PART ONE

CURRENT ECONOMIC DEVELOPMENTS

CHAPTER 1

THE ECE ECONOMIES IN AUTUMN 1999

1.1 The global context and the western market economies

(i) The global context

About this time a year ago, the general assessment of the global economic situation was quite gloomy. Short-term forecasts were not only surrounded by an unusually large margin of uncertainty, but the balance of risks was also seen to be predominantly on the downside. The background to this was the turbulence in financial markets caused by the Russian debt default in August 1998, which triggered a massive withdrawal of private capital from emerging markets to safe havens in the industrialized countries. In Japan, the recession was deepening and the depth of the adjustment recession in the Asian emerging markets affected by the financial crisis of 1997 was difficult to gauge. Falling prices of oil and raw materials contributed to fears of global deflation. To all this was added the lingering fiscal and exchange rate crisis in Brazil and related fears of another bout of financial contagion, notably in the countries of the western hemisphere. But developments in the world economy in 1999 have proved to be more favourable than expected at the beginning of the year.

In fact the short-term outlook for the international economy has improved further since mid-1999.[1] World output is now forecast to increase by 3 per cent in 1999, which is about ¾ of a percentage point more than was expected in the spring and 0.5 percentage points above the actual increase in 1998.[2] To a large degree, this improvement reflects the better than expected economic performance in countries which were at the heart of the succession of financial and currency crises since mid-1997. In the Asian economies, the deep recession has bottomed out and has been followed by a stronger than expected recovery this year. In Brazil, the recession that followed in the wake of the currency crisis was milder than anticipated. Similarly, there has been a striking improvement (also largely unexpected in early 1999) in the economic situation in Russia, largely reflecting the surge in oil prices and the favourable impact of the large depreciation of the rouble on net exports and, especially, on import-substituting domestic production. Net private capital flows to emerging markets have stabilized at some $136 billion in 1999, the same level as in the preceding year.[3] This masks a strengthening of net private capital inflows in Asia associated with the rebound in economic activity. But the overall flows of private capital to emerging markets are still subdued. Their level in 1999 is likely to be less than half the average annual inflow over the period 1995 to 1997. A moderate strengthening of net private capital flows to emerging markets is generally expected in 2000, but net credit flows are likely to remain very depressed.

Outside these emerging market countries, the recession appears to have bottomed out in Japan, but the prospects for a sustained recovery in the private sector are still dim. In the United States, the economic expansion has remained strong and is about to enter its ninth year, the result in part of the stimulus to domestic demand provided by the monetary easing in the final months of 1998. Economic growth for the year as a whole will once again be higher than forecast at the beginning of the year. The United States economy has thus remained the main driving force behind world output growth over the past two years. In western Europe, economic activity advanced at a moderate pace in the first two quarters of 1999, but survey data point to some acceleration in the rate of expansion in the second half of the year. The recovery has been supported by easier monetary conditions and the improved international environment. Annual output growth, however, will remain below the average increase in world output. Economic prospects have also improved lately in the transition economies (as well as Russia) although the outcome for the year as a whole will be more or less adversely affected by the repercussions of the Kosovo conflict and the continuation of depressed domestic demand in Russia.

In the *Asian crisis economies*, the deep recession bottomed out in 1998 or early 1999 and has been followed by a stronger than expected recovery. This is especially true of the Republic of Korea, which has been experiencing a boom this year: real GDP is expected to increase by 9 per cent in 1999, more than offsetting the decline of 5.5 per cent in 1998. The recovery has been supported by expansionary economic policies. The rebuilding of inventories has provided a strong stimulus

[1] UN/ECE, *Economic Survey of Europe, 1999 No. 2*, pp. 23-25.

[2] IMF, *World Economic Outlook* (Washington, D.C.), October 1999.

[3] Institute of International Finance, Inc., *Capital Flows to Emerging Market Economies* (Washington, D.C.), 25 September 1999.

to industrial production, while private consumption and fixed investment expenditures have been increasing strongly and also exports have been edging upward. Although the government has introduced a large range of reform measures designed, *inter alia*, to strengthen the banking sector and increase the effectiveness of corporate governance, a major challenge remains the restructuring of the financial sector and the large conglomerates (*chaebols*). There has also been a strengthening of economic activity in the ASEAN-4, i.e. Indonesia, Malaysia, the Philippines and Thailand. Interest rates have fallen to levels prevailing before the financial crisis. Exchange rates have stabilized, but the earlier large declines have boosted price competitiveness in foreign markets. The scope for expansionary fiscal policy to support incomes and employment was enlarged by funds provided by the Japanese government within the framework of the Miyazawa Initiative.[4] As in the Republic of Korea, the restocking of inventories appears to be an important factor behind the rise in domestic output. But domestic activity continues to be restrained by the reluctance of banks to lend. Progress in effective bank and corporate financial restructuring has been limited so far in Indonesia, Malaysia and Thailand. Prospects for recovery in Indonesia have probably been badly affected by the recent political uncertainty. The sustainability of the recovery in all these countries will hinge not only on a continued favourable external environment but also on the successful restructuring of their financial and non-financial corporate sectors.

In *Japan*, real GDP rose in the first two quarters of 1999, following five consecutive quarters of declining aggregate output. Technically, the economy has moved out of recession, but activity levels are still very depressed and there are strong doubts as to whether this upturn can be sustained without another large fiscal stimulus package. In fact, the government announced its intention to launch yet another round of fiscal spending (the eleventh since 1992) in late September 1999. But there are concerns that in view of the serious deterioration of the government finances over the past years the result might be a further rise in long-term interest rates, which would have a negative impact on private sector spending. The very large November 1998 fiscal package boosted public investment, which accounted for nearly half of the 2 per cent increase in real GDP in the first quarter. In addition, private consumption was stimulated by spending vouchers distributed for free by the government and temporary tax cuts for high income earners. Consumer confidence weakened slightly in the second quarter, following a marked improvement in the two preceding quarters. The slight rise in GDP in the second quarter reflects the continuing strength of private consumption and an upturn in exports. In addition, residential investment responded to targeted tax stimuli. In contrast, non-residential and public investment fell sharply. The unemployment rate rose to a postwar record of 4.9 per cent in July but fell slightly in August. Employment continued to fall in the third quarter against the background of considerable excess capacity and overmanning in the corporate sector. The September 1999 *Tankan* survey of the Bank of Japan points to increased optimism about short-term prospects in the business sector. This could also reflect the government measures already implemented to rehabilitate the banking sector. The process of corporate restructuring which is underway, however, will have a depressing effect on business fixed investment and employment. Increased job insecurity has been restraining household spending propensity. Another matter of concern has been the impact of the sizeable appreciation of the yen on external price competitiveness, given that rising exports are seen to be one of the principal supports of the nascent recovery. The yen rose to a three and a half year high against the dollar in mid-September but has since weakened somewhat. Real GDP is forecast to increase by 1 per cent in 1999, which compares with a fall of 1 per cent or more expected in the spring.

The stance of monetary policy has remained unchanged. The overnight call money rate has been held at virtually zero since February 1999, but this has not had a noticeable impact on domestic demand. The marked appreciation of the yen, moreover, has led to a tightening of monetary conditions. As a result, economic policy discussion has focused on alternative ways for the central bank to increase the money supply and support domestic economic activity. One possibility suggested is for the central bank to intervene in the foreign exchange market to stem the appreciation of the yen without sterilization. The Bank of Japan, however, has preferred to neutralize the impact of these interventions on the money supply. But in mid-October, the central bank announced its intention to enlarge the supply of liquidity by purchasing short-term government bonds outside the framework of repurchase agreements and also to include longer-term (two-year) government bonds in repurchase transactions.

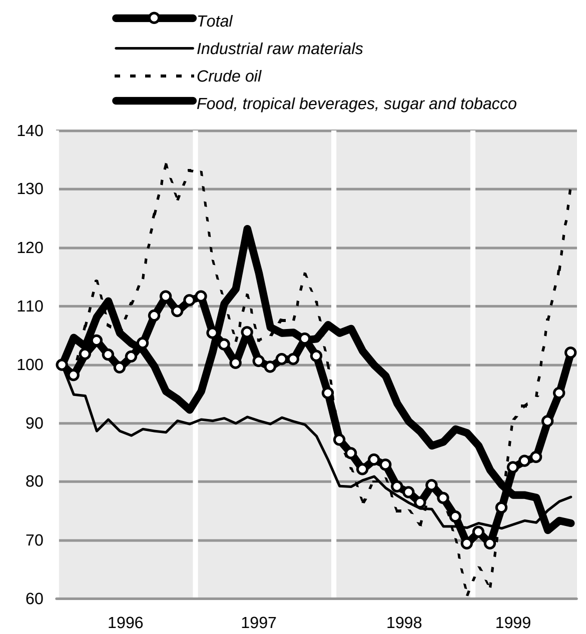
In *Latin America*, the overall economic performance in 1999 has continued to be strongly influenced by the restrictive policies put in place in response to the deteriorating international economic and financial environment in the aftermath of the Asian and Russian crises. To these were added the devastating economic effects of bad weather (hurricane Mitch) in some countries towards the end of 1998. Although economic activity is expected to recover somewhat during the second half of 1999, regional GDP is forecast to fall by about 0.5 per cent[5] or at best to increase

[4] See also UNCTAD, "The potential contribution of Japan to Asian recovery: external aid versus domestic fiscal stimulus", paper prepared by the UNCTAD secretariat (Geneva), October 1998.

[5] This would be the first decline in regional GDP in the current decade. ECLAC, *Economic Survey of Latin America and the Caribbean 1998-1999* (Santiago), August 1999.

CHART 1.1.1

World commodity prices, January 1996-September 1999
(Indices, January 1996=100)



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

slightly[6] for the year as a whole. These outcomes mask, however, a much sharper economic contraction in a number of countries (Argentina, Ecuador, Venezuela). Faced with a deep economic and financial crisis, the government of Ecuador has defaulted on interest payments on some $6 billion of Brady bonds held by private creditors. This suspension of payments met with the agreement of the IMF and, in principle, it constitutes a first step towards a policy designed to achieve a greater burden-sharing between official and private creditors in the event that countries can no longer sustain their debt burden. There have been no adverse implications so far for the financing conditions available to other emerging markets. In Brazil, the adjustment recession following the January 1999 currency crisis has been much less pronounced than feared initially. The considerable depreciation of the real has had only a small inflationary impact, which, in combination with a return of capital flows from abroad, has allowed the central bank to lower interest rates. Real GDP is now forecast to fall by 1 per cent in 1999, although there has in fact been an upturn in economic activity since the second quarter. Economic activity in Mexico, Central America and the Caribbean countries held up quite well in 1999 on account of the close trade and investment links with the buoyant United States economy. But there are continuing concerns about the structural weakness of the Mexican banking sector, which has its roots in the peso crisis of December 1994.

In the *international commodity markets*, the main development so far in 1999 has been the sharp rise in crude oil prices. The spot price for Brent crude more than doubled from $10 per barrel in mid-February to $23 in early October thus reaching its previous peak of late 1996 (chart 1.1.1). The surge in oil prices reflects in the main the one-year supply restraint agreement reached by members of OPEC and other oil exporters in March 1999. This agreement to cut back oil supplies has been followed by an unexpectedly high degree of compliance of producers. This lowering of supply coincided with a rise in the demand for oil associated with the strengthening economic activity in the world economy, notably in the Asian emerging markets and in western Europe.[7] The combined effect has been a significant reduction in the large overhang of stocks of crude oil, which had accumulated mainly in the course of 1998. The upshot is that there is now a better balance between supply and demand in the oil market. The surge in petroleum prices has brought relief for oil exporting countries (especially in the developing world) whose economic and financial situation had been strained by the price slump in 1997 and 1998. Apart from global demand developments, future oil price developments will hinge crucially on the willingness of oil producers to adhere to agreed production ceilings. In contrast to oil prices, raw materials prices have in general remained depressed in 1999. Prices of industrial raw materials recovered somewhat in the third quarter of 1999, largely reflecting a stronger increase in the prices of non-ferrous metals (chart 1.1.1).

(ii) Western Europe and North America

(a) The recent macroeconomic performance

In *western Europe*, economic activity gained slightly more momentum in the second quarter of 1999. Real GDP rose by 0.5 per cent compared with 0.4 per cent in the preceding quarter (table 1.1.1). Real GDP rose by about 1.5 per cent in the first half of 1999 (chart 1.1.2), but industrial activity remained sluggish. Industrial output edged upward slightly in the second quarter of 1999, but in the first half of 1999 was still about 0.5 per cent lower than in the same period of 1998. In manufacturing industry, capacity utilization rates were still falling, albeit only modestly, in the second quarter of 1999.

Short-term economic indicators suggest a strengthening of cyclical growth forces in the course of the third quarter. Industrial output continued to edge upward, order books improved and the level of inventories

[6] The IMF is forecasting an increase in real GDP by 0.1 per cent in 1999. IMF, op. cit., table 1.1.

[7] World oil demand is forecast to increase by 1.5 per cent in 1999 and 2.4 per cent in 2000, up from only 0.6 per cent in 1998. International Energy Agency, *Oil Market Report* (Paris), 11 October 1999.

TABLE 1.1.1

Quarterly changes in real GDP, 1998-1999
(Percentage change over preceding period)

	1998				*1999*	
	QI	*QII*	*QIII*	*QIV*	*QI*	*QII*
France	0.9	0.9	0.5	0.6	0.4	0.6
Germany	1.1	–	0.4	-0.3	0.4	–
Italy	-0.5	0.5	0.6	-0.4	0.2	0.4
United Kingdom	0.5	0.5	0.5	–	0.2	0.6
4 countries above	0.6	0.4	0.5	–	0.3	0.4
Canada	0.7	0.3	0.6	1.2	1.0	0.8
United States	1.4	0.5	0.9	1.5	1.1	0.4
Japan	-1.2	-0.7	-0.3	-0.8	2.0	0.2
Total above	0.6	0.2	0.5	0.5	1.0	0.4
10 smaller economies	0.6	0.8	0.5	0.6	0.5	0.8
Austria	1.0	0.4	0.1	0.2	0.4	0.9
Belgium	–	1.6	0.1	-0.3	0.3	1.6
Denmark	1.2	-0.4	2.0	-0.2	-0.4	0.2
Finland	1.5	1.1	1.1	0.9	0.3	1.0
Netherlands	1.0	0.6	0.5	1.2	0.7	0.8
Norway	0.1	0.9	-0.7	-0.1	0.6	-0.9
Portugal	0.5	1.2	-1.3	2.4	..	..
Spain	0.6	0.8	1.2	0.6	0.6	1.1
Sweden	0.3	0.9	0.6	1.0	0.9	0.7
Switzerland	0.4	0.3	0.3	0.2	0.2	0.3
Memorandum items:						
Euro area	0.6	0.5	0.5	0.2	0.4	0.5
European Union	0.6	0.5	0.6	0.1	0.4	0.5
Western Europe	0.6	0.5	0.5	0.1	0.4	0.5

Source: National statistics.
Note: Data are seasonally adjusted.

was judged to be more in line with sales expectations.[8] There has been notably a marked revival of new orders and of output in the manufacturing sector in Germany in the summer. This improving performance finds its summary expression in the surge of industrial confidence in western Europe between March and September 1999, largely reversing the sharp decline since the summer of 1998, when exports turned increasingly sluggish on account of the crises in Asia, Latin America and Russia. The bottoming out of these crises and the ensuing upturn of domestic activity in these regions has begun to stimulate export activity in western Europe (chart 1.1.3). Exports from members of the euro area have also been supported by gains in price competitiveness stemming from the steady depreciation of the euro against the dollar between January and July 1999. In addition, interest-sensitive components of domestic demand have been stimulated by the steady easing of money policy in late 1998 and in the first half of 1999, which led to lower bank lending rates. Private consumption was also supported by gains in real incomes associated with rising employment and increased hourly earnings. Consumer confidence remained very strong in the first nine months of 1999.

The slight acceleration in economic growth in western Europe in the second quarter of 1999 masks, however, a conspicuous slowdown in the rate of expansion of all three main components of final domestic demand (table 1.1.2). Changes in stockbuilding had a broadly neutral effect on domestic activity in the second quarter, following a significant negative impact in the first. Real exports of goods and services rose strongly, but import demand also strengthened. In the event, the changes in real net exports made a small positive contribution to overall economic growth in western Europe, following two quarters during which they subtracted from output growth. (The available country data suggest that changes in real net exports had a neutral effect on economic growth in the euro area in the second quarter of 1999.)

The moderate rate of economic expansion in western Europe as a whole in the first two quarters reflects in the main the slow recovery in Germany and Italy (table 1.1.1). In part this can be attributed to the asymmetric effects of the adverse trade shocks of 1997-1998 on the west European countries. These two countries were more exposed to the regions in crisis than other countries such as France, for example. Domestic demand in Italy is probably also still restrained by the restrictive fiscal policy measures required to meet the EMU convergence criteria and, subsequently, the requirements of the Stability and Growth Pact.

In *France*, the recovery gained somewhat more momentum in the second quarter of 1999. The main feature was the rebound of exports, which had fallen in the two preceding quarters. Import demand also strengthened, but changes in real net exports provided some support to overall economic growth. Private consumption picked up again, more than offsetting a slowdown in fixed investment. Residential investment continued to rise strongly, stimulated by low mortgage rates and the anticipated phasing out of tax incentives (*Loi Périssol*) at the end of August 1999. As in the preceding quarter, changes in stockbuilding had a slight negative impact on growth.

In *Germany*, there was a pronounced weakness of private consumption in the second quarter, accompanied by a decline of fixed investment. Business expenditures on machinery and equipment continued to expand, but this was more than offset by a fall in construction activity. Export demand strengthened markedly compared with the preceding quarter but remained slightly below its level in the second quarter of 1998. Changes in real net exports had a neutral effect on economic growth in the second quarter.

In *Italy*, exports supported economic growth in the second quarter of 1999, following five consecutive quarters of negative contributions to growth. Private consumption edged upward slightly and business investment in machinery and equipment was sluggish, a reflection of sufficient spare capacity and uncertain sales prospects. In contrast, there was a large increase in spending on transport equipment and buildings.

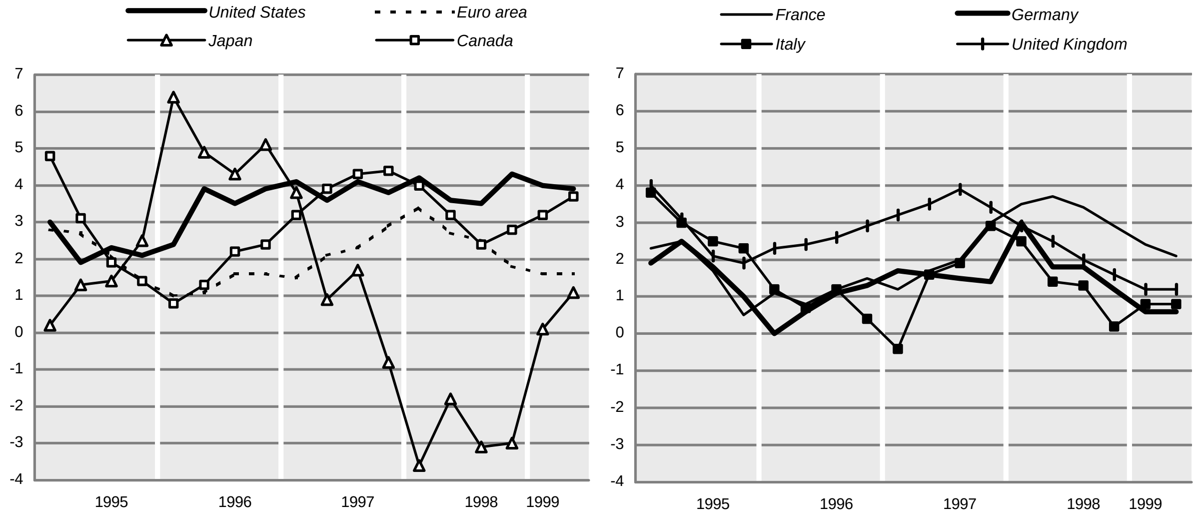
[8] According to the business and consumer surveys published by the European Commission.

Among the *smaller economies of the euro area*, the upward cyclical momentum continued to be very strong in Finland, Ireland, the Netherlands, Portugal and Spain. These countries are clearly at a more advanced stage of the business cycle than the other countries of the euro area (table 1.1.1). The ongoing expansion is broadly based on strong domestic demand and exports. As is typical for the late phase of a cyclical upswing, consumer demand is booming. The cyclical upturn in activity also strengthened in Austria and Belgium after the first quarter of 1999. These two countries are relatively specialized in the production of intermediate goods for which there is increasing demand at this stage of economic recovery in many countries.

