.5	3.4	1.6	1.5
Turkey	-5.0	7.2	-6.0	3.0
Western Europe	2.2	3.5	1.4	1.9
Canada	5.1	4.4	1.4	1.7
United States	4.1	4.1	1.0	1.2
North America	4.2	4.2	1.0	1.2
Japan	0.8	1.5	-0.5	-0.5
Total above	2.8	3.5	0.9	1.3
Memorandum items:				
4 major west European economies	2.1	3.0	1.6	1.7
Western Europe and North America	3.2	3.8	1.2	1.6

Source: OECD, *National Accounts of OECD Countries* (Paris) various issues; Eurostat, New Cronos Database; national statistics; Consensus Economics Inc., *Consensus Forecasts* (London), various issues.

[a] Forecasts.

actors in financial markets. The possibilities for a coordinated fiscal policy response to offset the weakening of private sector demand should also be explored.

The costs of a further weakening of global growth and a failed recovery in the United States are potentially so high that governments should take measures to avoid such an outcome. In view of the increasingly large downside risks to the global economic outlook, there is now an urgent need for a coordinated policy response, including multilateral measures, to ensure a sustainable recovery, avoid disruption to the liquidity needs of developing countries and guarantee the inflow of other funds to support their economies.[104]

The current situation is especially worrisome because of the presence of factors that have been posing serious risks for the world economy for quite some time but which have become more acute in a context of sharply diminished growth expectations. Apart from the fragility of the financial sector in Japan and the risk of emerging market crises, this refers especially to the considerable domestic and external imbalances in the United States economy. The reduction of these imbalances is a necessary condition for a new sustainable upswing. There is now a much greater risk that the inevitable adjustment costs to be borne by the rest of the world (mirrored in the reduction of its current account surplus) will be abrupt rather than gradual; sudden and large changes in exchange rates and in the direction of international capital flows would greatly increase the risk of international financial turmoil and of even larger disruptions to global economic activity.

In the United States, both monetary and fiscal policy has shifted to a significantly more expansionary stance. It can be expected that the Federal Reserve will lower interest rates further if there are no definite signs of a recovery emerging in the near future. Hopes for a rapid and strong rebound of economic activity in the United States in the course of next year (the so-called V-shaped recovery) – with concomitant benefits for the rest of the world – are pinned on the potential stimulus to domestic demand associated with the expansionary stance of fiscal and monetary policies. But such a domestic demand-led recovery in the United States economy could turn out to be a mixed blessing for the world economy because it would only postpone the inevitable reduction of the large domestic and external imbalances and actually increase the risk of abrupt and disruptive adjustment.

Sustained growth in the rest of the world, especially in western Europe, would create the best environment for a smoother adjustment in the United States.[105] More generally, western Europe needs to face the fact that the strengthening of global economic growth forces cannot be left to the United States alone. The orderly reduction of economic imbalances in the United States requires sustained growth in the rest of the world, especially in western Europe and Japan. In Japan, huge fiscal imbalances and official interest rates close to zero have left economic policy with little room for manoeuvre, although there is still some scope for further monetary easing to reverse deflationary pressures and stimulate domestic demand. In western Europe, the need for greater reliance on domestically generated growth now requires a more deliberate shift toward expansionary economic policies in the euro area. Such action, which would support the expansionary stance of United States economic policy, has now become rather urgent, and it would be in line with the advocacy of multilateral action to sustain the global economy.

[104] UNCTAD, *Global Economic Trends and Prospects* (Geneva), 1 October 2001 (UNCTAD/GDS/Misc.21); IMF, "Statement of the managing director on the situation of the world economy and the fund responses", *News Brief No. 01/98* (Washington, D.C.), 5 October 2001 (www.imf.org).

[105] UNECE, *Economic Survey of Europe, 2001 No. 1*, p. 5.

(ii) The transition economies

The short-term outlook for the ECE transition economies is also surrounded by considerable uncertainty. During the first half of 2001 most of these economies escaped the immediate impact of the global economic slowdown, but this is unlikely to continue because the synchronous global downturn – unprecedented in recent history – has increased considerably the downside risks. Several major factors have to be taken into account when judging the short-term economic outlook for the transition economies:

- Most of the east European and Baltic countries are small, open economies with intense trade links with the European Union, and their recent performance indicates that they are increasingly synchronized with the EU trade cycle. Thus, the notable weakening of output and import demand in the euro area will inevitably have an adverse effect on east European and Baltic exports and may have a negative impact on capital flows to this region, especially as privatization runs its course;
- The global economic downturn is already causing a considerable weakening of oil and commodity prices and this is likely to continue at least in the short run. Although not all commodity exports may be immediately affected (with oil standing somewhat apart),[106] the combined effect on export revenue of declining activity, increasing uncertainty and falling prices is likely to be negative for both commodity and oil exporters;
- In addition, some of the central Asian economies in the CIS are exposed to political risks due to the increasing tensions in the region following the terrorist assault on the United States. A prolonged military conflict in Afghanistan may have both direct and indirect negative economic consequences for the whole central Asian region.