CHART 1.1.2

Changes in real GDP, 1995 QI-1999 QII

(Percentage change over same quarter of preceding year)



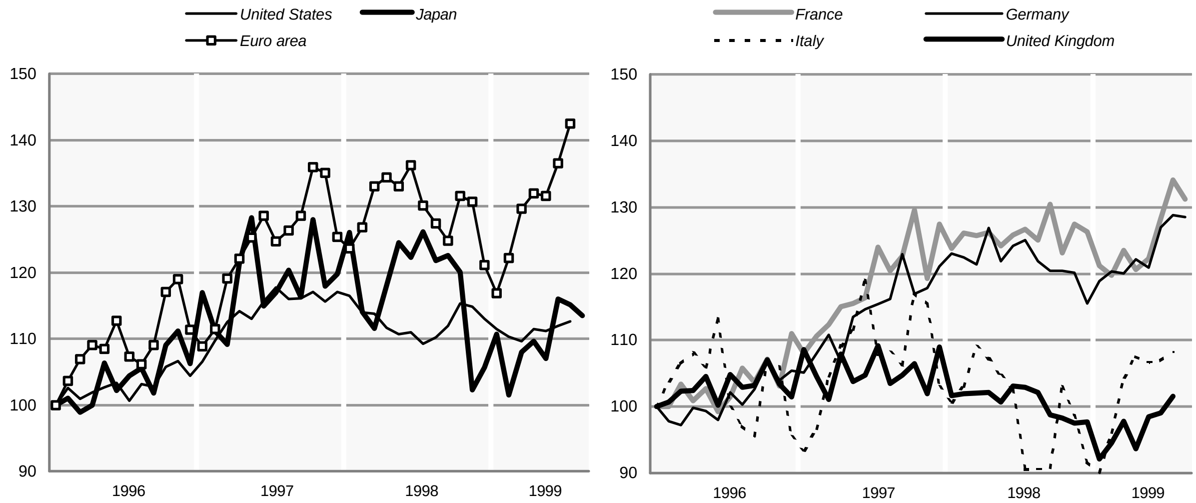
Source: National statistics.

Note: Data are seasonally adjusted.

CHART 1.1.3

Monthly export value indices, 1996-1999

(January 1996=100)



Source: Euro area: Eurostat; France: Secrétariat d'Etat au Commerce Extérieur; Germany: Bundesbank; Italy: ISTAT; Japan: Ministry of Finance; United Kingdom: Office for National Statistics; United States: Census Bureau.

Note: Total merchandise exports measured in national currency units. Data are seasonally adjusted, with the exception of Italy and the euro area for which a three-month moving average was used.

Outside the euro area, in the *United Kingdom*, the cyclical downturn of 1998 has proved much milder than expected and did not end, as feared earlier, in recession. Instead, economic activity strengthened again in the second quarter of 1999. To a large extent this reflects the lagged effects of monetary easing on domestic demand. The moderate upward tendency in manufacturing activity, apparent in early 1999, has continued. Construction activity has also strengthened, in part a reflection of the rise in demand for housing, which has been stimulated by lower interest rates and real income gains. Buoyant private consumption, fuelled by large increases in incomes, was the mainstay of economic growth in the first two quarters. (Household consumption

TABLE 1.1.2

Quarterly changes in real GDP and main expenditure items, 1998-1999

(Percentage change over preceding period)

	Western Europe [a]			Euro area [b]			United States		
	1998	1999		1998	1999		1998	1999	
	QIV	QI	QII	QIV	QI	QII	QIV	QI	QII
Private consumption	0.6	0.7	0.3	0.4	0.5	0.2	1.2	1.6	1.2
Government consumption	–	1.2	0.2	-0.2	1.2	0.1	1.1	–	–
Fixed investment	0.6	1.6	0.6	0.3	2.1	0.9	2.6	3.1	1.5
Final domestic demand	0.5	1.0	0.4	0.3	1.0	0.3	1.5	1.7	1.1
Changes in stock building [c]	0.2	-0.4	-0.1	0.4	-0.4	0.1	-0.2	-0.1	-0.4
Total domestic demand	0.7	0.6	0.3	0.6	0.6	0.5	1.3	1.6	0.7
Exports	-1.7	0.1	1.7	-1.9	0.3	1.8	4.6	-1.3	1.2
Imports	0.6	1.0	1.3	0.4	1.0	1.8	2.9	3.2	3.6
Net exports [c]	-0.6	-0.3	0.2	-0.6	-0.2	–	0.1	-0.7	-0.4
GDP	0.1	0.3	0.5	–	0.4	0.5	1.5	1.1	0.4

Source: National statistics.

Note: Data are seasonally adjusted.

a The 11 countries are: Belgium, Denmark, France, Finland, Germany, Italy, Norway, Spain, Sweden, Switzerland and United Kingdom.

b Euro area: excluding Austria, Ireland, Netherlands and Portugal.

c Growth contribution (percentage points).

was in fact restrained by a rise in the saving ratio in the second quarter.) Fixed capital formation was relatively sluggish (though at a relatively high level) and changes in inventories had a substantial negative effect on growth. Exports, which had fallen in the two preceding quarters, recovered somewhat in the second quarter, although they were still below their level in the same period of 1998. The strength of the pound sterling continues to hold back export activity, but since there was relatively little growth in import demand real net exports, nevertheless, made a small positive contribution to growth in the second quarter, the first since the third quarter of 1997.

Among the *smaller economies outside the euro area*, economic activity weakened markedly in Norway, reflecting in the main tight economic policies (adopted to prevent overheating) and a fall in investment activity, which has been the most dynamic component of demand during the strong cyclical expansion over the past five years. Economic growth was also relatively weak in Denmark and Switzerland. In contrast, vigorous economic growth was maintained in Sweden in the first two quarters of 1999. Swedish exports held up better than expected in the face of the deteriorating international environment in 1998 and domestic demand was supported by easier monetary conditions and increases in real incomes (table 1.1.1).

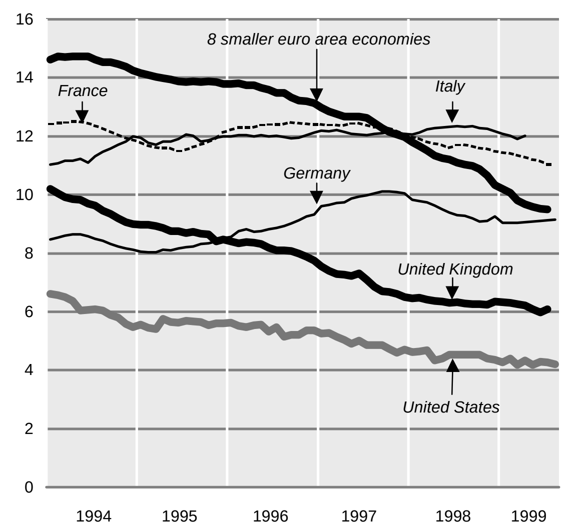
There has been a further slight improvement of the situation in the *west European labour markets* in 1999. Employment has continued to edge upwards, but the average annual rate of increase is expected to slow down to some 1 per cent, as compared to an equivalent increase of 1¼ per cent in 1998.[9] Among the four larger economies, demand for labour remained very sluggish in Germany in the first three quarters of 1999, although official statistics are not available at the time of writing. Increased demand for labour in west Germany was apparently offset by further labour shedding in the eastern part of the country. Forecasts point to a small annual increase of 0.2 per cent in total employment in 1999. In contrast, employment rose markedly in France in the first two quarters of 1999 and for the year as a whole the level is forecast to increase by 1.5 per cent. Employment rose also perceptibly in Italy. In both France and Italy, these gains are largely concentrated in services and construction where output growth has been robust. But employment has also been supported by labour market measures in both countries. In France, the government has introduced a special programme to reduce youth unemployment, and in Italy a new legislative framework facilitates the use of fixed and short-term labour contracts. In the United Kingdom, employment continued to rise modestly in the first two quarters of 1999, but the rate of increase has weakened since the third quarter of 1999.

The dynamic output growth in many of the smaller economies continued to be associated with a strong demand for labour, although the cyclical slowdown is also mirrored in somewhat smaller employment gains compared with 1998. The available data point to annual employment growth within a range of 2.5 to 3 per cent in Finland, Spain and Sweden. In Ireland, which continues to have by far the highest rate of output growth in the

9 Excluding Turkey.

CHART 1.1.4

Unemployment rates in major ECE market economies, January 1994-August 1999
(Per cent of civilian labour force, monthly figures, standardized rate)



Source: OECD, *Main Economic Indicators* (Paris), various issues.
Note: Eight smaller euro area economies: Austria, Belgium, Finland, Ireland, Luxembourg, Netherlands, Portugal and Spain.

ECE region, employment is still projected to increase by about 5 per cent this year.

The tendency of slightly falling unemployment rates in western Europe has continued during the first eight months of 1999. The average unemployment rate of the European Union was 9.3 per cent in August, down from 9.6 per cent in January. The main exception to this common pattern is Germany, where unemployment rose slightly, largely because of a further reduction of labour market measures in east Germany. The favourable output performance of many of the smaller economies over the past couple of years has also contributed to a steady and significant fall of their unemployment rates. This continued, albeit at a more moderate pace, in 1999 (chart 1.1.4).

Consumer price inflation in western Europe remained low during the first three quarters of 1999. The surge in oil prices (see above) triggered a strong rise in domestic energy prices and this put some upward pressure on the inflation rate.[10] But the average increase (year-on-year) in the harmonized consumer price index was only 1.2 per cent in the European Union in September 1999, up from 1 per cent at the beginning of the year. In the euro area, the average inflation rate was also 1.2 per cent in September compared with 0.8 per cent in January (chart 1.1.5). It is noteworthy that the so-called core inflation rate (a measure which excludes energy, food, tobacco and alcohol) fell in the euro area to 0.9 per cent in September 1999, down from 1.3 per cent at the beginning of the year.[11] Inflation was significantly above the EU average (within a range of 2-2.6 per cent) in Denmark, Ireland, the Netherlands and Spain in September 1999. In Greece, the economic policies introduced to meet the EMU convergence criteria contributed to a conspicuous fall in the inflation rate to 1.5 per cent in September 1999, down from 5 per cent in the same month of 1998. In the United Kingdom, the underlying inflation rate[12] was below the government's inflation target of 2.5 per cent between April and September 1999.

Labour cost pressures have remained moderate in western Europe. Nominal hourly labour costs in the total economy rose by slightly more than 2 per cent in the euro area in the first half of 1999 compared with the same period of 1998, but this was probably offset to a large extent by productivity gains. Even countries with strong economic growth such as Finland, Ireland, and Spain have been successful in containing this cost component, in part with the help of income policies. There were somewhat stronger labour cost pressures in the United Kingdom where labour markets are relatively tight.

In the *United States*, the long economic expansion, which started in the second quarter of 1991, has continued. But the growth of real GDP slowed to 0.4 per cent in the second quarter of 1999 from 1.1 per cent in the first (table 1.1.1). Real GDP in the first half of 1999 was some 4 per cent higher than a year earlier. Strong domestic demand and improved export demand led to a steady rise in manufacturing production between February and August 1999, following sluggish activity in the final months of 1998. The decline in capacity utilization rates bottomed out in the spring and was followed by a slight increase after the second quarter of 1999. But margins of spare capacity remain considerable.

Robust domestic demand has remained the principal engine of economic growth. Private consumption remained buoyant reflecting strong increases in the demand for durable goods (motor cars, furniture, household equipment). Household demand was

[10] Changes in commodity prices have tended to have an impact on inflation in industrialized countries. But the average share of the related expenditure items in total final household consumption is rather small. To illustrate, energy accounts for 8.8 per cent of the total basket of goods and services used for the calculation of the Harmonized Index of Consumer Prices (HICP) in the European Union. In addition, the share of energy in the total production costs of firms has fallen significantly since the first oil price shock in 1973.

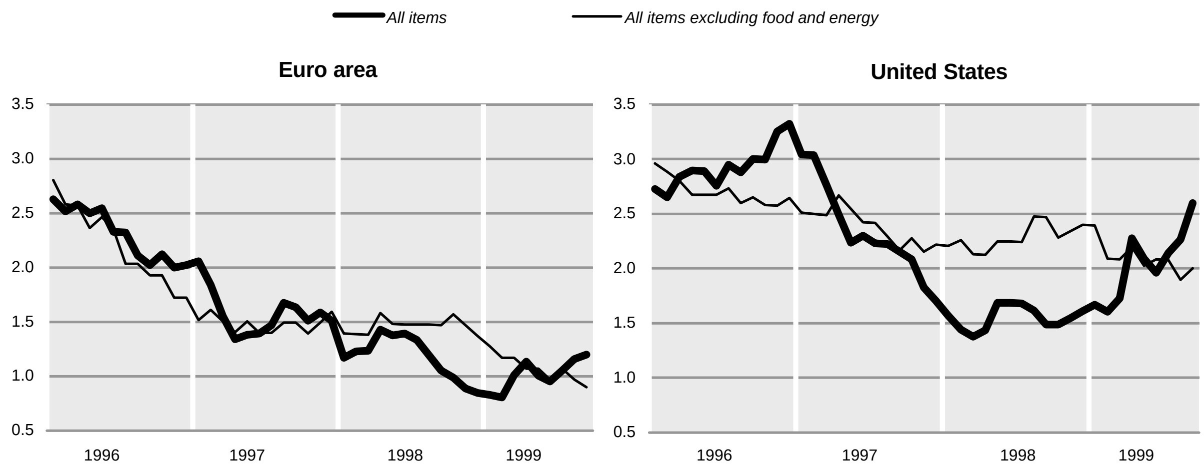
[11] Core inflation was only 0.4 per cent in France and even lower, at 0.1 per cent, in Germany in September 1999.

[12] This is measured by the 12-month increase in the national retail price index excluding mortgage interest payments (RPIX). This index rose by 2.1 per cent in September 1999, 1 percentage point more than the all items index (RPI). The gap reflects the reduction of interest payments due to lower mortgage interest rates. The standardized (HICP) inflation rate was only 1.2 per cent in September 1999.

CHART 1.1.5

Changes in consumer price indices in the euro area and the United States, January 1996-September 1999

(Percentage change over same month of preceding year)



Source: Eurostat and Bureau of Labor Statistics.

Note: In the case of the euro area, the "All items excluding food and energy" index also excludes tobacco and alcohol.

supported by further large gains in employment and real incomes, as well as by gains in financial wealth. Aggregate consumer spending continued to rise faster than disposable incomes in the second quarter, the negative household savings ratio increasing to 1.3 per cent. But consumer confidence weakened in the course of the third quarter against the background of tighter monetary policy and volatile share prices.

In the business sector, fixed investment in machinery and equipment, notably information processing equipment has continued to advance at a rapid rate. Residential investment has also remained strong, although single family housing has been stagnant, albeit at a high level. But reductions in business inventories (largely in the retail sector) were a major drag on domestic activity in the second quarter. This was the third consecutive quarter during which inventory changes subtracted from economic growth.

Exports picked up again in the second quarter, benefiting from the improvement in global economic activity, notably in East Asia.[13] But the buoyancy of domestic demand led to a further surge in import growth (to a quarterly increase of nearly 4 per cent). The change in real net exports subtracted nearly half a percentage point from the overall economic growth rate in the second quarter. With domestic demand persistently outpacing domestic supply, the current account deficit rose to a record 3.6 per cent of GDP in the second quarter of 1999.

The continued rise in output has been accompanied by further increases in employment. Non-farm employment rose in each of the first eight months of 1999 but stagnated in September, because of bad weather. Quarter-to-quarter gains in employment have been relatively steady at some 0.5 per cent since the second quarter of 1998. Employment in the third quarter of 1999 was about 2 per cent higher than a year earlier. Services continued to be the main source of increasing employment. In contrast, labour shedding continued in the manufacturing sector, though the rate of decline moderated in the third quarter of 1999. Employment growth also slowed down in the construction sector. The pool of available workers searching for a job has been largely depleted. Between March and September the unemployment rate remained at, or slightly above, a 30-year low of 4.2 per cent. Despite widespread reports of labour shortages there is little evidence of acceleration in nominal wages and salaries.[14] Robust growth in hourly earnings in the non-farm business sector since early 1998 has so far been largely offset by productivity gains. In fact, labour productivity (output per hour worked) rose by 2.8 per cent in the first half of 1999 (over the same period in 1998), the largest increase in the current upswing. A strengthening of productivity growth at such an advanced stage of the business cycle is unusual.

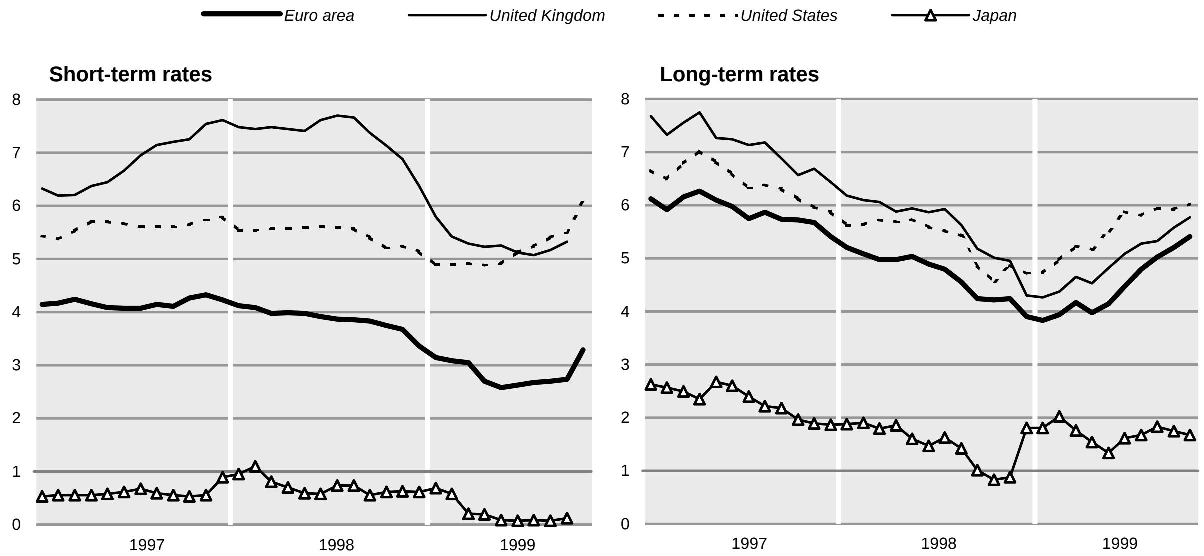
[13] The value of merchandise exports to the Republic of Korea rose by 52 per cent in January-August 1999 compared with the same period of 1998.

[14] Federal Reserve Board, *The Beige Book*, 22 September 1999 [www.bog.frb.fed.us].

CHART 1.1.6

Nominal short-term and long-term interest rates, January 1997-October 1999

(Average monthly rates, per cent per annum)



Source: National statistics; OECD, *Main Economic Indicators* (Paris), various issues; European Central Bank; *Financial Times*, various issues.

Note: Short-term rates: three-month money market rates. Long-term rates: yields on 10-year government bonds. Long-term interest rates for the euro area are GDP-weighted averages of national rates. The same holds for short-term interest rates before 1999. The figures for October 1999 are average rates for the first half of the month.

Consumer price inflation has remained relatively moderate in 1999. The rise in energy prices led to some upward pressure on the average price level, contributing to a rise in the average inflation rate to above 2 per cent since April 1999. Inflation accelerated slightly to 2.6 per cent in September, up from 1.7 per cent at the beginning of the year (chart 1.1.5). Core inflation (CPI excluding energy and food) has remained broadly stable at 2 per cent over the same period. There was relatively strong upward pressure on producer prices in September 1999, largely due to the surge in oil prices.

In *Canada*, the rate of economic expansion remained quite strong in the second quarter. Real GDP rose by 0.7 per cent and was 3.7 per cent higher than in the second quarter of 1998. The overall performance reflects to a large extent the buoyant domestic demand in the United States, which accounts for more than 80 per cent of Canadian exports. But economic growth has also been increasingly supported by private consumption and business fixed investment in machinery and equipment, and by a strong pick-up in residential investment.

(b) Monetary conditions

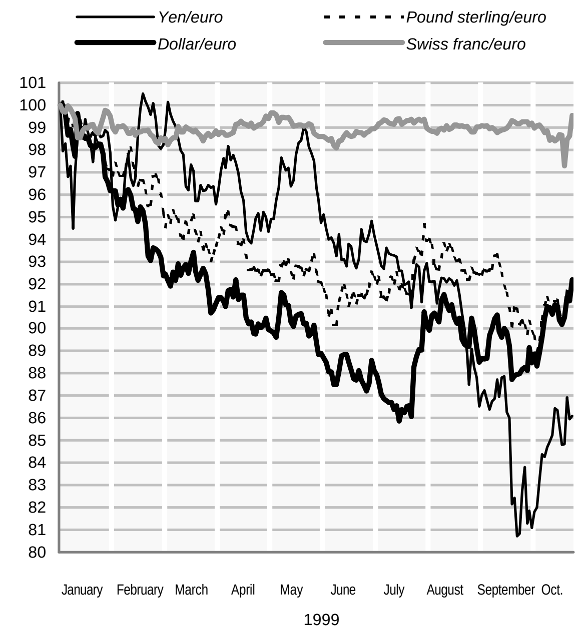
Monetary conditions have continued to support the expansion of economic activity in the *euro area*. The stance of monetary policy has not been changed since the ECB lowered its key repo-rate by half a percentage point to 2.5 per cent in April 1999. Three-month EURIBOR have fluctuated within a narrow range of about 2.6 to 2.7 per cent between September and May. But money market conditions firmed significantly in the first half of October, with three-month interest rates rising to some 3.3 per cent. But short-term rates were still low compared with preceding years (chart 1.1.6). This conspicuous rise in three-month interest rates reflects, to a large part, the increased risk premium required by lenders of short-term funds for the provision of liquidity around the turn of the year on account of the perceived Y2K problem. Another influence was probably the expectations of strengthening economic activity and, associated with that, an increased probability of a tightening of monetary policy. Average real short-term interest rates (based on the harmonized consumer price index) were only 1.5 per cent in September 1999, down from 2.4 per cent at the beginning of the year.

In the *United Kingdom*, the Bank of England's Monetary Policy Committee raised its base lending rate by a quarter of a percentage point to 5.25 per cent in early September 1999. Interest rates had been successively lowered from 7.5 per cent between October 1998 and the spring of this year. The decision was motivated by expectations of mounting inflationary pressures in a context of stronger economic growth, the risks of rising wage cost pressures in already tight labour markets and a strong increase in housing prices.

In the *United States*, monetary policy was tightened in late June and August 1999, the target for the federal funds rate being raised in two steps from 4.75 per cent to

CHART 1.1.7

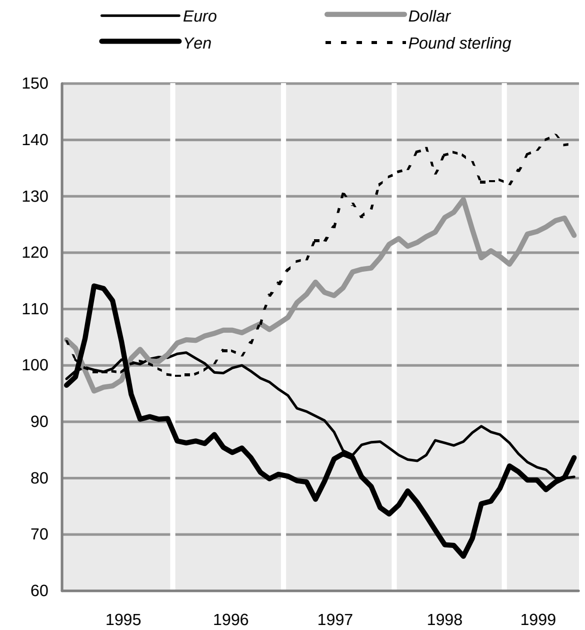
Euro reference rates, January 1999-October 1999
(Indices, 4 January 1999=100)



Source: European Central Bank.
Note: Daily rates from 4 January to 15 October 1999.

CHART 1.1.8

Real effective exchange rates, January 1995-August 1999
(Indices, 1995=100)



Source: IMF, *International Financial Statistics* (Washington, D.C.), September 1999.

Note: Based on relative unit labour costs. The real effective exchange rate for the euro before January 1999 is based on the so-called "synthetic euro", i.e. a trade-weighted average of the bilateral exchange rates of the participating EMU countries against the dollar using their national conversion rates vis-à-vis the euro. For more information see the source.

5.25 per cent. This increase of 50 basis points largely reversed the lowering of interest rates by 75 basis points between end-September and mid-November of last year. The tightening of monetary policy is intended to check the build-up of inflationary expectations in an environment where calm has been restored in the international financial markets. Interest rates have since remained unchanged, but in early October 1999 the FOMC announced a "tightening bias" in its money market operations. The background to this was the persistent growth of domestic demand in excess of domestic supply, the decreasing pool of workers available to take jobs, and the ensuing risks of rising labour cost pressures. Another likely factor in this decision was the high level of share prices, which are generally judged to be significantly overvalued. Nominal short-term interest rates rose on average to 5.5 per cent in September 1999, up from 4.9 per cent in January 1999 (chart 1.1.6). As in the euro area, and for largely the same reasons, United States money market rates firmed significantly to above 6 per cent in the first half of October 1999.

Long-term interest rates have steadily edged upwards since early 1999, more or less in line with the improved global economic outlook and less favourable expectations for inflation (chart 1.1.6). There was initially some decoupling between the United States and the euro area, which led to a sizeable yield differential of about 1.4 percentage points in favour of United States treasuries in June. But this gap was reduced to 0.6 percentage points in the first half of October 1999.

In the *foreign exchange markets* in 1999, the steady depreciation of the euro against the dollar was arrested in mid-July, when the bilateral exchange rate was close to parity (with a low of $1.0124 on 12 July), corresponding to a depreciation by some 14 per cent compared with the first trading day on 4 January. The ensuing appreciation of the euro petered out in early August, and it has since been difficult to discern any clear tendency (chart 1.1.7). This development can be partly attributed to the increasing evidence of a strengthening cyclical upturn in the euro area and a marked narrowing of the differential between long-term bond yields in the United States and the euro area.

The real effective exchange rate index of the euro fell by about 7 per cent in August 1999 compared with both January 1999 and August 1998. The real effective dollar exchange rate fell in August 1999, but it was still some 4.5 per cent higher than in January. Compared with its recent peak in August 1998, however, the dollar has weakened by about 5 per cent (chart 1.1.8).

(c) The short-term outlook

TABLE 1.1.3

Real GDP in the developed market economies, 1996-1999
(Percentage change over previous year)

	1996	*1997*	*1998*	*1999* [a]
Western Europe	1.9	2.7	2.6	1.9
4 major countries	1.3	2.0	2.2	1.7
France	1.1	2.0	3.2	2.5
Germany	0.8	1.5	2.2	1.4
Italy	0.9	1.5	1.3	1.2
United Kingdom	2.6	3.5	2.2	1.7
17 smaller countries	3.1	4.1	3.5	2.3
Austria	2.0	2.5	3.3	2.2
Belgium	0.9	3.2	2.9	1.7
Cyprus	2.0	2.5	5.0	4.5
Denmark	2.8	3.1	2.7	1.6
Finland	4.1	5.6	5.6	3.8
Greece	2.4	3.2	3.7	3.2
Iceland	5.6	4.4	5.0	5.1
Ireland	7.7	10.7	8.9	7.5
Israel	4.6	2.9	2.2	2.0
Luxembourg	3.0	3.7	5.7	3.3
Malta	4.0	4.8	4.1	2.2
Netherlands	3.0	3.8	3.7	2.8
Norway	4.9	4.3	2.1	0.5
Portugal	3.2	3.7	3.5	3.1
Spain	2.3	3.7	4.0	3.3
Sweden	1.3	1.8	2.6	3.8
Switzerland	0.3	1.7	2.1	1.2
Turkey	7.0	7.5	2.8	-1.0
North America	3.3	3.9	3.8	3.8
Canada	1.7	4.0	3.1	3.6
United States	3.4	3.9	3.9	3.8
Total above	2.6	3.3	3.2	2.8
Japan	5.0	1.4	-2.8	1.0
Total above, *including Japan*	3.0	3.0	2.3	2.5
Memorandum items:				
European Union	1.6	2.5	2.7	2.1
Euro area	1.4	2.3	2.7	2.1

Source: National statistics and national economic reports. Consensus Economics Inc., *Consensus Forecasts.*

Note: All aggregates exclude Israel.

[a] Forecasts.

The current consensus of forecasts is for an annual increase in real GDP by 2 per cent in the European Union and the euro area in 1999. The average rate of growth is slightly lower for western Europe largely because of the adverse effects of the recent earthquake on economic activity in Turkey, where real GDP is declining this year (table 1.1.3). This overall picture masks a considerable variation in the economic performance of individual countries, with buoyant growth in many of the smaller economies contrasting with the more sluggish performance of major economies such as Germany and Italy. In North America, economic growth will be somewhat stronger than expected earlier this year. Real GDP now seems likely to increase by 3.8 per cent in 1999, unchanged from last year and, again, significantly higher than in western Europe. This regional growth pattern, however, is expected to change next year, when the recovery in western Europe is forecast to gain further momentum and for a cyclical slowdown to occur in the United States. Current forecasts point to an increase in real GDP by 2.9 per cent in western Europe in 2000, largely reflecting stronger growth in the four major economies (table 1.1.3). The cyclical slowdown in the United States is expected to be relatively mild (the "soft landing" scenario) which would imply an increase in real GDP in 2000 of about the same rate as in western Europe.

This scenario assumes not only favourable economic developments in the emerging markets and Japan but also (and most importantly) a smooth reversal of the considerable domestic and external imbalances which have built up in the United States economy over the past several years. Developments could turn out, however, to be much less favourable. A sharp and sustained fall of United States share prices would risk an abrupt slowdown in domestic demand. In a similar vein, the rise in the United States current account deficit to record levels is testing the willingness of foreigners to continue to provide the necessary financing. A sudden shift in investor sentiment away from dollar-denominated assets (triggered for example by the strengthening of economic growth in western Europe and Japan) could lead to a substantial decline in the external value of the dollar. This would not only exert upward pressures on United States interest rates but would also lead to a corresponding strong appreciation of the euro and the yen, with ensuing negative repercussions on the export performance of the euro area and Japan. Finally, mounting inflationary pressures could trigger a stronger than currently anticipated tightening of United States monetary policy. The overall improved short-term economic prospects therefore remain subject to major downside risks.

A key feature of the optimistic growth scenario is that the slowing down of economic growth in the United States will be offset by stronger growth in western Europe and Japan, thus helping to reduce the United States current account deficit and to support global economic activity. But this is only one reason for the need to ensure a sustained recovery in western Europe. Sustained and strong growth is also necessary to help alleviate the persistent problem of high unemployment.

The current consensus is for a significant improvement of economic performance in western Europe in 2000. The strengthening of economic growth is expected to lead to further gains in employment and falling unemployment. Inflation has fallen to low levels and is expected to remain moderate next year. This contrasts with strengthening expectations in financial markets of a tightening of monetary policy in the euro area on account of perceived upward risks of inflationary pressures, expectations which have also contributed to the recent rise in the yields on long-term bonds. But a tightening of monetary policy at the current juncture would not be appropriate and would be difficult to justify in the light of the two pillars of the ECB's monetary policy strategy. One pillar is the reference value for the annual increase in monetary supply (M3) fixed at 4.5 per cent by the ECB. Actual money supply growth was by about 1 percentage point above the reference value in late summer and the divergence has been increasing in the course of the year. But these changes in money supply should be interpreted with caution. The existence of a stable relationship between changes in money supply and inflation has still to be proven for the euro area. Also, the recent strengthening of money supply growth may be influenced by special factors such as an increased liquidity propensity in the run-up to the year 2000 (the Y2K problem). Also, the assessment of inflation prospects, the second pillar of the ECB's monetary policy strategy, does not currently provide any cause for concern. In the euro area, the consensus of current forecasts are for an average inflation rate of some 1.5 per cent in 2000, up from 1¼ per cent in the current year but significantly below the 2 per cent ceiling of the ECB's inflation target. The impact of higher oil and commodity prices on consumer price inflation has been negligible. High unemployment can also be expected to restrain wage increases in a context of stronger growth. There is excess capacity on global manufacturing industry and therefore intensive price competition, which will tend to maintain downward pressure on retail prices. In addition, there are the benign price effects of deregulation in the telecommunications and electricity markets. Given all these elements, it is difficult at present to see any good reason for an increase in ECB interest rates. In view of the still nascent recovery in most of the euro area such a move would also be premature. Keeping monetary policy on hold would in fact be in line with the other main objective of the ECB specified in the Treaty, namely to support economic activity and employment in the euro area.

1.2 The transition economies

(i) Introduction

While 1999 began as a difficult and challenging year for the transition economies, the worst case scenarios and downside risks have been avoided. Moreover, as the year progressed, there were distinct signs of improvements in trade (section 1.2(v)) which had been subject to an exceptionally precipitous drop in the wake of the 1998 Russian crisis, and in output (section 1.2(ii)). This, in combination with the expectation of continued improvement in economic conditions in the west European market economics (section 1.1 above), has led to an overall outlook of cautious optimism, less subdued for central and eastern Europe.

Differential ability to respond to adverse conditions unfortunately served to widen further the gap between the more stable, advanced and flexible economies in transition, and those whose restructuring and liberalization have been delayed or stalled. Geography also played a notable role in the uneven impact of the continuing aftershocks of the Russian crisis of 1998, not just in the countries of the CIS. No country in south-east Europe could escape the economic impact of the Kosovo conflict;[15] the Baltic states' exceptional reliance on exports to their Russian neighbour led to a massive initial trade shock and was an exceptional blow to output and employment.

The caution in prognosis is necessarily much more profound for the countries of the CIS than for those of central and eastern Europe. The relief at the recovery from the collapse of the economy after August 1998 cannot blind any observer who notes that the intervening period has seen no basic structural reforms, and certainly little or no improvement in the progress towards the rule of law, more well-defined property rights and transparency. The *Survey* has consistently analysed the reasons why the long-postponed return to sustained growth in Russia cannot occur without confronting these issues. Moreover, the magnitude of the resources required for serious restructuring, *a fortiori* in conditions of democracy requiring popular support, is still not recognized by the international community.

For the more advanced reformers, on the other hand, the successful weathering of this recession, even with less than hoped for outcomes, does mark the achievement of a level of maturity in economic management. For even the more dynamically growing countries, notably Hungary and Poland, the recession posed challenges to fiscal balance, tested the often difficult coordination of monetary and fiscal policy, and demanded a thoroughly professional capacity to assess the indicators and to inform the markets of what to expect. A notable marker of this maturing stability has been the capacity of these countries (and, for example, the Baltic states) to cover trade deficits which might, *ex ante*, have been considered dangerously high (section 1.2(vi)).

Clearly this does not yet indicate that the fragility of the transition economies is a question of history, but it is an indicator of the distance the most advanced have travelled. If the more favourable official forecasts of growth were to be achieved across the ECE transition economies next year, this would provide a much more favourable environment for change in the lagging countries, given the proper international support, which must necessarily include that of the European Union.

Across the region, governments have been presenting drafts of budgets with projections of a somewhat tighter fiscal stance. While these have met with predictable opposition and resistance in a number of places – in Latvia there will be a referendum on pension

[15] This question is addressed in depth in UN/ECE, *Economic Survey of Europe, 1999 No. 2*, chap. 1, "Postwar Reconstruction and Development in South-East Europe", pp. 1-22.

reform, an initiative which required the signatures of 10 per cent of the electorate – the ease of achievement of these targets will also depend to a substantial extent on the fulfilment of the expectation for renewed growth.

(ii) Output and demand

Economic activity in a number of ECE transition economies has remained subdued throughout most of 1999 due to the adverse external environment. The negative aftershocks of the global financial turmoil in 1997 and 1998 – and especially of the Russian crisis in 1998 – continued to affect some of the more exposed transition economies. In addition, the Kosovo conflict had serious negative repercussions not only on the economies of the countries directly involved in the conflict but also on the whole of south-eastern Europe. However, the combined strength of these negative shocks was diminishing during the course of the year and by the third quarter most of the affected transition economies had probably passed the worst of the crisis.

The general weakening of output which began in the second half of 1998 intensified during the first quarter of 1999 when almost half of the ECE transition economies that compile quarterly GDP figures reported falling GDP (table 1.2.3).[16] The aggregate GDP growth figures for the three main subregions (eastern Europe as a whole, the Baltic states and the CIS) also turned negative. This was the first case of synchronized recession among the transition economies – and one covering a large number of countries – since the great transformation shock of the early 1990s.

However, there has been a certain revival of economic activity throughout the whole region since the second quarter when the majority of the transition economies reported better year-on-year output figures (in terms of either stronger growth or slower output decline). The strengthening of economic recovery in western Europe (in particular of west European import demand) helped to improve expectations in many of the transition economies. As a result, by mid-year the overall trend of economic activity in the transition economies as a whole was rising and starting to offset the setbacks in the first quarter.

Nevertheless, the year-on-year rate of change in the aggregate GDP of the transition economies was still negative (-0.3 per cent) for the first half of 1999 (table 1.2.1). The Baltic states did the worst with a 3.8 per cent decline in their aggregate GDP in this period, while the strengthening of output in most of the central and east European economies in the second quarter reversed the decline of the first quarter (table 1.2.3), resulting in a small increase in aggregate GDP in the first half of 1999 (0.3 per cent). In Russia the upturn during the second quarter was not sufficient to offset completely the decline of output in the first quarter, and for the CIS as a whole GDP declined by 0.5 per cent, year-on-year, in the first half of 1999 (table 1.2.1).

(a) Eastern Europe and the Baltic states

Among the east European transition economies economic growth was rather uneven in the first half of 1999, with distinctly different performance in central Europe (where aggregate GDP grew by 1.7 per cent year-on-year) and in south-east Europe (where the comparable change in GDP was -3.5 per cent). While these two subregions have persistently diverged during the course of transition, the difference in the growth patterns has recently surfaced as one of the main distinguishing characteristics of these two groups. In fact, most of the south-east European transition economies (with the exceptions of Romania and Yugoslavia) have made considerable progress towards macroeconomic (in particular price) stability during the last several years; so far, however, this has not been sufficient to set them on a path of sustained recovery.[17]

In contrast, the more advanced economies of *central Europe* have already acquired a satisfactory degree of resilience and they have been able to weather relatively successfully the negative effects of the recent global financial turmoil. Although they were also affected by the collapse of exports to Russia, the negative impact of the shock was relatively short-lived and its amplitude was in general smaller than for other transition economies. The effect of the external shock on output was least pronounced in Hungary and Slovenia where GDP continued to grow at relatively high rates in the first half of 1999. These two countries had the highest rates of economic growth among the east European and Baltic economies; however, the factors behind this strong performance were quite different in each country.

Hungary's robust performance continued to be driven by an export-led expansion in the manufacturing sector although its pace decelerated from the very high rates seen in 1997-1998. Hungary's GDP in the first half of 1999 grew by 3.6 per cent, year-on-year; although this was high compared with other transition economies, it was still some 1-2 percentage points less than expected *ex ante*. The rate of growth of industrial output in Hungary was also the highest among the east European transition economies (table 1.2.3)[18] although there were large differences among the various manufacturing branches. Electrical engineering and the automotive branches remained the principle driving forces of economic growth (thanks to the continuing expansion of exports to western Europe) while the output of other manufacturing industries stagnated or even declined. Private domestic demand (in particular retail sales – table

[16] At present the statistical offices in 23 out of 27 transition economies compile quarterly GDP statistics, although at varying levels of detail (table 1.2.3), which is a considerable progress compared with the situation several years ago. Only Albania, Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia do not yet report such statistics.

[17] For a more detailed discussion on the economic problems of the south-east European transition economies see UN/ECE, *Economic Survey of Europe, 1999 No. 2*, chap. 1, op. cit.

[18] Leaving aside the special case of Bosnia and Herzegovina.

1.2.4) also remained relatively strong, reflecting the favourable expectations of consumers.

By contrast, the unexpectedly strong economic growth in Slovenia in the first half of 1999 (and especially during the second quarter when quarterly GDP grew by 6.4 per cent, year-on-year) was mostly driven by an upsurge in final domestic demand. Thus according to preliminary estimates, real investment outlays during the first six months increased by 26 per cent, year-on-year,[19] and quarterly real retail sales in the second quarter rose by 15.5 per cent.[20] The main reason for this unexpected surge in domestic demand in the second quarter seems to be the introduction of VAT in July, which was expected to increase certain domestic prices and which led to large anticipatory purchases. At the same time, gross industrial output and the dollar value of exports were declining in the first half of the year (tables 1.2.2 and 1.2.3), while the tourist industry was badly affected by the implications of the Kosovo crisis.[21] The demand-driven upsurge in output in the second quarter is therefore likely to have been a temporary phenomenon.

[19] Institute of Macroeconomic Analysis and Development, *Slovenian Economic Mirror* (Ljubljana), July 1999.

[20] UN/ECE secretariat calculations, based on national statistics.