Given the considerable external threats, it is not realistic to expect that the transition economies as a whole will be able to maintain their present rates of economic growth; moreover, increasing output volatility in individual countries can be expected in the rest of 2001 and the beginning of 2002. A general slowdown of output growth thus seems most likely in the short run; at the same time, given the differential impact of external factors, there may be large differences in the performance of individual transition economies. The outlook for the transition economies as a whole as well as for individual countries will also depend crucially on the duration and depth of the global downturn.

The current economic situation presents a serious challenge for all the transition economies but the immediate risks for eastern Europe and the Baltic area appear to be greater than those for the CIS. While the central European and the Baltic economies have made substantial progress towards establishing functioning market economies and strengthening their institutions, they are extremely dependent on trade with western Europe. In addition, some of them (particularly the Baltic states) are very small economies where even a single event can have a considerable impact on overall performance (as was the case with the closure of the Elcoteq operation in Estonia – box 1.2.2). Most of the south-east European transition economies – which are generally lagging behind in the reform process – still suffer from chronic weaknesses while at the same time also being more exposed to west European markets. In the present circumstances this combination increases their susceptibility to external disturbances. Thus, if the west European downturn intensifies, the consequences for eastern Europe and the Baltic area could be considerable. The manufacturing sector of these transition economies, which relies heavily on exports, is most exposed to such risks and would be the first to be affected; however, the negative repercussions would be wide-ranging and overall economic performance can be expected to suffer as well.

Contrary to the situation in previous cases of global turmoil, the CIS as a whole appears to be less exposed to the immediate impact of the current global economic downturn. In the present circumstances, the fact that intra-CIS trade still accounts for a significant share of the total trade of most of these countries provides some insulation from weakening demand in the rest of the world. Hence, the continuing strong recovery in Russia and in some of the other large economies in the Commonwealth (Ukraine and Kazakhstan) provides a source of growth for the rest of the CIS.

The escalating global economic risks and the ensuing threats for the transition economies have not so far triggered major revisions to the official growth forecasts. At the moment of writing this *Survey*, there were few indications that policy makers were preparing for a notable weakening of growth in the coming months.[107] It was only after the terrorist attacks on the United States on 11 September that some warnings were made about the possible economic fallout in the region. Nevertheless, as of early autumn, and despite some modest downward revisions of forecasts,[108] governments remained generally optimistic about their short-term

[106] The increase in uncertainty about the future, which is detrimental for investment, manufacturing output and exports, may have different implications for oil and commodity exporters: for example, there may be a rise in "precautionary demand" for oil but not necessarily for cotton. Thus, while declining activity combined with increasing uncertainty will most likely negatively affect real demand for most commodities, their joint effect on the real demand for oil is a priori unclear.

[107] The exception of Poland stands out as a special case, as the deterioration in output and the lowering of forecasts were mostly driven by domestic factors.

[108] Slight downward revisions were made in some countries in this period: apart from Poland, these included Bulgaria, Croatia, Hungary, Slovenia, Estonia and Latvia.

prospects despite the persistent lowering of output forecasts in western Europe. Thus, according to the official October forecasts for the year 2002, aggregate GDP was still expected to grow by some 3.5 per cent in eastern Europe and by close to 5 per cent in both the Baltic states and the CIS (table 1.2.1).

These fairly optimistic forecasts suggest that governments in most transition economies see few serious risks from the present global downturn. Consequently, with few exceptions, there is little sign that they are considering specific policy responses to an eventual slowdown in their economies. One important reason for this may be the fact that policy makers in most transition economies have fairly limited degrees of freedom to design and implement such measures. Widespread constraints on policy in the transition economies are the existing macroeconomic imbalances: current account deficits (table 1.2.2) as well as fiscal deficits are already quite high in a number of countries. Moreover, these imbalances are likely to increase because of various factors such as different rates of adjustment of exports versus imports in response to the global downturn, insufficient flexibility of product or factor markets, and a possible inconsistency of policy in a changing environment.