[21] Thus, in the second quarter of the year the number of foreign tourists dropped by 18.6 per cent compared with the same period of 1998. Institute of Macroeconomic Analysis and Development, op. cit.

TABLE 1.2.1

Basic economic indicators for the ECE transition economies, 1997-2000

(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)*		
			1999												
	1997	*1998*	*April official forecast*	*Jan.-Jun. actual*	*October official forecast*	*2000 official forecast*	*1997*	*1998*	*Jan.-Jun. 1999*	*1997*	*1998*	*1999* [a]	*1997*	*1998*	*Jun. 1999*
Eastern Europe	2.2	1.5	2.9	0.3	1	3	4.8	1.2	-3.2	..	..	..	11.9	12.6	..
Albania	-7.0	8	8	..	5-6	8	-5.6	10	18.0	42.0	7.8	-1.4	14.9	17.6	18.0
Bosnia and Herzegovina [b]	..	..	..	..	18	..	35.7	23.8	9.6	12.2	2.2	-1.6	39*	38.5	39.0
Bulgaria	-6.9	3.5	3.7	0.5	1.5	4	-10.0	-12.7	-13.4	578.7	0.9	-3.2	13.7	12.2	12.8
Croatia	6.8	2.5	1.5-2	-1.1	–	..	6.8	3.7	-1.9	4.0	5.6	3.9	17.6	18.6	18.9
Czech Republic	0.3	-2.3	-0.8	-1.9	-0.5	1.4	4.5	1.6	-6.6	9.9	6.7	2.2	5.2	7.5	8.4
Hungary	4.6	5.1	5	3.6	4-5	4.5	11.1	12.5	6.9	18.4	10.4	9.1	10.4	9.1	9.4
Poland	6.9	4.8	4.5	2.3	4	5.2	11.5	4.6	-0.7	13.2	8.5	6.3	10.3	10.4	11.6
Romania	-6.9	-7.3	-2	-3.9	-4.8	0.4	-7.2	-17.0	-9.4	151.7	40.7	48.1	8.8	10.3	11.3
Slovakia	6.5	4.4	3	2.4	2.8	2.5	1.7	5.0	4.3	6.5	5.5	7.1	12.5	15.6	17.7
Slovenia	4.6	3.9	4	4.5	3.5	3¾	1.0	3.7	-2.3	8.8	6.6	4.3	14.8	14.6	13.4
The former Yugoslav Republic of Macedonia	1.5	2.9	6	..	1-2	..	1.6	4.5	-9.7	4.5	-1.0	..	42*	..	..
Yugoslavia [c]	7.4	2.6	7	..	-24	..	9.5	3.6	-28.4	10.3	45.7	36.5	25.6	27.2	..
Baltic states	8.4	4.4	4.5	-3.8	¾	3¾	8.2	4.9	-10.0	..	..	..	6.3	7.3	8.1
Estonia	10.6	4.0	4	-3.9	0.4	3.8-4.0	14.6	2.3	-9.8	12.3	6.8	3.3	4.6	5.1	6.7*
Latvia	8.6	3.6	4	-2.0	1	3.5	13.8	3.1	-13.9	7.0	2.8	1.9	6.7	9.2	10.0
Lithuania	7.3	5.1	5	-4.8	0.3-1.3	3.5-3.8	3.3	7.0	-8.4	8.5	2.4	0.6	6.7	6.9	7.5
CIS	1.1	-2.8	-1.1	-0.5	1¼	2½	2.6	-3.0	2.6	..	..	..	7.6	9.0	8.3
Armenia	3.3	7.2	4	4.9	4	..	8.2	-2.7	2.8	21.8	-1.2	2.2	11.0	8.9	10.4
Azerbaijan	5.8	10.0	9	5.6	6.5-7.0	8	0.3	2.2	2.0	0.3	-7.6	-9.7	1.3	1.4	1.2
Belarus	11.4	8.3	4-6	2.2	4	..	18.8	12.0	7.0	63.4	181.6	329.8	2.8	2.3	2.1
Georgia	11.3	2.9	8	1.7	4	..	8.2	-2.7	0.6	7.3	10.8	21.0	8.0	4.2	5.5
Kazakhstan	1.7	-2.5	1.5	-3.3	-1.5	1	4.0	-2.1	-4.1	11.3	1.9	9.8	3.9	3.7	3.5
Kyrgyzstan	9.9	1.8	2.8	0.4	2.8	4	50.4	8.8	-10.0	14.7	18.3	41.4	3.1	3.1	3.1
Republic of Moldova [d]	1.6	-8.6	-3	-5.3	(-2-3)	2	–	-11.0	-25.2	11.1	18.2	42.8	1.7	1.9	2.3
Russian Federation	0.9	-4.6	-2.5	-0.7	0.5-1.5	1.5-3	2.0	-5.2	3.1	11.0	84.5	120.8	11.2	13.3	12.4
Tajikistan	1.7	5.3	..	2.3	3	..	-2.0	8.2	7.9	159.9	2.7	19.3	2.8	2.9	3.2
Turkmenistan	-11.4	5.0	..	14.6	7	..	-32.3	0.2	18.0	21.5	19.8	24.9	..	..	..
Ukraine	-3.2	-1.7	-1	-3.0	–	2	-0.3	-1.5	0.2	10.1	20.0	26.5	2.8	4.3	4.0
Uzbekistan	5.2	4.4	4.4	3.8	4.4	5	4.1	5.8	5.6	27.5	25.9	29.5	0.3	0.4	0.6
Total above	1.6	-1.1	0.7	-0.3	1	2¾	3.7	-1.0	-0.2	..	..	..	..	..	..
Memorandum items:															
CETE-5	4.8	3.2	3.6	1.7	3	4	8.3	5.1	-0.6	..	..	..	9.8	10.2	11.3
SETE-7	-3.9	-2.6	1.3	-3.5	-4½	½	-4.0	-9.9	-11.9	..	..	..	14.3	15.4	..
Former GDR	1.7	2.0	..	..	..	..	7.0	7.6	2.7	2.3	1.1	0.2	19.4	17.4	16.8

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

Note: Aggregates are UN/ECE 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 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 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 June 1999 over June 1998.

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

c Gross material product instead of GDP.

d Excluding Transdniestria.

TABLE 1.2.2

International trade and external balances of the ECE transition economies, 1997-1999
(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)*		
	1997	*1998*	*1999* [a]	*1997*	*1998*	*1999* [a]	*1997*	*1998*	*1999* [a]	*1997*	*1998*	*1999* [a]
Eastern Europe [b]	6.6	9.4	-4.5	6.4	9.2	-5.6	-10.3	-10.0	-9.5	-4.3	-4.6	-5.6
Albania	-35.6	50.9	69.5	-32.1	28.2	14.2	-21.1	-19.2	-15.9	-11.9	-1.5	1.8
Bosnia and Herzegovina	232.1	134.5	22.6	29.2	30.2	-18.8	-40.8	-38.4	-26.2	-31.7	-26.8	-37.1[c]
Bulgaria	1.0	-13.1	-21.7	-2.8	1.3	-1.0	0.1	-5.7	-13.6	4.2	-3.1	-10.2
Croatia	-7.6	8.9	-9.1	16.9	-7.9	-10.2	-24.3	-17.7	-17.5	-11.5	-7.1	-10.6
Czech Republic	4.0	15.7	0.7	-2.0	6.0	-1.3	-8.3	-4.3	-2.8	-6.1	-1.9	-0.1
Hungary	21.6	20.4	5.8	17.0	21.1	7.2	-4.7	-5.7	-6.6	-2.1	-4.8	-5.2
Poland	5.4	2.6	-8.1	13.9	10.9	-6.6	-11.6	-11.9	-11.6	-3.0	-4.3	-6.9
Romania	4.3	-1.6	-7.0	-1.4	4.8	-11.5	-8.2	-9.2	-7.7	-6.1	-7.8	-5.6
Slovakia	0.2	11.2	-6.7	-8.0	10.9	-13.3	-10.2	-10.7	-6.6	-10.0	-10.1	-7.9
Slovenia	0.7	8.1	-3.5	-0.6	7.8	3.1	-5.5	-5.4	-9.2	0.2	–	-4.7
The former Yugoslav Republic of Macedonia	2.8	11.0	-19.1	7.8	9.0	-22.2	-15.5	-17.0	-6.7	-7.5	-8.2	-2.3
Yugoslavia	45.0	6.8	-48.3	17.3	0.5	-51.8	-10.9	-12.2	..	-6.7	-7.9*	..
Baltic states	23.1	3.5	-15.8	26.7	7.5	-18.2	-21.9	-22.4	-17.8	-9.5	-11.1	-9.7
Estonia	41.1	10.3	-10.3	37.4	7.8	-20.8	-32.5	-29.8	-19.5	-12.2	-9.2	-5.5
Latvia	15.9	8.3	-9.5	17.4	17.1	-11.8	-18.6	-21.5	-16.3	-6.1	-11.1	-9.3
Lithuania	15.1	-3.9	-23.5	23.8	2.6	-19.4	-18.6	-19.4	-18.0	-10.2	-12.1	-12.1
CIS	1.2	-13.3	-5.1	19.5	-12.0	-39.0	5.4	6.6	15.0	-0.4	-1.6	..
Armenia [c]	-11.9	-12.9	30.9	4.5	13.2	-7.0	-27.9	-29.1	-32.0	-27.9	-26.5	-37.7[d]
Azerbaijan	18.2	-7.2	53.7	-28.7	51.8	-6.2	-1.0	-7.3	-6.0	-23.1	-33.1	-28.6
Belarus	1.8	-0.7	35.9	21.2	4.3	-27.0	-7.1	-8.1	-0.3	-6.0	-7.1	0.6
Georgia [c]	45.9	-17.4	18.5	44.0	12.7	-49.6	-10.0	-12.0	-10.6	-10.1	-11.1	-2.7
Kazakhstan	28.7	-7.9	-9.4	52.0	13.8	-14.1	7.0	4.4	7.3	-3.6	-5.3	-8.3[d]
Kyrgyzstan	154.5	-0.7	-2.7	-22.2	46.8	-18.6	0.7	-7.4	-3.0	-7.8	-23.4	-15.7[d]
Republic of Moldova	5.9	-23.9	3.2	35.0	3.0	-60.1	-15.6	-23.2	-11.6	-13.9	-20.4	-2.5
Russian Federation	-1.2	-15.8	-6.3	23.2	-16.8	-44.7	6.8	9.2	20.0	0.9	0.6	11.5
Tajikistan	7.7	-16.7	-7.9	-6.0	-1.2	-4.7	22.2	9.8	13.2	-6.5	-10.6	..
Turkmenistan	-50.8	47.3	36.6	18.0	-0.2	49.1	-8.6	-3.2	-6.0	-21.6	-34.2	–[c]
Ukraine	23.6	-2.4	-7.7	12.8	-6.5	-40.5	2.8	4.0	12.7	-2.7	-3.1	3.1
Uzbekistan[e]	-19.0	-9.8	-8.0	-4.6	-26.0	-7.3	-2.4	1.2	2.8	-4.0	-0.4	..
Total above [b]	4.8	-0.6	-5.2	10.7	3.3	-14.9	-1.4	-2.4	-0.3	-2.1	-3.2	..
Memorandum items:												
CETE-5	7.1	11.6	-2.0	6.5	11.4	-2.5	-9.3	-9.0	-8.6	-3.7	-4.1	-5.3
SETE-7 [b]	4.7	1.1	-15.5	6.0	2.1	-16.5	-13.1	-12.9	-13.1	-6.5	-6.6	-7.4

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE secretariat; IMF; UN/ECE 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. Trade values include the "new trade" among the successor states of former Czechoslovakia and the former SFR of Yugoslavia, but not intra-CIS trade. Current-price GDP values for the first half of 1999 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.

b Aggregates of current account balances exclude Bosnia and Herzegovina and Yugoslavia.

c Current account excludes official transfers.

d January-March 1999.

e Growth rates for 1998 and 1999 are based respectively on CIS Statistical Committee estimates for merchandise trade values in 1998 and on TACIS estimates for January-June 1998 and 1999.

TABLE 1.2.3

GDP and industrial output in the ECE transition economies, 1998-1999
(Percentage change over the same period of the preceding year)

	GDP							*Industrial output*						
	1998				*1999*			*1998*				*1999*		
	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.-Aug.*
Eastern Europe	3.1	3.0	2.5	1.5	-0.4	0.3	..	5.8	4.3	3.4	1.2	-3.9	-3.2	-2.5
Albania	..	..	..	8.0	..	..	..	-14.3	0.4	10.7	10.0	26.6	18.0	10.0
Bosnia and Herzegovina	..	..	..	..	..	..	..	14.2	21.1	25.4	23.8	11.7	9.6	9.3[a]
Bulgaria	16.8	8.9	4.3	3.5	-0.7	0.5	..	6.2	-0.7	-6.7	-12.7	-16.2	-13.4	-14.9
Croatia	5.7	5.7	5.0	2.5	-1.5	-1.1	..	6.4	5.8	6.8	3.7	-3.6	-1.9	-2.8[a]
Czech Republic	-0.7	-1.3	-1.8	-2.3	-4.1	-1.9	..	8.4	6.7	5.0	1.6	-9.1	-6.6	-5.6
Hungary	4.5	4.8	5.1	5.1	3.3	3.6	..	13.6	13.5	13.5	12.5	6.9	6.9	7.5
Poland	6.4	5.8	5.5	4.8	1.5	2.3	..	11.0	8.4	7.0	4.6	-2.6	-0.7	1.5[a]
Romania	-9.4	-5.2	-5.7	-7.3	-4.6	-3.9	..	-21.8	-19.0	-17.0	-17.0	-9.6	-9.4	-9.0
Slovakia	6.2	6.2	5.8	4.4	1.8	2.4	..	4.7	5.3	6.4	5.0	3.8[b]	4.3[b]	3.8[b]
Slovenia	6.1	4.3	4.1	3.9	2.5	4.5	..	9.8	4.8	4.5	3.7	-2.9	-2.3	-2.1
The former Yugoslav Republic of Macedonia	..	..	..	2.9	..	..	..	8.3	9.6	7.9	4.5	-13.3	-9.7	-2.7[a]
Yugoslavia	..	..	..	2.6	..	..	..	15.9	12.3	7.0	3.6	-10.7	-28.4	-26.0[a]
Baltic states	8.7	8.4	6.3	4.4	-4.8	-3.8	..	11.9	10.2	8.1	4.9	-10.6	-10.0	-10.1
Estonia	9.8	7.9	5.8	4.0	-5.6	-3.9	..	13.9	10.2	6.2	2.3	-12.3	-9.8	-8.4
Latvia	8.9	7.2	5.4	3.6	-2.3	-2.0	..	14.7	11.2	7.0	3.1	-12.5	-13.9	-12.4
Lithuania	8.1	9.3	7.1	5.1	-5.8	-4.8	..	9.8	9.8	9.5	7.0	-9.1	-8.4	-9.9
CIS	1.0	0.5	-1.4	-2.8	-2.3	-0.5	..	3.2	1.6	-1.8	-3.0	-1.2	2.6	4.7
Armenia	6.4	6.7	6.9	7.2	4.6	4.9	..	4.3	3.2	0.6	-2.7	-4.4	2.8	7.7
Azerbaijan	8.2	9.1	8.5	10.0	6.2	5.6	6.9	0.2	0.7	1.1	2.2	4.1	2.0	2.7
Belarus	12.5	12.3	9.6	8.3	1.1	2.2	2.0	15.7	14.4	11.7	12.0	3.7	7.0	6.6
Georgia	11.2	8.9	7.3	2.9	1.2	1.7	2.4	-3.2	0.8	-1.2	-2.7	-5.7	0.6	1.2
Kazakhstan	1.9	1.7	–	-2.5	-3.6	-3.3	..	3.8	1.1	-1.2	-2.1	-4.1	-4.1	-1.2
Kyrgyzstan	11.5	5.0	1.4	1.8	0.3	0.4	3.5	52.1	23.5	9.7	8.8	-4.6	-10.0	-4.6[a]
Republic of Moldova	-4.2	-4.7	-4.7	-8.6	-7.8	-5.3	..	3.4	2.3	-5.7	-11.0	-27.1	-25.2	-16.0
Russian Federation	–	-1.0	-3.3	-4.6	-2.9	-0.7	..	2.2	0.4	-3.7	-5.2	-1.6	3.1	7.0[a]
Tajikistan	1.3	2.6	6.5	5.3	2.4	2.3	0.9	9.5	12.5	8.7	8.2	4.4	7.9	6.7
Turkmenistan	-8.0	3.0	3.7	5.0	13.3	14.6	14.0	-11.0	-5.0	2.0	0.2	15.0	18.0	18.0
Ukraine	-0.2	0.2	-0.5	-1.7	-4.8	-3.0	-1.7	1.7	0.7	-0.3	-1.5	-2.4	0.2	2.3[a]
Uzbekistan	3.3	4.0	4.4	4.4	2.9	3.8	4.3	4.3	5.5	6.1	5.8	4.7	5.6	5.6
Total above	2.0	1.6	0.2	-1.1	-1.6	-0.3	..	4.5	2.9	0.7	-1.0	-2.6	-0.2	1.2
Memorandum items:														
CETE-5	4.5	4.1	3.9	3.2	0.7	1.7	..	10.3	8.4	7.3	5.1	-2.1	-0.6	0.3
SETE-7	-0.8	0.1	-1.0	-2.6	-3.0	-3.5	..	-7.1	-7.2	-7.9	-9.9	-9.7	-11.9	-11.8
Former GDR	3.6	1.7	1.7	2.0	..	..	..	12.1	9.9	9.1	7.6	4.6	2.7	..

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

Note: Industrial output figures are based on monthly statistical reporting. Because of differences in coverage, monthly cumulative figures for 1998 as a whole differ slightly from reported annual figures for some countries. For these countries reported annual figures have been used. On regional aggregates see the note to table 1.2.1.

a January-September.

b Industrial sales.

Economic activity in the rest of the central European transition economies was generally weaker although it began to improve during the course of the year. The first quarter was particularly disappointing for the Czech economy as GDP fell by 4.1 per cent, year-on-year. However, after two years of recession the second quarter brought a long-awaited turnaround with quarterly GDP rising by 0.3 per cent. A recovery of private consumption (largely based on rising real incomes and improved expectations about the future) appears to have been the most important demand-side factor checking the fall in output: in the first six months of 1999 the real consumption of households increased by 1.2 per cent, year-on-year,[22] and the volume of retail sales by 1.8 per cent (table 1.2.4), while gross fixed capital formation declined by 7.1 per cent.[23] The basis of the recovery is still rather fragile as manufacturing activity remained subdued in the first half of the year with gross industrial output falling by 6.6 per cent, year-on-year.

22 UN/ECE secretariat calculations, based on national statistics.

23 Ibid.

The Polish economy performed in 1999 considerably below expectations, especially in the first quarter when GDP increased by a meagre 1.5 per cent. In the second quarter it accelerated to some 3 per cent bringing the GDP growth in the first six months to 2.3 per cent (compared with the same period of 1998), which was roughly half the official forecast for 1999 (table 1.2.1). Poor performance in mining and quarrying as well as in the manufacturing sector resulted in declining gross industrial output during the first half of the year (and especially during the first quarter – table 1.2.3). The continuing fall in exports to Russia (table 1.2.8) also contributed to the weakening in output performance. However, by the third quarter industrial output was recovering strongly when, according to preliminary data, it increased by 5.9 per over the same period of 1998.[24] The preliminary data on private consumption in 1999 are somewhat confusing: on the one hand, according to the retail trade statistics the volume of retail sales in Poland increased by 13.2 per cent in the first half of the year (table 1.2.4); on the other hand, recent polls suggest that in mid-1999 consumer confidence had fallen to a five-year low.[25] So it remains to be seen what turn these developments will take in the second half of the year.