Another policy constraint stems from the rigid monetary regimes to which some countries adhere (such as the currency boards in Bosnia and Herzegovina, Bulgaria, Estonia and Lithuania or the fixed exchange rate regime in Latvia). Such regimes preclude the use of monetary policy to cushion the economy from an external shock. In principle, a rigid monetary regime such as a currency board implies that the external shock is fully absorbed by the real economy which, in turn, requires a sufficient degree of flexibility on the labour and product markets (this in fact is a precondition for the smooth functioning of a currency board arrangement). To put it differently, an aggravation of the current economic situation will provide a test not only of the degree of flexibility of markets in these countries but also of the stability of their monetary regimes in the event of an external shock.

Among the advanced reformers, Hungary and Slovenia, which in recent years have enjoyed balanced growth and adhere to more flexible monetary regimes, appear to have more room for engaging in activist policies in response to a deteriorating external environment. With both external and internal balances broadly in check, a moderately expansionary policy would seem to be the proper response to an external shock.[109] However, even in these countries the current macroeconomic equilibrium is rather delicate and much policy caution would be needed to avoid upsetting it. Slovakia and to a lesser extent the Czech Republic are facing some difficulties in keeping their macroeconomic balances under control: the latter is currently coping with a fiscal shock caused by the bailout of several large banks, while the former has been trying to scale down an ambitious public investment programme that has led to a dangerous escalation of both external and domestic imbalances. The policy response in such cases will have to be much more cautious and selective, avoiding measures that could further destabilize the macroeconomy. Poland is in an even weaker position due to its acute fiscal crisis (box 1.2.1); possible counter-cyclical measures may only be envisaged in the context of an internal restructuring of an already shrinking government budget. The three Baltic states as well as Bulgaria adhere to rigid monetary regimes which, as noted above, leave very little, if any, degrees of freedom to policy makers to undertake counter-cyclical measures. At the same time, as indicated by past experience (for example in the aftermath of the Russian crisis in 1998), they are highly susceptible to external shocks. These economies are now exposed to a double risk: first, the extent to which they may be affected by an external shock and, second, whether the real economy can absorb it without jeopardizing macroeconomic stability. Most of the remaining south-east European transition economies also have limited room for manoeuvre due to their overall macroeconomic instability.

The immediate downside risks for the CIS are probably not so high; as already noted, as long as the Russian economy continues to grow the direct negative repercussions of the global downturn on the rest of the CIS will be partly offset. In fact, while the Russian authorities envisage some slowdown in the rate of growth in the short run (the draft budget for 2002 submitted to the *Duma* assumes a 4.3 per cent rate of GDP growth), the prevailing expectation is that output will remain relatively strong in the medium term.[110]

The most important external influence on the continuation of recovery, not only in Russia but in the whole of the CIS, is the direction of world commodity prices. These economies can probably weather a temporary drop in world oil prices and, actually, some governments in the region have been preparing for such a turn. Thus, some of the CIS oil exporting countries (Azerbaijan, Kazakhstan and Russia) have already instituted, or are in the process of doing so, special off-budgetary reserve funds, which accumulate some of the windfall revenue in periods of boom. When conditions

[109] Hungary is one of the few transition economies where a policy stimulus (in particular, by stimulating home construction and investment in infrastructure) is actually being discussed as a precautionary measure to offset any adverse impact of the global slowdown on the Hungarian economy. *Reuters Business Briefing*, 28 September 2001.

[110] According to the medium-term economic programme approved by the Russian government in August, the average annual rate of growth of GDP in the period 2002-2004 is expected to be in the range of 3.5 to 4.5 per cent. *Interfax News Agency* as reported in *Reuters Business Briefing*, 9 August 2001.

reverse, some of the accumulated resources may be used as a cushion against the shock. However, as this is a relatively recent development, the reserve funds have not yet accumulated sufficient resources to cope with a prolonged period of distress. Thus, a deep and lasting fall in commodity prices will inevitably have a direct detrimental effect on the economic performance of all the commodity exporters, including Russia, and, indirectly, further negative repercussions due to any weakening in the Russian economy.

Given the depth and scope of the present synchronous global downturn, the transition economies obviously cannot isolate themselves from the external shock or cope with its negative consequences on their own. Economic policy in the transition economies should obviously try to counter weakening cyclical growth forces, but the extent to which this is possible will vary among countries. In general, such measures will only be able to complement and strengthen the policy responses to recessionary forces in western Europe and overseas. It goes without saying that a long-lasting negative shock could jeopardize reform efforts in the transition economies and prolong still further the time required to reduce the gap between their per capita income levels and those of the more developed part of the continent.