The slowdown of economic growth in Slovakia was more or less in line with the *ex-ante* expectations, as the government had introduced a series of austerity measures aimed at curbing the fiscal and current account deficits. Gross fixed capital formation (including construction activity) were most affected by these measures as public financing of large infrastructure projects was reduced substantially.[26] The quarterly national accounts also indicate a significant positive net trade effect in the first half of the year which undoubtedly gave support to output. However, on the supply side the sources of economic growth in 1999 are not yet clear as there is some confusion in the current statistics on industrial output with different series pointing to diverging tendencies.[27]

TABLE 1.2.4

Retail trade in selected transition economies, 1998-1999
(Percentage change over same period of preceding year)

	1998				1999		
	Jan.-Mar.	Jan.-Jun.	Jan.-Sept.	Jan.-Dec.	Jan.-Mar.	Jan.-Jun.	Jan.-Aug.
Bulgaria	6.3	8.8	5.9	5.1	-4.6	-1.8	-1.6
Croatia	2.4	3.2	1.7	-0.6	-7.1	-7.9	-7.9 [a]
Czech Republic	-4.3	-5.8	-6.0	-6.6	1.2	1.8	1.7
Hungary	7.3	8.7	9.8	10.6	2.9	3.9	5.6
Poland	13.2	14.3	14.3	12.9	10.8	13.2	15.0
Romania	-3.0	6.2	5.6	4.1	4.6	0.8	0.5 [a]
Slovakia	7.3	9.6	9.1	8.2	6.6	9.7	7.5
Slovenia	3.2	–	1.5	2.1	-5.9	5.5	..
The former Yugoslav Republic of Macedonia	5.2	3.3	3.5	3.2	12.2	10.3	..
Yugoslavia	22.0	18.8	9.3	2.3	-6.5	-22.2	-24.0
Estonia	1.0	–	-2.1	-4.6	6.5	5.2	4.8
Latvia	21.5	25.4	24.8	21.8	19.9	12.2	9.3
Lithuania	23.4	20.6	17.2	10.8	-14.8	-12.7	-12.2
Armenia	5.1	8.3	5.2	6.1	12.7	14.9	16.1
Azerbaijan	11.9	10.0	9.2	10.3	14.8	13.9	13.9
Belarus	33.6	35.9	35.5	26.1	-3.9	-1.7	0.2
Georgia	20.1	15.1	13.2	11.7	-8.4	4.5	4.8
Kazakhstan	31.3	22.5	19.5	17.9	7.2	3.7	-0.9
Kyrgyzstan	12.4	9.3	8.6	8.4	1.6	0.7	1.0
Republic of Moldova [b]	-10.7	-10.2	-8.1	-12.6	-33.1	-33.0	-23.5
Russian Federation	-0.7	-1.2	-0.8	-4.4	-15.1	-14.2	-14.3
Tajikistan	-35.6	-26.3	-9.3	8.2	49.4	37.8	25.8
Turkmenistan	9.0	..	..	..	23.0	28.0	39.0
Ukraine	0.4	0.4	-3.1	-4.5	-8.5	-7.2	-7.1
Uzbekistan	17.1	12.1	13.1	14.0	12.9	11.8	9.7

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

Note: Retail trade covers mainly goods in eastern Europe, the Baltic states and the Russian Federation (since 1998), good and catering in other CIS countries. The coverage in 1998 and 1999, based on current reporting, may differ from the coverage in the annual statistics.

a January-July.

b Registered enterprises.

The *Baltic states* were plunged into an unexpectedly deep recession in 1999, mostly because of the shock caused by the Russian crisis. The three economies followed broadly similar lines as a result of the crisis: in the 18 months to mid-1999 they lost some 70 per cent of their aggregate exports (in value) to the CIS (table 1.2.7) which led to a sharp fall in industrial output (table 1.2.3) and a significant decline in overall economic activity. The recession appears to have bottomed out in the first quarter of 1999 when GDP in both Estonia and Lithuania was close to 6 per cent lower than a year earlier and 2.3 per cent lower in Latvia (table 1.2.3). Although the output decline decelerated during the second quarter, the first half of the year was marked by a sharp reduction in GDP in all three countries.

The economic situation in the *south-east European transition economies* remained precarious in the first half of 1999 with the Kosovo conflict dominating both the political and economic arenas for much of the year. The conflict had a wide-ranging negative impact on the whole

[24] Ibid.

[25] *Rzeczpospolita*, 13 September 1999, as reported by *Polish News Bulletin*, 14 September 1999.

[26] Quarterly national accounts data suggest that real gross fixed capital formation in Slovakia declined by almost 13 per cent, year-on-year, during the first half of 1999. UN/ECE secretariat calculations, based on national statistics.

[27] As of January 1999 the Slovak Statistical Office introduced two monthly series: an index of industrial production (based on the output statistics for selected products and adjusted for the number of working days) and an index of industrial sales (based on the receipts from industrial activities). Neither of them are fully compatible with the previously reported industrial output data and thus there is a break in the series, including those reported in this *Survey*. The two new indices diverge in the first half of 1999: while the index of industrial production indicates a fall in output by 7.9 per cent, year-on-year, the industrial sales index suggests an increase of 4.3 per cent for the same period. To add to the confusion, the quarterly national accounts statistics show a significant rise in the value added produced in industry during the first half of 1999.

region and raised considerably the uncertainties surrounding the economic prospects of these countries. The direct negative consequences of the conflict were most severe for the economy of Yugoslavia which suffered enormous damage to its economic infrastructure and productive capacity as a result of 78 days of NATO air strikes.[28] Although a precise assessment of current economic performance in Yugoslavia is not possible, it is obvious that the bombing has greatly reduced economic activity in this country.[29] The hardship now being borne by the population of Yugoslavia, especially in Serbia and including the many refugees in the country, is already considerable and is certain to worsen with the onset of winter.

The ending of hostilities prevented a more serious economic catastrophe developing for the whole south-east European region and the direct economic impact of the conflict on neighbouring countries turned out to be relatively limited. Most of the reported direct damage was related to the loss of markets in neighbouring countries and/or to the loss of trade flows to and from other countries due to the disruption of international transport routes.[30] The most affected country was probably The former Yugoslav Republic of Macedonia where gross industrial output fell by some 10 per cent in the first half of 1999 (table 1.2.3). However, the service sector in this country reportedly received a boost from the inflow of aid to the Kosovo refugees and from the expenditure of the international forces stationed there (retail trade reportedly grew by some 10 per cent, year-on-year, in the first half of 1999 – table 1.2.4). In aggregate, these two factors were to a large extent offsetting and, although the official statistics are rather scarce and not up-to-date, the net negative economic impact of the conflict appears to have been smaller than was feared during the conflict. Nevertheless, GDP during the first half of the year was undoubtedly much lower than the pre-conflict forecast of 6 per cent (table 1.2.1). The scarce statistical data available in Albania and in Bosnia and Herzegovina suggest that for them as well the direct negative economic consequences of the conflict were probably not very large (industrial output was growing in the first half of the year in both countries – table 1.2.3). Nevertheless, the economic situation in both countries remains extremely fragile due to the chronic weaknesses of their economies and the lack of sufficient progress in the reform process.

In Bulgaria, Croatia and Romania the economies were already in difficulty before the outbreak of the Kosovo conflict. The Romanian economy is undergoing a process of painful restructuring and has been in recession since 1997 (table 1.2.1). Although the falling GDP in 1999 was not surprising (the official forecast did not expect a turnaround to materialize this year), the actual outcome in the first half of the year (GDP was nearly 4 per cent lower than a year earlier) was considerably worse than had been expected and, at least partly, this can be attributed to the impact of the Kosovo conflict. The latter added to the dampening impact of the austerity policy of the last three years, which has combined tight monetary and fiscal policies with the consolidation and restructuring of the banking system (which is burdened by bad loans). Manufacturing industry has borne the brunt of the restructuring and adjustment effort with output continuing to shrink at a high rate for the third consecutive year.

The weakening of output in Bulgaria had already started in the second half of 1998 in the wake of the Russian crisis. During the first quarter of 1999 the decline continued and it was feared that a further fall in output might follow as a result of the Kosovo conflict. Indeed, the latter did have a negative effect on Bulgarian exports, exacerbating the continuing decline in manufacturing output (table 1.2.3); however, other sectors of the economy (notably services and agriculture) fared somewhat better and GDP started to recover in the second quarter (with a 1.6 per cent, year-on-year, increase) resulting in a small but nevertheless positive increase for the first half of the year (0.5 per cent).

Similarly, the weakening of economic activity in Croatia began in the last quarter of 1998, when GDP fell by 4.2 per cent, year-on-year, and continued in early 1999, although at a decelerating rate: GDP declined by just over 1 per cent in the first half of the year. The most important domestic factor behind this development has been the fall in private demand: retail sales in the first half fell by 7.9 per cent year-on-year (table 1.2.4) while the final consumption of households shrank by 7.6 per cent.[31] In part, the latter was caused by the poor performance of the tourist industry after the outbreak of the Kosovo conflict (which led to widespread cancellations of tourist bookings).[32]

If there was a positive outcome of the Kosovo episode, it was the fact that the conflict attracted considerable public attention in the west to the deep-

28 For more details see UN/ECE, *Economic Survey of Europe, 1999 No. 2*, chap. 1.

29 Since the outbreak of the Kosovo conflict the official Yugoslav statistics on current economic performance have been extremely scarce. Apart from the apparent difficulties in assessing a wartime economy, reportedly there are serious problems in collecting and processing information on the economic situation in Kosovo.

30 The most damaging and lasting economic consequence of the conflict has been the blockage of navigation along the Danube (which followed the destruction of several bridges bombed during the air strikes) due to the continuing dispute over the financing of the clean-up operation. Apart from the continuing damage to transport, there are growing fears, especially in Croatia and Hungary, that the wreckage of the bridges could trap ice floes and cause severe flooding if it is not cleared before the winter sets in.

31 UN/ECE secretariat calculations, based on national statistics.

32 Tourist nights in the first half of 1999 were 22.1 per cent lower than in the same period of 1998. National Bank of Croatia, *Bulletin*, No. 41 (Zagreb), September 1999, p. 11.

seated economic problems of the transition economies in south-east Europe. One of the results of the ensuing policy discussion was the adoption of the so called "Stability Pact for South Eastern Europe", initiated by the European Union and endorsed by the heads of state and governments of the south-east European countries at a summit held in Sarajevo on 30 July 1999. This development has had an initial positive impact on economic expectations and investor confidence as regards the south-east European region but whether this can be consolidated by effective programmes for regional economic regeneration remains to be seen.

(b) Commonwealth of Independent States

The majority of the CIS countries were severely hit by the Russian crisis and the negative repercussions continued to be felt in 1999. At the beginning of the year there were fears that the crisis might deepen further, a development which would have had grave consequences not only for the Russian economy but also for the many of the other CIS countries. These fears, however, have not been borne out by events in 1999.

In fact the Russian economy in 1999 has performed considerably better than was predicted not only by independent analysts but also by the Russian authorities. The main force behind the gradual improvement in output has been the revival in the manufacturing sector. By March the decline in gross industrial output, which had started in May 1998, came to an end and industrial production started to increase rapidly: in the second quarter of 1999 it was 8 per cent higher than a year earlier and in the third quarter it was nearly 16 per cent higher.[33] It should be borne in mind that these high growth rates are from a very low base (the fall in output only hit the bottom in the third quarter of 1998); but even so, the data indicate that by the third quarter the level of output in mining and manufacturing had recovered from the catastrophic fall in 1998.[34] Besides, the recovery of industrial output in 1999 was broadly based, with most industrial branches showing positive growth.[35]

The reasons for this unexpectedly fast expansion of industrial output are not entirely clear, especially, as noted below, final domestic demand remained quite depressed in the first half of 1999. But there are two factors which appear most likely to have played a significant role in this development. In the first place, the sharp rebound in world prices of oil and gas (as well as of other commodities and intermediate goods) benefited a number of Russian producers and exporters (and at the same time boosted the government's fiscal revenue). Secondly, the large devaluation of the rouble appears to have induced large scale import substitution,[36] giving a significant boost to local production.[37] Thus, despite the decline in the value of total exports, the net trade effect appears as the most significant demand side factor supporting the recovery of output.

At the same time, domestic absorption continued to contract in the first half of 1999. Private consumption has been particularly hard hit by the sharp fall in real incomes that followed the collapse of the rouble: in 1999 the volume of retail sales was contracting at double-digit rates (table 1.2.4). Fixed investment also continued to fall albeit at a lower rate than in previous years.[38]

The output recovery in Russia reflects both the improvement in the external environment and the relatively prudent management policy followed by the Russian authorities since the crisis of August 1998 (which enabled them to avoid hyperinflation). However, the fundamental problems of economic restructuring have still to be addressed and, as argued in previous issues of this *Survey*, this is a major pre-condition for sustained recovery and growth in Russia.

The recovery of output in Russia has also been a favourable development for the neighbouring transition economies and especially the *European CIS countries*. Although economic activity in these countries remained relatively low in the first half of 1999, there were some signs of improvement in the third quarter of the year. Thus the output decline in Ukraine hit bottom in the first quarter when GDP fell by 4.8 per cent, year-on-year, and industrial output by 2.4 per cent. There were already some early signs of revival in the second quarter and especially, as in Russia, in manufacturing industry (with industrial production increasing by 2.6 per cent). The recovery in industry became more pronounced in the third quarter when gross output increased by 6 per cent, year-on-year.[39] Ukrainian GDP was also growing in the

[33] UN/ECE secretariat calculations, based on national statistics.

[34] Quarterly industrial output in the third quarter of 1999 was 2 per cent higher than in the same quarter of 1997 when Russian industrial output was growing. UN/ECE secretariat calculations, based on Goskomstat data.

[35] The chemical industry posted the highest rate of year-on-year growth for the first three quarters of 1999 (20.3 per cent); but even in branches that had suffered a chronic decline over several years, such as mechanical and electrical engineering, light industry and food processing, there were high positive growth rates of output in this period (13.1 per cent, 8.4 per cent and 9.9 per cent, respectively). Russian Federation Goskomstat, O proizvodstve promyshlennoi produktsii v yanvare-sentyabre 1999 goda (www.gks.ru).

[36] In the first half of 1999 the value of total Russian imports fell by more that 45 per cent, year-on-year (table 1.2.7).

[37] Although in earlier issues of this *Survey* import substitution had been hypothesized as one of the possible driving forces of the Russian recovery, the available data did not allow any definite conclusions on this subject. The most recent statistics published by Goskomstat (showing in particular the high rates of output growth in sectors such as engineering, light industry and food processing, quoted above) would seem to support this hypothesis.

[38] Real investment outlays in January-September 1999 were 0.7 per cent lower than in the same period of 1998. Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii*, No. 8 (Moscow), 1999.

[39] UN/ECE secretariat calculations, based on national statistics.

third quarter but the cumulative change for the first three quarters of the year was still negative (-1.7 per cent, year-on-year – table 1.2.3).

During the first three quarters of 1999 economic activity in Belarus was much below its level during the previous two years during which GDP reportedly increased by a cumulative 20 per cent or so.[40] The growth of GDP (2 per cent, year-on-year – table 1.2.3) was well below the official forecast for 1999 (table 1.2.1). In the Republic of Moldova the economy plunged into a deep recession in 1998 and GDP continued to fall in the first half of 1999 (table 1.2.1). Nevertheless, the rate of decline reportedly started to decelerate in the third quarter and at the moment of writing this *Survey* there were expectations that the second half of the year would bring some improvement in output performance.

The economies of the *CIS countries in the Caucasian rim* were growing in the first half of 1999 but on average at somewhat below the rates of the last few years. Although the direct effect of the Russian crisis was probably less severe for these countries, they were nevertheless affected both by the general weakening of economic activity in the CIS and by the fall in world commodity prices in 1998. The manufacturing sector was particularly affected in some of these countries: gross industrial output continued to weaken in Armenia and Georgia in the first quarter of 1999 before starting to rebound in the second and third quarters. But despite these negative elements, the rates of growth of GDP in Armenia and Azerbaijan during the first half of 1999 (4.9 per cent and 5.6 per cent, respectively) were among the highest not only among the CIS but among all the transition economies.

Economic performance was mixed in the *central Asian CIS countries* in the first half of 1999. With GDP falling by 3.3 per cent in the first six months of the year, the biggest economy in the region, Kazakhstan, was also the worst performing of all the central Asian CIS countries in this period. This outcome was considerably worse than the official forecasts which had envisaged the Kazakhstan economy emerging from the recession of 1998. However, the delays in introducing needed changes in economic policy (especially the prolonged defence of the exchange rate which came under strong pressure after the rouble devaluation and which was finally abandoned in April) helped to prolong the period of output decline.

In contrast, very high rates of output growth are reported in Turkmenistan in 1999: according to the official statistics, GDP increased by 14 per cent, year-on-year, during the first nine months and the rate of growth of industrial output was even higher (table 1.2.3). Although the accuracy of these figures is uncertain, the economy does appear to have been recovering strongly, mainly as a result of the resumption of gas deliveries to Ukraine and other CIS countries.[41] The first half of the year was marked by a relatively high level of economic activity in Uzbekistan (GDP increased by 3.8 per cent, year-on-year), thus continuing the trend of the past two years. Growth was broadly based, with both industry and agriculture contributing to the strong performance on the supply side; at the same time, domestic demand (both private consumption and fixed investment) continued to recover strongly.

The economies of Kyrgyzstan and Tajikistan were also growing during the first three quarters of the year but at a rather uneven pace. In Kyrgyzstan, after a period of stagnation during the first half of the year, the rate of GDP growth accelerated in the third quarter. According to the preliminary statistics, the reverse pattern appears to have been the case in Tajikistan where the cumulative GDP growth figure for the first three quarters was considerably worse that those for the first half of the year (table 1.2.3).

(iii) Inflation

Moderate disinflation remained the norm in *central and eastern Europe* through the summer of 1999 (table 1.2.5). A key factor behind disinflation in 1998 was the marked fall in world commodity prices. The reversal in this, led by the sharp rise of crude oil prices,[42] accelerating from March, did not have an initial reflection in higher inflation in 1999. Feed-through from this imported inflation is, in any event, subject to lags. Additionally, this shift in trend was at first counterbalanced by the subdued economic environment and intensified competition, in both external and internal markets. (The same downturn also produced fiscal strain, consistently threatening revenues while giving rise to additional claims on government expenditure.) Thus, a model of fiscal prudence, Estonia, was running a 7.7 per cent budget deficit by July.[43] The exceptions to the trend of lower inflation in this part of the region were chiefly Slovakia, where the new government is trying to speed up the liberalization of its economy without accelerating inflation unduly, and Romania, suffering from a multiplicity of long-standing economic problems,[44] of

[40] It should be borne in mind, however, that the reliability of the official Belarussian statistics (especially concerning real growth) has been frequently questioned by independent analysts.

[41] It should be remembered that this upsurge in output is mostly a recovery from a period of almost two years when gas deliveries were discontinued.

[42] UN/ECE, *Economic Survey of Europe, 1999 No. 2*, p. 39 and sect. 1.2(v) below.

[43] For central and local government, as reported in Bank of International Settlements, *Economic Indicators for Eastern Europe* (Basle), August 1999.

[44] UN/ECE, *Economic Survey of Europe, 1999 No. 1*, pp. 70-81, analyses this in detail.

TABLE 1.2.5

Consumer prices in the transition economies, 1997-1999
(Percentage change)

	Annual average		*December over previous December*		*August over previous December*		*August over previous August*	
	1997	*1998*	*1997*	*1998*	*1998*	*1999*	*1998*	*1999*
Albania	33.1	20.3	42.0	7.8	3.7	-4.4	15.8	-0.6
Bosnia and Herzegovina	11.8	4.9	12.2	2.2	0.1	-3.1	3.1	-1.0
Bulgaria	1 082.6	22.2	578.7	0.9	-0.2	2.2	6.1	3.3
Croatia [a]	3.7	5.9	4.0	5.6	3.7	3.3	5.4	5.2
Czech Republic	8.4	10.6	9.9	6.7	7.3	1.9	9.3	1.4
Hungary	18.4	14.2	18.4	10.4	8.1	8.6	13.4	10.9
Poland	15.1	11.7	13.2	8.5	6.0	5.3	11.1	7.7
Romania	154.9	59.3	151.7	40.7	26.6	34.6	51.8	49.6
Slovakia	6.1	6.7	6.5	5.5	3.3	12.2	5.7	14.6
Slovenia	8.4	7.9	8.8	6.6	5.1	5.2	7.6	6.8
The former Yugoslav Republic of Macedonia [a]	3.6	1.0	4.5	-1.0	-3.0	..	–	..
Yugoslavia	23.2	30.4	10.3	45.7	28.0	21.1	37.6	37.9
Estonia	11.1	10.6	12.3	6.8	6.4	2.3	9.8	2.6
Latvia	8.5	4.7	7.0	2.8	2.0	1.3	3.7	2.1
Lithuania	8.8	5.1	8.5	2.4	2.1	–	4.4	0.3
Armenia	13.8	8.7	21.8	-1.2	-5.5	0.1	1.4	4.6
Azerbaijan	3.6	-0.8	0.3	-7.6	-0.1	-2.5	2.2	-9.8
Belarus	63.9	73.2	63.4	181.6	30.1	111.3	46.8	357.5
Georgia	6.9	3.6	7.3	10.8	-3.3	5.6	1.5	21.0
Kazakhstan	17.4	7.3	11.3	1.9	2.4	12.6	6.3	12.0
Kyrgyzstan	25.5	12.1	14.7	18.3	5.5	30.7	9.7	46.6
Republic of Moldova	11.8	7.7	11.1	18.2	-0.6	26.4	4.1	50.4
Russian Federation	14.7	27.8	11.0	84.5	8.1	29.6	9.8	121.1
Tajikistan	85.4	43.1	159.9	2.7	-10.2	42.9	5.0	63.5
Turkmenistan	83.7	16.8	21.5	19.8	6.3	14.4	13.7	29.0
Ukraine	15.9	10.6	10.1	20.0	2.3	8.6	6.9	27.3
Uzbekistan	73.2	17.7	27.5	25.9	11.4	..	16.4	..

Source: UN/ECE secretariat estimates, based on national statistics.

[a] Retail price index. For Croatia the food price index is from the cost of living index.

which its rather high inflation rate is more a symptom than a cause.

Even in the more diverse pattern in the *countries of the CIS* (table 1.2.5) the general picture is one in which the exceptional inflationary shocks arising from the Russian crisis have now been contained, although the overall situation is far more unsatisfactory and fragile. Real wages bore a great deal of the initial adjustment, and macroeconomic policy was more austere than had been thought likely last autumn. Nonetheless, the Russian crisis shaped the inflationary processes in some closely-tied economies, by precipitating, with varying lags, reactive devaluations in their currencies. In Belarus the Russian crisis brought more rapidly into the open a much higher rate of inflation[45] which would have occurred anyway as a consequence of the expansionary policies, in particular the subsidized credits and other exceptional quasi-fiscal measures which, in 1998, were adopted by the Belarus government as a special path to national recovery.

In *central and eastern Europe* there have been a few indicators of possible increases in inflationary pressure on the horizon. With the higher than expected jump in Polish inflation (1.4 per cent) from August to September causing some concern, whether deserved or not, it is worth reviewing these potential problems.

The obvious potential inflationary pressure on the horizon is the feed-through from the increase in energy prices from a very low level (see section 1.2(v) and chart 1.1.1). Some increases in transport costs have already had an effect on consumer prices in the normally favourable summer months, but the full effect is still to come. Moreover, upward changes in spot and near-term future prices in oil in mid-September mean that it is

[45] The CPI changes in table 1.2.5 for Belarus reflect open inflation, but there are major controls on food and other goods considered socially important, which is one of the reasons why the population has expressed more concern about shortages than price rises in the autumn. TACIS European Expertise Service, *Belarus Economic Trends*, Monthly Update, May 1999, p. 11 in particular. This source also provides information on Presidential Decree No. 285, which states that annual limits for changes in price indices are to be set and revised by the Council of Ministers and the National Bank of Belarus. In TACIS, *Belarus Economic Trends*, Quarterly Issue, April-June 1999, pp. 15-20, a special section by D. Nuti suggests that, in reality, Belarus remains a command economy.

entirely possible that this trend can continue, depending of course on supply discipline and demand.[46]

Moreover, as continued disinflation in the face of rising world commodity prices was possible this year in the context of subdued demand, achievement of the forecast improvement in the economic environment may increase inflationary pressure, although it should also lead to productivity growth, easing the pressure on labour costs, and making the resolution of fiscal strain less problematic.

An additional factor to watch in costs has been that the growth of wages in industry has generally continued to outpace industrial productivity growth by a significant margin for some time. With continued disinflation, this may simply be a normal cyclical phenomenon, reflecting inertial expectations, accelerated in some cases (particularly the Baltics) by sharp recession-induced falls in productivity. Thus, it is entirely plausible that this has occurred despite the continuation of rather high levels of unemployment. (See section 1.2(iv) on the latter, and section 1.2(v) on the problems this may pose for international competitiveness.) Developments in the Czech Republic provide a clear example. As a consequence of the Czech recession, productivity in industry fell 6.9 per cent in the first quarter of 1999 and 3.8 per cent for the first half of the year. Employment in Czech industry fell, respectively, by 2.3 per cent and 2.9 per cent in the first quarter and first half,[47] and unemployment has risen to levels not seen before in the country, exceeding 15 per cent in a number of industrial regions. Yet nominal gross wages in industry rose by 6.5 per cent in the first quarter, and moderated only to 6 per cent in the first half year. In the low inflationary environment of 1999 this meant that Czech real unit labour costs in industry rose 14.1 per cent in the first quarter and 9.8 per cent in the first half of the year.

The Czech National Bank[48] understands these developments to have been spurred by the stated inflationary expectations of the trade unions (9.5 per cent or higher), and encouraged by the 17 per cent wage increase in the government sector where wage increases have lagged behind those in the rest of the economy.[49] This is the most dramatic case of divergence between wage and productivity growth in 1999, but it is not unique: it has been the rule except in Slovakia.

With a rise in output and productivity, accompanied at the end of this year by higher inflation than at the beginning, if the same inertial factors operated and this is a normal cyclical experience, we will see the opposite phenomenon. However, in the absence of evidence of sufficient cycles to be certain of this, it is worth observing that a substantial rise in real wages in conditions of rising unemployment might also suggest, as an additional factor, the development of an "insider/outsider" labour market. The development of institutional mechanisms to address these labour market issues is not easy, of course, and is no substitute for growth with jobs, but the issue is clearly becoming increasingly important.[50]

Despite these potential problems the majority of central and east European countries are close to meeting their declared annual inflation targets. The country with the most acute inflation outside the CIS remains Romania. The sharp decline in the leu exchange rate earlier in the year, combined with the need to continue to raise administratively-controlled prices,[51] make it less likely that major disinflation can be achieved in the near future.

In the other exceptional country, Slovakia, inflationary pressures stem from the difficulties of catching up with the lead reformers in liberalizing both prices and the economy more generally. Slovak inflation will be higher this year, a predictable consequence of the new government's ambitious programme, as already foreseen in the two previous issues of this *Survey*.[52]

The initial Slovak austerity package had hoped to contain inflation at 10 per cent (December over December), a target which proved as difficult as this *Survey* had suggested.[53] This target was raised to 19.5 per cent and then, in October, the decision was taken to postpone rent increases which, also ambitiously, led to the inflation forecast being lowered to 15 per cent.[54] The magnitude of the reduction of the forecast, however, is out of line with the weight of rents in the CPI,[55]

[46] IMF, *World Economic Outlook*, October 1999 (preliminary website edition), p. 50.

[47] These data refer to the percentage changes over the same period of the preceding year; the source is the UN/ECE Database of National Statistics.

[48] Czech National Bank, *Inflation Report* (Prague), July 1999, pp. 34-35.

[49] On wages throughout the region, see also D. Vaughn-Whitehead (ed.), *Paying the Price: The Wage Crisis in Central and Eastern Europe*, Macmillan/ILO Study Series (London), 1998, especially chap. 5. In the recent Polish case, the strike of nurses is another example in which "stop-go" for budget-paid workers can be a short-sighted policy. When efforts are eventually made to catch up they may threaten wider inflationary pressure and thereby politicize an otherwise ordinary government employees' bargaining situation.

[50] Institute of Macroeconomic Analysis and Development, *Slovenia: Analysis of Economic Developments and Target Developmental Scenario by 2003: Spring Report 1999* (Ljubljana), 1999, pp. 103-106 discusses the Slovenian approach to this challenge.

[51] Additionally, in July the Romanian government agreed with the IMF to raise excise taxes on petroleum by 70 per cent. Romania Letter of Intent and Memorandum on Economic Policies, 26 July 1999 (IMF website).

[52] UN/ECE, *Economic Survey of Europe, 1999 No. 1*, pp. 112 and 120, and *1999 No. 2*, pp. 39-40.

[53] Ibid., *1999 No. 1*, p. 112.

[54] TASR (Bratislava), 11 October 1999.

[55] UN/ECE, *Economic Survey of Europe*, *1999 No. 1*, pp. 115-118 is devoted to a detailed consideration of the role of rent in the CPI basket in the transition economies, which still remains very low.

particularly as the government's announcement states that the weight of rents regulated by the state now has a weight of only 1.3 per cent in the consumer basket. The official explanation for the large impact on inflation of this small change is that there will be important secondary effects of the decision, for example on the behaviour of landlords of unregulated properties. It may also be that this measure is hoped to have an effect on wage demands (real wages have actually fallen somewhat in Slovakia) and a palliative effect on the unavoidable tensions resulting from any austerity programme.

In the countries of the *CIS*, the inflationary picture has ranged from price falls in Azerbaijan to the already-noted high inflation of Belarus. There is, however, one clear overall generalization: namely, that the Russian crisis, involving a large devaluation that quickly led to much higher inflation in that country, subsequently affected a number of already troubled economies heavily dependent on exports to Russia. This affected, above all Belarus and the Republic of Moldova,[56] as these countries also found themselves unable to avoid devaluation. Another of the CIS countries in difficulty and closely tied to the Russian economy, Ukraine, has had a lower-than-expected rise in inflation despite a year of considerable difficulty. The credit here is generally attributed to macroeconomic policy and to the influence of increased domestic competition in the supply of food, in turn a reflection of exportables being diverted to the internal market. Since it is the case that the less affluent the transition economy, the larger is the weight of food in the consumer price basket, this phenomenon has played a role in other countries as well.

In Russia the more alarmist fears in 1998 about high inflation, even hyperinflation, were clearly not borne out. The most striking statistic is arguably the failure of nominal wages to respond very much to the initial large rise in prices which followed the 1998 devaluation. The reduction in wage arrears (and the even greater effort to pay pension arrears) has provided some mitigation in terms of living standards, but the reality is that real wages have fallen dramatically and the numbers earning less than the poverty level have risen substantially. The virtual absence of indexation in the Russian economy is one more indication of the effective absence of trade unions and may also reflect the remaining "employment overhang".

The greater economic difficulties and political uncertainties in the CIS make it difficult to forecast further disinflation with any confidence, although in most cases the tempo of inflation has slowed during the course of the year. Rekindling inflationary expectations is also more likely in situations where central bank and Ministry of Finance credibility is low. Although there is no sign of a return to very high or even hyperinflationary rates anywhere in the CIS, there is still a high variance of inflation forecasts. This remains a contrast and a source of increasing divergence with central and eastern Europe, where the state budgets and economic programmes presently being negotiated into legislation remain more firmly fixed on the objective of continuing disinflation under conditions in which, it is forecast, there will be a less harsh economic climate.

(iv) Unemployment

As a result of the Russian crisis and the general economic slowdown, unemployment started to increase in most transition economies in the second half of 1998 and continued to do so in 1999, with a sharp rise in the first quarter of the year. In February-March, nine countries (Croatia, the Czech Republic, Estonia, Latvia, Lithuania, Romania, Russia, Slovakia and Yugoslavia) reported their highest unemployment rates since the transition started in 1989. During the spring and summer, despite the usual seasonal fall in unemployment, there was no significant improvement and, in some countries, where the external demand shock was amplified by deepening internal problems, the situation continued to deteriorate.

In August 1999, registered unemployment rates in most of the *central and eastern European countries* varied between 9 per cent (the Czech Republic) and 19 per cent (Croatia)[57] (table 1.2.6). In the 12 months to August 1999, the rate declined slightly only in Slovenia[58] and remained broadly unchanged in Hungary. In all the other countries of the region, the rate of unemployment increased markedly, in most cases by 2-3 percentage points, reflecting already weak economic situations which were aggravated by the Russian and Kosovo crises and, in some of them, intensified restructuring.

The immediate outlook for the labour markets in central and eastern Europe remains rather bleak. Among the central European transition economies a small decline in unemployment (from the current 9.5 per cent to some 9 per cent of the labour force) can be expected only in

[56] Government of Moldova and TACIS European Expertise Service, *Moldova Economic Trends*, Quarterly Issue, April-June 1999, and the Monthly Update, July 1999, provide further detail on the country's serious difficulties, of which the still moderately high inflation rate is only one.

[57] Note that Croatian unemployment is consistently exaggerated by this measurement method, and considerably above the results of the labour force survey, which found only 11.6 per cent unemployed in the second half of 1998, for example, as opposed to 18 per cent as indicated by the registered method. (Republic of Croatia, Central Bureau of Statistics, *Monthly Statistical Report*, No. 9 (Zagreb), 1998.) As the same problem applies to the Slovene figures, caution about methodology is needed in the interpretation of all unemployment data for the countries formerly part of Yugoslavia.

[58] Some, but not all of the decline is due to the change in methodology which resulted in the transfer of 6,000 persons engaged in public works programmes (including in the health and social work sector) from the ranks of registered unemployed to the employed as of 1 January 1999. The Slovene labour force survey, which shows a far lower unemployment rate than the registered figures found an unemployment rate of 7.7 per cent in February 1999 and 7.5 per cent in May. Bank of Slovenia, *Monthly Bulletin* (Ljubljana), August 1999, p. 69.

TABLE 1.2.6

Registered unemployment in the transition economies, 1998-1999
(Per cent of labour force, end of period)

	1998		1999			
	Aug.	Dec.	Mar.	Jun.	Jul.	Aug.
Eastern Europe [a]	10.2	11.2	12.6	12.3	12.4	12.4
Albania	17.0	17.6	18.0	18.0	18.0	..
Bosnia and Herzegovina	39.0	38.5	39.2	39.0	39.1	..
Bulgaria	10.8	12.2	13.2	12.8	13.0	13.6
Croatia	17.0	18.6	19.1	18.9	19.1	19.1
Czech Republic	6.4	7.5	8.4	8.4	8.8	9.0
Hungary	9.0	9.1	10.4	9.4	9.5	9.4
Poland	9.5	10.4	12.1	11.6	11.8	11.9
Romania	8.7	10.3	12.0	11.3	11.3	10.9
Slovakia	13.8	15.6	16.7	17.7	18.3	18.2
Slovenia	14.2	14.6	14.1	13.4	13.4	13.4
The former Yugoslav Republic of Macedonia	..	..	..	..	..	..
Yugoslavia	27.0	27.2	29.3	..	..	..
Baltic states	5.8	7.3	8.7	8.1	8.2	8.3
Estonia [b]	4.2	5.1	7.0*	6.7*	6.6*	6.5*
Latvia	7.4	9.2	10.1	10.0	9.9	9.8
Lithuania	5.4	6.9	8.5	7.5	7.8	8.1
CIS	7.8	9.0	9.0	8.3	8.3	8.3
Armenia	8.7	8.9	10.4	10.4	11.3	11.3
Azerbaijan	1.4	1.4	1.1	1.2	1.2	1.2
Belarus	2.3	2.3	2.3	2.1	2.1	2.1
Georgia	3.6	4.2	5.5	5.5	4.5	4.8
Kazakhstan	4.0	3.7	3.6	3.5	3.6	3.6
Kyrgyzstan	3.7	3.1	3.1	3.1	3.1	3.1
Republic of Moldova	2.0	1.9	2.4	2.3	2.4	2.4
Russian Federation [c]	11.6	13.3	13.6	12.4	12.4	12.4
Tajikistan	3.5	2.9	3.1	3.2	3.2	3.3
Ukraine	..	..	..	..	..	..
Uzbekistan	3.6	4.3	4.0	4.0	4.0	4.1
Total above	0.4	0.4	0.6	0.6	0.6	0.5
Memorandum items:						
CETE-5	9.4	10.2	11.7	11.3	11.6	11.7
SETE-7	..	..	..	..	..	..
Russian Federation [d]	2.4	2.7	2.7	2.2	2.0	1.9
Former-GDR	17.1	17.4	18.4	16.8	17.4	17.6

Source: National statistics; direct communications from national statistical offices to UN/ECE secretariat.

a Excluding The former Yugoslav Republic of Macedonia and Yugoslavia.

b Job seekers.

c Based on monthly Russian Goskomstat estimates according to the ILO definition, i.e. including all persons not having employment but actively seeking work. The previously published figures have been seriously revised in line with the results of the February and May 1999 labour force surveys.

d Registered unemployment.

Hungary where strong output growth continues to generate a relatively strong demand for labour. A stabilisation or even a slight fall in unemployment can also be expected in Slovenia which was not much affected by the Russian crisis and where a slight downward trend in unemployment has continued since October 1998.[59]

In the Czech Republic, where a moderate revival of the economy appeared in the second quarter, there was no improvement in the labour market in the first eight months of 1999.[60] The main causes of rising unemployment – weak economic performance and intensified restructuring of traditional Czech industrial companies, particularly in the chemical, manufacturing and metallurgy sectors – are expected to continue, and unemployment is forecast to reach 10 per cent by the end of the year and climb further to 11 per cent in 2000. In Poland, despite a relatively strong output recovery since March, the situation on the labour market remains difficult[61] and the high level of unemployment is expected to persist in the near future as the wave of mass layoffs continues and the number of people losing their jobs due to enterprise restructuring or the end of job guarantees that come with the privatization process has been increasing.[62] Nevertheless, the National Labour Office (KUP) still maintains its forecast of a 12 per cent unemployment rate at the end of the year, which looks rather optimistic. In Slovakia, the austerity measures and weak performance in mining and manufacturing, and especially, in construction, together with a much delayed macroeconomic adjustment, has led to a dramatic rise in unemployment.[63] The situation is unlikely to improve radically by the end of the year; on the contrary, the recently amended privatization law, which opens the way for some progress in privatizing large-scale companies, may lead to further increases in unemployment.

In Bulgaria, after some stabilization during the spring-summer period mainly reflecting seasonal factors, the unemployment rate started rising again in July and reached 13.6 per cent in August. Given the weak economic performance and taking into consideration that closing down unviable loss-making enterprises is still a key reform target for the government under the three-year programme agreed with the IMF in 1998, unemployment is likely to continue rising for the rest of the year. In Romania, there was a seasonal fall in the unemployment

[59] Among all the east European and Baltic countries, employment in the first half of 1999 compared to the same period in 1998 increased only in Hungary and Slovenia. Up to half of the 2.7 per cent increase in employment in the latter between the end of 1998 and the end of July 1999 is considered in some sense artefactual. (Institute of Macroeconomic Analysis and Development, *Slovenian Economic Mirror* (Ljubljana), September, 1999, p. 16 and July 1998, page 14.) In addition to the recognition of those on public works programmes as employed, a new law on the shadow economy has, in their view, resulted in the formal registration as employed those previously not registered.

[60] In the first half of 1999, employment fell by nearly 4 per cent, and the unemployment rate continued to rise through the summer months reaching a record 9 per cent in August, up from 6.4 per cent in August of last year.

[61] August was the seventh month of declining employment in the business sector and the unemployment rate at the end of the month was 11.9 per cent (compared with 11.8 per cent in July and 9.5 per cent a year earlier).

[62] The number of people losing their jobs amounted to 156,500 in August, 3,300 more than in July and 38,600 more than a year earlier. *Interfax Poland Business News Service*, 29 September 1999.

[63] In August 1999, the unemployment rate stood at 18.2 per cent, up from 13.8 a year earlier, the largest increase among all the transition countries.

rate during spring and summer,[64] but it is expected to start rising again and may reach 14 per cent by the end of the year due to the continued recession and the planned massive layoffs in loss-making companies.[65] In Albania and Croatia, unemployment rates were broadly unchanged over the first eight months but at very high rates of 18-19 per cent; these are unlikely to decline by the end of the year given the usual seasonal rise in unemployment in winter months, the consequences of the Kosovo conflict, and the weak economic performance in Croatia. The Kosovo crisis dramatically affected the labour markets in The former Yugoslav Republic of Macedonia and Yugoslavia, and although the data on unemployment rates in these countries are not available, some unofficial estimates have suggested that they could reach very high levels in both countries.[66]

In the *Baltic states*, the recession, caused mainly by the loss of key export markets after the Russian crisis, has resulted in a considerable growth in unemployment. The unemployment rates varied in August 1999 between 6.5 per cent in Estonia and 9.8 per cent in Latvia (both more than 2 percentage points higher than in the same period of 1998). In Latvia and, particularly, Estonia, the level of unemployment, perhaps reflecting the first signs of economic recovery, has declined slightly since April.[67] In contrast, in Lithuania where the fallout from the Russian economic crisis was initially mitigated by government intervention, unemployment started rising again in July. Given the usual seasonal unemployment upturn in the autumn and winter months and the economic difficulties facing the economy, the 8.7 per cent unemployment rate forecast by the Lithuanian Economics Ministry for the end of 1999 could prove to be optimistic.[68] It would take a rapid turnaround and reorientation of trade for rates of unemployment in the Baltic states to return to their pre-crisis levels (around 5-7 per cent) in the short run.[69]

Statistics on registered unemployment, which are the only source for the majority of the *CIS countries*, do not indicate any notable changes in unemployment rates in the 12 months to August 1999. These rates, however, are increasingly misleading as indicators of both the magnitude and the dynamics of unemployment since a large proportion of the jobless who are willing to work do not register. Thus, in May 1999, unemployment rates calculated on the basis of labour force surveys stood at 12.4 per cent in Russia, 11 per cent in Ukraine (June) and, according to some estimates, was close to 10 per cent in the Republic of Moldova,[70] compared with 2.3 per cent, 4 per cent and 2.1 per cent, respectively, on the basis of the registration figures.

In Russia, the results of the labour force survey suggest a notable improvement in the unemployment situation during the spring. The unemployment rate declined from 14.1 per cent in February to 12.4 per cent in May, representing a reduction of 1.3 million in three months.[71] The Russian Federation Goskomstat, estimates[72] that unemployment remained flat after May, and attributes the second quarter change to essentially seasonal factors.[73] As this is the first year of the quarterly Russian labour force survey it is, of course, impossible to be certain of the situation at this point.[74] The Ukrainian State Statistical

[64] The decline from a record 12 per cent in March 1999 to 10.9 per cent in August was mainly a result of the clearly pronounced seasonal factor attributed to the structure of the Romanian economy, where the share of agriculture in total employment has reached 40 per cent.

[65] The eight month stand-by arrangement signed with the IMF on 5 August 1999 contains several benchmarks with regard to structural changes in the economy addressing primarily privatization and state enterprise restructuring of state owned enterprises and banks. The World Bank's $44.5 million loan is to be used to compensate miners for the closure of 29 unprofitable mines which was postponed this year when protesting miners forced the government to backtrack on closures. *Romania Economic Newsletter*, Vol. 9, No. 2 (Bethesda, MD), July-September 1998.

[66] In The former Yugoslav Republic of Macedonia, the most recent official data on unemployment refer to December 1997. Since that time the statistics office has stopped publishing unemployment figures. Some estimates indicate that by the end of August 1998, the rate of registered unemployment stood at 44 per cent, but the accuracy of this is uncertain. Since April 1999 unemployment has increased rapidly and, according to Macedonian Statistical Institute estimates, the number of unemployed reached some 345,000 people in August, more than the number employed in the economy. (*Macedonian Press Digest* as reported in *Reuters News Service*, 19 September 1999.) In Yugoslavia, government officials state that during the NATO bombing nearly 1 million workers lost their jobs when their factories were destroyed. (*Reuters News Service*, 29 September 1999.) Before the bombing started there were around 2.5 million employed in the country.

[67] In Latvia, the unemployment rate dropped further to 9.5 per cent in September reflecting, according to the State Employment Service, that numerous companies which suffered during the Russian crisis (particularly the fish processing and textile industries, which were the most hard hit by the recession), resumed operation and small and medium businesses have provided new jobs. *Reuters Business Briefing*, 14 October 1999.

[68] In September, the unemployment rate further increased to 8.4 per cent, which is 0.1 percentage points below the March peak.

[69] When discussing unemployment in these countries it should be kept in mind that the official figures for persons registered as unemployed may underestimate the actual number. Unemployment rates in May 1999, derived from labour force surveys based on the ILO definition of unemployment, stood at 11.7 per cent in Estonia (June), 14.4 per cent in Latvia and 13.1 per cent in Lithuania, whereas the registered rates were 6.5, 10.1 and 7.8 per cent respectively.

[70] The Moldovan figure was calculated from population polls, and reported by BBC Monitoring, *Summary of World Broadcasts*, former USSR, 11 June 1999. A quarterly labour force survey started in the Republic of Moldova in October 1998. However, the results are not available becase the information can not be processed due to a lack of financing. *Moldova Economic Trends*, Quarterly Issue, April-June 1999, p. 26.

[71] Rossiiskoe statisticheskoe agentsvo, *Sotsial'no ekonomicheskoe polozhenie Rossii, yanvar'-iul' 1999 goda* (Moscow), p. 223. The rise in employment during the period is given as 1.4 million, and labour expansion as 100,000.

[72] Although the Russian Federation Goskomstat continues to give monthly estimates of unemployment, these are now regularly, and often substantially, revised when the results of the subsequent labour force survey are known. For a detailed discussion of this, see UN/ECE, *Economic Survey of Europe, 1999 No. 1*, p. 132 and *1999 No. 2*, p. 43.

[73] Rossiiskoe statisticheskoe agentsvo, op. cit

[74] T. Gorbacheva and Z. Ryzhikova, "Metodologiya i nekotorye itogi vyborochnogo obsledovaniya naseleniya po problemam zanyatosti v 1998 godu", *Voprosy Statistiki*, No. 6 (Moscow), 1999, pp. 18-21 reveal some features and instructions for the new labour force survey methods started in

Committee did observe a parallel process in its newly-instituted quarterly labour force survey: the unemployment rate declined from 14 per cent to 11 per cent between March and June. According to their analysis, the main reasons are both seasonality and the continued growth of the informal sector.[75]

(v) International trade

(a) Eastern Europe and the Baltic states

The deterioration of the external environment has adversely affected the foreign trade of eastern Europe and the Baltic states. In early 1998, their trade continued to expand rapidly, but the pace slowed in the second half of the year. Despite this deceleration, the value of eastern Europe's exports and imports grew by 9-10 per cent in the full year 1998 (table 1.2.7). In the first half of 1999, these trade flows continued to weaken, their dollar value declining by some 4-5 per cent.[76]

1999. In contrast with the massive 600,000 person sample in 1992-1994 and the 170,000 person sample from 1995, this is a 60,000 person stratified sample.

[75] Direct communication from the Ukrainian State Statistical Committee

[76] It should be noted that the growth rates of total east European trade in table 1.2.2 differ somewhat from those in table 1.2.7. The regional aggregate in the latter table excludes the trade of Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia, for which adequate trade data by direction are lacking.

TABLE 1.2.7

Foreign trade of the ECE transition economies by direction, 1997-1999

(Value in billion dollars, growth rates in per cent) [a]

	Exports				Imports			
	Value	Growth rates			Value	Growth rates		
Country or country group [b]	*1998*	*1997*	*1998*	*1999* [c]	*1998*	*1997*	*1998*	*1999* [c]
***Eastern Europe,** to and from:* [d]								
World	112.9	5.0	9.3	-3.3	150.4	5.7	9.3	-3.5
ECE transition economies	26.2	6.6	-5.2	-26.3	28.8	-0.1	-3.8	-14.1
CIS	3.9	14.3	-24.9	-57.1	8.7	-3.6	-16.9	-24.1
Baltic states	0.4	27.0	9.1	-13.6	0.1	0.3	20.4	27.5
Eastern Europe [e]	16.2	2.2	2.9	-10.9	13.8	3.3	5.3	-6.9
Developed market economies	79.9	6.8	17.0	5.2	107.4	7.5	13.5	-0.6
European Union	73.5	6.5	17.2	5.2	93.9	6.8	14.4	–
Developing economies	6.8	-13.5	-8.1	-5.8	14.3	6.6	9.0	-2.7
***Baltic states,** to and from:*								
World	8.8	23.1	3.4	-15.8	13.8	26.7	7.5	-18.2
ECE transition economies	3.7	19.1	-13.1	-42.5	4.3	14.9	-2.9	-17.2
CIS	2.3	19.4	-23.4	-60.3	2.7	9.2	-11.3	-23.3
Baltic states	1.2	25.1	11.8	-7.6	0.8	23.2	19.8	-8.3
Developed market economies	4.7	26.5	21.0	8.5	8.6	32.8	13.7	-17.4
European Union	4.2	24.5	20.1	10.0	7.4	30.5	12.0	-18.3
Developing economies	0.3	45.4	14.7	-16.0	0.8	48.9	7.0	-29.4
***Russian Federation,** to and from:*								
World	71.3	-0.1	-16.2	-12.8	43.5	15.2	-17.9	-45.2
Intra-CIS	13.7	4.6	-17.9	-37.8	11.3	-2.2	-20.9	-46.6
Non-CIS economies	57.6	-1.2	-15.8	-6.3	32.3	23.2	-16.8	-44.7
ECE transition economies	10.4	6.0	-21.9	-17.8	3.9	34.4	-27.7	-60.6
Baltic states	2.3	17.4	-28.0	-11.0	0.7	61.9	-33.4	-69.6
Eastern Europe	8.2	3.0	-20.0	-19.6	3.2	29.2	-26.3	-58.6
Developed market economies	34.6	-0.2	-13.8	-9.0	22.0	24.1	-17.0	-44.2
European Union	23.2	2.4	-17.1	-13.2	15.7	23.4	-19.6	-42.7
Developing economies	12.6	-9.0	-15.8	11.8	6.4	13.0	-7.8	-36.4
***Other CIS economies,** to and from:*								
World	31.6	3.5	-12.9	-17.4	37.2	2.9	-8.7	-25.8
Intra-CIS	13.7	-3.2	-22.0	-35.6	19.1	-3.7	-14.3	-25.1
Non-CIS economies	17.9	10.8	-4.4	-1.6	18.1	12.3	-1.9	-26.7
***ECE transition economies,** to and from:*								
World	227.8	3.6	-3.5	-9.4	251.8	8.3	0.5	-17.3

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

Note: There were changes in the methodology of foreign trade reporting in several transition economies in 1996-1998. Starting 1998, Slovakia reports foreign trade flows according to the new methodology (including imports for inward processing and exports after processing). The Czech Republic has recently revised its export and import figures back to 1994; however, these revisions are not reflected in the east European aggregate above because the revised data by destination are not yet available. For details on changes prior to 1998 see UN/ECE, *Economic Bulletin for Europe,* Vol. 48 (1996) and Vol. 49 (1997).

a Growth rates are calculated in dollar values.

b "Eastern Europe" refers to Albania, Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. For lack of adequate data, the trade of Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia is not covered. The partner country grouping has been revised recently (subsequent changes back to 1980 were made also in appendix table B.13) following the changes in the national statistical sources. Thus, the earlier reported "Transition economies" group is now replaced by "ECE transition economies", which covers the east European countries, including the successor states of the former SFR of Yugoslavia, the Baltic states and the CIS. "Developed market economies" excludes Turkey and includes Australia, New Zealand and South Africa.

c January-June over same period of 1998.

d Revisions for Czech Republic included; 1998 value and growth rates include Polish figures according to the previous customs declaration system.

e Including Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia.

In volume terms, the region's exports remained broadly unchanged (table 1.2.8), as average dollar unit values were 3-5 per cent lower than a year earlier. Sharply reduced demand from the CIS markets (above all reflecting the collapse of Russia's imports), constrictive macroeconomic policies, various restraints on intraregional transactions (especially within south-east Europe) and weak import growth in western markets contributed to this outcome. In the Baltic states, more dependent on the CIS markets, export growth began to fall already by mid-year 1998, and in early 1999 the eventual decline in the value of exports was much steeper than in eastern Europe.

However, signs of a recovery of trade flows were apparent in several countries in the third quarter of 1999.

In the Baltic states, the Czech Republic, Hungary and Slovenia, exports picked up somewhat in July and/or August (month-on-month), raising expectations for a stronger recovery later in the year.[77] This improvement was mainly due to reviving demand in the EU, particularly in Austria, France, Germany and Italy; in contrast, CIS and intraregional import demand remained very depressed (trade within BAFTA and within CEFTA shrank by 8-11 per cent, with the mutual trade of the Czech and Slovak Republics falling by one fifth).

In January-June 1999, the developed market economies, and particularly the EU, were the only markets to which east European and Baltic countries' exports increased. The Czech Republic, Hungary and the three Baltic countries reported buoyant growth of exports to the EU (increases of 10-12 per cent in dollar value and 13-16 per cent in volume), while exports of Slovakia and Slovenia to the same markets rose 2-5 per cent in dollar value and 5-8 per cent in volume, as compared with the first six months of 1998. However, apart from the Czech Republic and Hungary, the growth of exports to the developed market economies was not sufficient to offset losses incurred on the CIS and intraregional markets (chart 1.2.1 illustrates the dramatic impact of Russia's market collapse on the quarterly exports of the eight east European and three Baltic countries through June 1999).

The Polish economy, in contrast to those mentioned above, has been falling behind: its exports to EU markets were virtually unchanged in January-June 1999 (-1 per cent in dollar value and +2 per cent in volume), and there were no signs of an export surge in late summer. The rapid growth in wages, in excess of productivity increases, and the relatively small change in the real exchange rate of the zloty against the euro have raised relative labour unit costs with a negative effect on the competitiveness of Polish exports. Although there were increases in relative labour unit costs also in the Czech Republic, Estonia and some other east European and Baltic countries, these nonetheless increased their exports to the EU.[78] The Polish export commodity structure, which is more strongly oriented towards relatively low value added industrial intermediate and consumer goods (SITC 5, 6, 8, 9) is likely to have been a major factor in the stagnation of Polish exports to the EU.[79] In addition, the dollar prices of most intermediate goods and raw materials (except energy) were lower than in 1998.[80] Also, the lower value added consumer goods have been subject to increased price competition from cheaper Asian products since 1997.

In January-June 1999, exports continued to fall in the south-east European transition economies, in particular those affected by the Kosovo crisis (Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and, especially, Yugoslavia).[81] Unfavourable external demand coupled with infrastructure constraints and shortages of imported inputs in some of the chronically depressed economies of the region substantially reduced their exports to all major markets (exports from Bulgaria and The former Yugoslav Republic of Macedonia fell by one fifth, for instance, see table 1.2.2). Exports from the south-east European countries to other European transition economies (including the CIS) were even more strongly affected: in the first half of 1999 the declines ranged from 18 per cent in Romania to 49 per cent in Bulgaria.

Although the value of imports increased somewhat in the summer months, due mainly to higher oil and non-ferrous metal prices and somewhat greater imports of consumer goods boosted by the recovery of personal consumption in several transition economies, total imports into the east European and Baltic countries in the first half of 1999 were lower than in 1998. The decline in dollar value of east European imports was nearly 4-6 per cent (year-on-year), following 9 per cent growth in 1998 (tables 1.2.2 and 1.2.7), but the import volume was down only slightly (2-3 per cent). There were increases only in Albania, Hungary and Slovenia; imports into all the other countries in the region fell, and by large amounts in the Baltic states (18 per cent) and in The former Yugoslav Republic of Macedonia (22 per cent). The decline of imports into the Baltic countries, in contrast to that of exports, was evenly spread in terms of trading partners: imports from the EU were down by 18 per cent, and those from eastern Europe and the CIS by about one

[77] In August-October (and probably through the end of 1999) the relative year-on-year growth of exports is expected to be somewhat stronger across the region than in the earlier months of the year. In part this is a statistical effect reflecting the collapse of Russian imports following the financial crisis in August and the resulting decline in the exports of its trade partners. For instance, in September 1998, east European and Baltic countries' exports to Russia dropped to 15-25 per cent of those in the same period of the previous year, then remained at 25-35 per cent through the end of 1998 and the first months of 1999.

[78] In Hungary, too, real wage growth accelerated sharply in the first half of 1999 while labour productivity growth slowed, but in contrast to the above-mentioned countries the forint's real depreciation vis-à-vis the euro quickened, which helped to keep relative labour unit costs on a downward trend. See sect. 1.2(ii) above.

[79] Jointly these commodities (SITC 5, 6, 8, 9) accounted for nearly 54 per cent of total Polish exports in the first half of 1999, while in the Czech Republic, Hungary and Slovakia their share varied from 31-45 per cent of total exports.

[80] Raw material (excluding energy) prices were 13 and 12 per cent down in the first and second quarters of 1999, year-on-year, but only 5 per cent lower in the third quarter as prices for industrial and agricultural raw materials were flat for that period and those for non-ferrous metals increased by 9 per cent. (Hamburg Institute of Economic Research (HWWA), direct communication.) Average export unit values for European manufactured goods in the first half of 1999 were also slightly lower (2 per cent) than a year earlier. United Nations, *Monthly Bulletin of Statistics*, October 1999 (www.un.org).

[81] The reported strong growth in the dollar value of exports from Albania and Bosnia and Herzegovina probably reflects recovery from the very low levels of trade and a somewhat improved coverage of transactions in the customs data.

TABLE 1.2.8

Changes in the volume of foreign trade in selected transition economies, 1995-1999
(Per cent)

	Exports						Imports					
					1999 [a]						1999 [a]	
	1995	1996	1997	1998	Jan.-Mar.	Jan.-Jun.	1995	1996	1997	1998	Jan.-Mar.	Jan.-Jun.
Czech Republic	5.7	2.7	14.2	14.4	-2.3	4.6	23.7	10.7	7.6	8.5	1.2	3.0
Hungary	8.4	4.6	29.9	22.1	12.1	11.3	-3.9	5.5	26.4	24.9	12.6	12.2
Transition economies	20.2	-0.2	25.2	4.7	-21.2	-20.3	-4.1	2.8	5.3	12.1	1.7	3.6
European Union	5.1	5.7	33.6	24.1	16.9	16.1	-2.7	4.0	29.7	23.8	15.9	13.6
Poland [b]	16.7	9.7	13.7	2.3	-7.6	-5.3	20.5	28.0	22.0	14.3	-2.3	-1.2
Transition economies	46.5	29.0	35.8	-5.0	-33.1	-29.0	25.1	19.3	13.5	12.6	-0.2	3.3
European Union	17.1	5.7	11.9	8.5	0.6	2.3	19.6	27.3	25.2	16.2	-1.1	-0.8
Slovenia [c]	7.5	3.1	11.4	8.4	5.8	3.6	15.5	-	9.6	10.4	2.6	5.8
Estonia	8.1	6.7	51.1	9.6	-10.1	-10.2	..	..	..	9.5	-17.7	-21.6
Latvia	7.1	8.8	20.1	10.2	-8.2	-8.6	..	..	..	..	..	..
Russian Federation	..	0.1	1.8	-0.3	18.1	17.2	..	-1.9	21.1	-11.0	-37.5	-29.0
Non-CIS	6.4	3.6	1.8	-0.6	25.4	21.3	-3.2	-0.1	31.7	-8.4	-39.1	-30.4
CIS	..	-15.6	1.9	0.8	-6.3	1.5	..	-6.2	-1.8	-18.4	-32.7	-25.8

Source: UN/ECE secretariat calculations, based on national foreign trade statistics.

a Over same period of 1998.

b Volume indices for 1998 are based on growth rates of trade value according to the previous customs declaration system.

c Volume indices for Slovenia as reported by IMAD, *Slovenian Economic Mirror*, Vol. III, 1997; Vol. V, 1999 and *Spring Report,* 1999. January-May instead of January-June in 1999.

fifth from a year earlier. This was not, however, the case with the east European countries: their purchases from the EU remained flat while those from the CIS were reduced by one third and those from within the region by 7 per cent.

Domestic demand, relatively strong in several countries of the region (see section 1.2(ii)), appears to be increasingly satisfied by locally produced goods which had previously been destined for the CIS and intraregional markets. The factors behind this development include protectionist measures introduced (often to the accompaniment of claims as to their temporary nature) by several east European and Baltic economies since the end of 1998[82] and the real depreciation of domestic currencies against the dollar and the euro in many countries.[83] The latter, coupled with reduced export earnings, has restrained imports including, in some cases, purchases of industrial inputs.

The reduction in imports led to a narrowing of trade deficits across the east European and Baltic countries – in aggregate, to $19.1 billion in January-June 1999 from $21.3 billion a year earlier. The marked exceptions were Albania, Bulgaria, Hungary and Slovenia where trade gaps widened.[84] Although it fell by $360 million compared with the first half of 1998, Poland's trade deficit was still the largest in absolute terms, at $8.4 billion, accounting for nearly one half of the region's aggregate deficit. In relation to GDP, however, the Polish deficit remained broadly unchanged, at slightly less than 12 per cent (table 1.2.2). In this respect, the situation worsened most seriously in Bulgaria: with the slump in the economy, the merchandise trade deficit rose from 5.7 per cent of GDP in 1998 to 13.6 per cent in

[82] For some details on the attempts of individual east European and Baltic countries to increase import duties, impose quotas and other non-tariff barriers to trade at that time see UN/ECE, *Economic Survey of Europe, 1999 No. 1*, chap. 3.6(ii), pp. 150-152. More recently, Slovakia, for instance, introduced an import surcharge of 7 per cent affecting nearly 70 per cent of goods (as from 1 June 1999), in Poland duties were increased on farm produce, and the Czech Finance Ministry has a plan to extend an import tariff on sugar as a 200-day emergency measure. Moreover, the representatives of CEFTA during the mid-September summit in Budapest failed to agree upon concrete measures to resolve their ongoing disputes concerning agricultural trade. This sector currently accounts for 80 per cent of all protectionist measures instituted by CEFTA countries, even though it is set to be nearly fully liberalized by 2004. (BBC Monitoring, *Summary of World Broadcasts,* central Europe and Balkans, 23 and 30 September 1999; *Rzecspospolita*, 29 September and 1 October 1999.) The Estonian government, one day before the parliament ratified the WTO accession agreement on 29 September 1999, for the first time approved customs tariffs on certain foodstuffs from third countries. BBC Monitoring, *Summary of World Broadcasts,* former USSR, 1 October 1999.

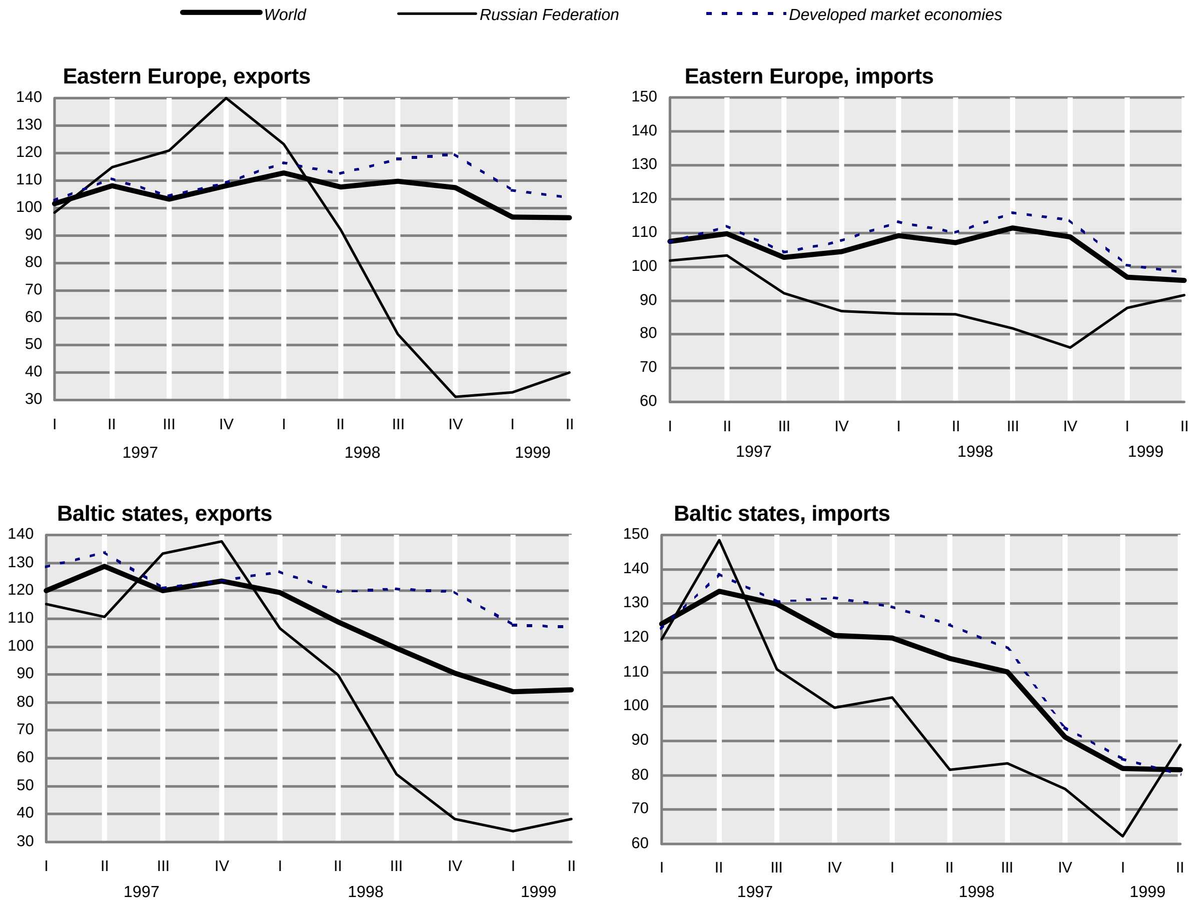
[83] In January-June 1999, most of the region's domestic currencies depreciated in real terms against the dollar and the euro; as compared with the same period of the previous year the Romanian leu lost one fifth of its value in real terms, the Slovakian koruna depreciated by some 10 per cent, and the currencies of Bulgaria, Hungary and Poland by 1-6 per cent. The Czech koruna, the Lithuanian litas and the Slovene tolar remained broadly unchanged, while the domestic currencies of Estonia and Latvia appreciated slightly (2-3 per cent) in real terms.

[84] Deficit widening was due in part to relatively strong imports in the above-mentioned countries partly because of relaxed import policies (for instance, in January 1999 average Bulgarian import tariffs were reduced significantly and a 5 per cent import surcharge was eliminated ahead of schedule), or in anticipation of new taxes or surcharges (in Slovenia, imports went up by the end of the second quarter in anticipation of a new VAT tax which was to be implemented on 1 July 1999). *BNA's Eastern Europe Reporter,* Vol. 9, No. 5, May 1999

CHART 1.2.1

Quarterly changes in the exports and imports of eastern Europe and the Baltic states, 1997-1999

(Index over same quarter of the preceding period)



Source: UN/ECE secretariat calculations, based on national statistics and direct communications from national statistical offices.

January-June 1999. At the same time, there were some marked reductions in trade deficits: in Estonia, for instance, the deficit-to-GDP ratio fell by 10 percentage points, and in Latvia and Slovakia by 5 percentage points. There were also some reductions (by about 1.5 percentage points) in relative trade deficits in the Czech Republic, Romania and Lithuania.

In respect of the major trading partners, the substantial narrowing of the deficits in trade with the EU were responsible for the overall improvement. For eastern Europe and the Baltic states as a whole, the trade deficit with the EU shrank from $10.6 billion in the first half of 1998 to $7.8 billion in January-June 1999, which more than offset the $1.4 billion widening of the gap in trade within ECE transition economies (including the CIS countries).[85]

In respect of commodities traded, the east European and Baltic countries remained traditional net exporters of manufactured consumer goods (SITC 8), with an aggregate surplus in January-June 1999 somewhat higher than a year earlier, but another traditional net export category, beverages and tobacco (SITC 1), moved into deficit. Total exports of the latter, together with food and agricultural products (SITC 0, 1, 4), fell by nearly a quarter in dollar terms (mainly because of the collapse of the CIS markets), whereas imports declined rather less, by 12-14 per cent.

The largest net import category, of about $8 billion ($1 billion less than in January-June 1998), was machinery and equipment (SITC 7), with chemical products and intermediates (SITC 5, 6) coming close behind. However, while the region's exports of machinery and equipment grew in aggregate some 6-7 per cent in dollar value (driven mainly by strong growth in the Czech Republic, Hungary, Romania and Slovakia), with imports being nearly flat, both exports and imports of chemicals and intermediates fell.

[85] The aggregates here, and in the discussion on commodities below, do not include The former Yugoslav Republic of Macedonia and Yugoslavia as foreign trade data by destination and commodities for these countries were not available at the time of writing this *Survey*.

The largest contribution to the reduction in the overall trade deficit was due to the considerable fall in net imports (by some $2 billion) of raw materials and fuels (SITC 2, 3, 4) in the first half of 1999, with both exports and imports falling sharply. Restrained domestic demand and an improvement in the terms of trade (by 6-7 per cent as compared with the same period of 1998) were among the main factors behind this development.

As the impact of two major shocks, the protracted crisis in Russia and the Kosovo conflict, begins to alleviate somewhat, and given the forecasts of recovery in the west European economy, which absorbs about two thirds of total exports from the region, merchandise exports of the east European and Baltic countries are expected to strengthen towards the end of 1999 and in early 2000. However, their terms of trade most probably will worsen because of recent increases in the international market prices of oil and some other commodities and as a result of increasing price competition from Asian producers on west European markets. Imports, if not hampered by weak domestic demand resulting from tighter fiscal policies in individual countries and a further real depreciation of domestic currencies against the euro and the dollar, are also likely to resume their growth at least insofar as imported inputs are necessary for exporting industries. According to the few available country forecasts for 1999, export and import growth in real terms is unlikely to exceed 4-5 per cent in those countries where there was already an upward tendency by mid-1999 (the Czech Republic, Slovenia). In Hungary, however, increases of 10-12 per cent are expected.[86] Forecasts for trade growth in 2000 show a further slight improvement in the majority of east European and Baltic countries.

(b) Commonwealth of Independent States

In the first six months of 1999, the dollar value of total merchandise exports from the CIS countries fell by 14 per cent and imports by 37 per cent. The value of CIS trade in 1999 continued to be affected by low world commodity prices and was greatly influenced by the effects of the Russian financial crisis (through falling GDP in Russia, Ukraine and Kazakhstan and depreciating, in dollar terms, national currencies throughout the region). As a result, most CIS countries' merchandise *exports* declined – between 4 per cent in Armenia and as much as 47 per cent in the Republic of Moldova. Exports from Azerbaijan and Turkmenistan increased while from Georgia and Tajikistan they were basically flat. Total merchandise *imports* fell across the board except in Turkmenistan, the declines ranging from about 5 per cent in Tajikistan and Uzbekistan to 57 per cent in the Republic of Moldova. The CIS region's merchandise *surplus* was about $16 billion, a more than twofold increase over the first half of 1998. The overall improvement was the result of a larger surplus in Russia and a smaller aggregate deficit in the other CIS countries – due, in both cases, to the value of imports falling at a greater rate than exports.

Commodity prices, a major determinant of export performance in many natural resource-dependent CIS economies, were generally lower than in the first six months of 1998. While most prices in the first six months of 1999 were still showing year-on-year declines of between 5 per cent (nickel, gold) and 16 per cent (cotton, copper), the price of the most important CIS export commodity – crude oil – rose by 25 per cent. More importantly, at the beginning of the third quarter, most commodities (except cotton) were trading at higher prices than the average levels in the second quarter. For example, crude oil and gasoline prices were higher by about 25 per cent, copper by 12 per cent, aluminium by 9 per cent and nickel by 23 per cent.[87] Similarly, gold traded at $325 an ounce in early October (about 19 per cent higher than in the second quarter of 1999), following an announcement by 15 European central banks to reduce gold sales from their official reserves for five years.

While this dramatic – but possibly short-lived – turnaround in commodity pricing bodes well for the third quarter export earnings in a number of CIS countries, the price changes came too late to improve the aggregate trade performance in the first half of 1999. In Russia, despite a 4 per cent increase in the volume of crude oil shipped abroad, 18 per cent in oil products and 16, 10, and 17 per cent in coal, aluminium and copper respectively, low commodity prices continued to have a negative impact on export receipts.[88] Overall, the volume of Russia's total exports increased by 17 per cent, but this failed to offset a 26 per cent fall in export prices.[89] Similarly, in Kazakhstan, the volume of exports of key natural resources such as crude oil, copper, zinc, coal and steel products was either steady or increased, but the export values were down significantly due to lower export prices. The value of Kazakhstan's crude oil exports were down by 38 per cent, coal by 60 per cent and all other metals by between 5 and 19 per cent.[90] In contrast, the increased export revenues of Azerbaijan were the result of greater volumes of crude oil exports: increased production in the first half of 1999 (up by 28

[86] IMAD, *Spring Report 1999* (Ljubljijana) 1999; *NAPI GAZDASAG* as quoted by *Reuters News Service*, 15 September 1999.

[87] IMF, *International Financial Statistics* (Washington, D.C.), September 1999.

[88] The Russian Federation Goskomstat, *Sotzial'no-ekonomicheskoe polozhenie Rossii* (Moscow), January-July 1999.

[89] Russian Federation State Customs Committee, *Tamozhennaya statistika vneshnei targovlii Rossiiskoi Federatsii*, Nos. 1 and 2 (Moscow), 1999.

[90] Based on the first five months of 1999. *Kazakhstan, Sotzial'no-ekonomicheskoe polozhenie respubliki*, June 1999, pp. 36-37.

per cent)[91] was induced and accommodated by the availability of additional (Baku-Supsa) export pipeline capacity.

One year after the *financial crisis in Russia*, the collapse of Russian domestic demand – retail trade was down 14 per cent in the first half of 1999 – has continued to affect the rest of the CIS. The dramatic decline in Russia's imports from other CIS countries led to falls in GDP and industrial output throughout the region. The most severe impact was on countries with economies and trade patterns closely tied to Russia. In the first six months of 1999, GDP fell in Kazakhstan, the Republic of Moldova and Ukraine, while the Belarussian economy bucked the trend and grew by 2 per cent (see section 1.2(ii)). Other countries such as Armenia, Azerbaijan, Georgia and Kyrgyzstan are relatively less dependent on the Russian economy and/or were able to shift some exports to non-CIS destinations. Still, in Georgia and Kyrgyzstan, industrial output fell in the first half of 1999, partly because of reduced mutual trade with Russia and other CIS countries. The impact on the remaining countries of central Asia (Tajikistan, Turkmenistan and Uzbekistan) – which are generally less open, have national currencies subject to administrative controls and rely more on commodity exports which are easily diverted to non-CIS markets – has been less pronounced.

The devaluation of the Russian rouble in August 1998, in addition to contributing to the reduction in intra-CIS trade, has also had detrimental effects on *exchange rates*. Currency devaluations characterized CIS foreign exchange markets as this external shock (exacerbated at the time by falling commodity prices) destabilized macroeconomic policies in the region. Moreover, generally loose fiscal policies, combined with low confidence in the domestic financial sectors, put additional pressures on already shaky currencies.[92] As a result, in the first six months of 1999 all CIS countries' currencies fell in nominal terms – depreciating against the dollar, year-on-year, between 25 per cent in Kazakhstan and 86 per cent (in the official rate) in Belarus. Only in Armenia and Azerbaijan were the currency devaluations relatively modest (7 and 2 per cent, respectively). Currencies in Armenia, Kazakhstan, Kyrgyzstan and Ukraine continued to fall after the second quarter.[93] The immediate effect of declining purchasing power has been lower imports from the non-CIS area and reductions in purchases of goods priced in dollars from other CIS countries. Depreciated currencies also create opportunities for more competitive exports to non-CIS markets. However, although there were considerable increases in non-CIS exports from Armenia, Azerbaijan, Belarus, Georgia and Turkmenistan, these were not necessarily due entirely to weaker currencies. In Armenia and Turkmenistan other factors at work included increased shipments of crude oil and natural gas, while the other countries shifted some of their exports away from the CIS markets to the non-CIS area. The impact of exchange rate instability on intraregional trade is more difficult to analyse. Intra-CIS trade is not transparent: extensive barter transactions, misreported prices, hard currency settlements and prevalent payments arrears all contribute to the opaqueness of international trade transactions. Nonetheless, most CIS countries have found it difficult to compete on the important Russian market as their national currencies strengthened against the rouble.

Russian oil companies clearly benefited from the weaker rouble and rising commodity prices. So did the Russian government both through higher tax revenue and, in particular, from the opportunity to raise export taxes.[94] However, the oil companies' rush to export rather than sell domestically led to price increases and supply shortages at home. The government responded by banning the export of gasoline and limiting the export of fuel oil and diesel in August. A similar situation, of gasoline shortages, rising prices and fears of insufficient heating fuel stocks for the winter, was also evident in Belarus, Kazakhstan and Ukraine. The governments of these countries responded in a similar way, by lowering import duties and taxes to increase supply (Ukraine), by prohibiting fuel exports and abolishing import taxes (Kazakhstan) and eliminating excise taxes, VAT, licences and customs duties on imports of oil products (Belarus).

Geo-political complexities have continued to influence international trade relations in the Caucasian and central Asian countries and, in fact, have become more complicated. First, the political instability in the Chechnya and Dagestan regions of Russia caused the Baku-Novorosiisk oil pipeline to be closed for considerable periods, forcing Azerbaijan's crude oil exports to be shipped by rail. As a result, an estimated 300,000 tonnes of oil have not been delivered. Second, the discovery of a massive natural gas field in Azerbaijan has made the country a potentially significant new competitor in the region. The two major gas producers in the region – Russia and Turkmenistan – have been competing to supply the fast growing natural gas market

[91] *Turan News Agency* as reported in BBC Monitoring, *Summary of World Broadcasts*, 6 August 1999.

[92] There were also other reasons for weaker national currencies. In Azerbaijan, for example, manufacturing and agriculture have faced intensified pressure from increasingly competitive Russian imports after the collapse of the rouble. The IMF has suggested that "it would now be appropriate for an exchange rate policy to be geared toward restoring the competitiveness of the non-oil sector". (IMF, "IMF concludes Article IV consultation with Azerbaijan Republic", *Public Information Notice (PIN)*, No. 99/72, 9 August 1999.) A week later the Azerbaijan central bank let the national currency depreciate by 7 per cent.

[93] The Ukrainian hryvnia began falling in July under the influence of gasoline shortages that triggered fears of an overall price increase and thus boosted demand for dollars.

[94] Export taxes on crude oil were raised to 7.5 euros per tonne from 5 euros in September.

in Turkey by planning to construct new gas pipelines.[95] Even before the discovery of natural gas reserves in Azerbaijan, the regional producers were engaged in complex political and commercial negotiations concerning the distribution of potentially enormous resource rents. These related to the route of a $3 billion oil pipeline from Azerbaijan, the issue of pipeline access for Turkmenistan's huge and largely underutilized natural gas reserves, and the division of Caspian sea resources by its littoral states.

In Ukraine, following the presidential veto of a 30 per cent export duty, the parliament reintroduced legislation to impose a 23 per cent duty on exports of sunflower seeds – one of a few successful export products. The country is also considering tightening restrictions on trade in grain and sunflower seeds by creating special exchanges. While the Ukrainian government has removed foreign exchange restrictions on current account transactions, it has continued to introduce restrictive import measures with a view to protecting domestic producers (e.g. of clothes, pharmaceuticals and food). It is also carrying out two anti-dumping investigations related to imports of lamps and artificial fur.[96] In Kazakhstan, there has been a recent reversal in trade liberalization, which was one of the motives that led the Executive Board of the IMF to refuse to renew the country's Extended Fund Facility in July. The Board expressed "serious" concern with respect to the imposition of trade restrictions on neighbouring countries, an upward drift in average tariffs and the proliferation of specific and mixed tariffs.[97]

In contrast, Armenia, Georgia and the Republic of Moldova are taking practical steps to liberalize trade policy and customs control. Georgia will be admitted to the World Trade Organization as a full member following domestic ratification of the accession agreement. The government has also transferred control of its main customs operations to a British company to stem smuggling, to ensure that all cargo is declared accurately and, in effect, to raise government revenues.[98] (A similar contract was awarded to a Swiss company in Armenia last year.) In Georgia, widespread cigarette smuggling lowers potential tax revenues and some 60 per cent of fuel imported into the country is believed to be unregistered by customs officials. In the Republic of Moldova, the government is considering the reduction of excise taxes on cigarettes to reduce the incentive to smuggle. By some estimates, only 7 per cent of tobacco products in the country is imported legally.[99]

Non-CIS trade

In the first six months of 1999, the dollar value of Russia's and other CIS countries' merchandise *exports* to non-CIS countries fell by 5 per cent (table 1.2.9). For commodity exporters such as Kazakhstan, Kyrgyzstan, Russia, Tajikistan, Ukraine and Uzbekistan, exports to non-CIS countries fell between 3 and 9 per cent. Many of them increased their shipments, but the volume increases were not sufficient to completely offset lower commodity prices. For example, Russian non-CIS exports were down by 6 per cent in value terms – the result of a 20 per cent volume increase and a 25 per cent fall in prices. Russia's exports of virtually all of its important commodities – crude oil, natural gas, aluminium, copper and coal – increased in volume in the first six months of 1999, but weaker prices continued to lower export earnings. The value of exports of steel products from Russia fell, in part because of increased trade barriers, especially anti-dumping procedures, in foreign markets.

[95] It is estimated that Turkish consumption of natural gas will rise more than fourfold in the next 20 years. "Baku opens the doors to natural gas development", *Petroleum Economist*, July 1999, p. 24.

[96] BBC Monitoring, *Summary of World Broadcasts*, 16 July 1999.

[97] IMF, "IMF concludes Article IV consultation with Kazakhstan", *Public Information Notice (PIN)*, No. 99/73, 9 August 1999,

[98] "Georgia to transfer control of custom duties", *Financial Times*, 10 August 1999.

[99] *Commersant Moldovy* as reported by *Novecon*, 29 June 1999.

Market access problems have constrained Ukraine's exports of ferrous metals, and low prices and supply difficulties in the chemical and agricultural sectors have also affected exports to non-CIS countries. Azerbaijan increased its non-CIS exports by over 50 per cent as a result of the new export pipeline and increased crude oil production while Uzbekistan's hard currency earnings were lower due to a large reduction in cotton exports in the first half of 1999. Other CIS countries – notably, Armenia, Belarus and Georgia – were able to divert some of their export production away from the CIS markets with a 20-30 per cent increase in exports to the non-CIS area.

The value of CIS *imports* from non-CIS countries fell by 39 per cent in the first half of 1999, with declines ranging from 5 per cent in Tajikistan to 60 per cent in the Republic of Moldova. The largest CIS economies drastically reduced their non-CIS imports: Russia by 45 per cent, Ukraine by 41 per cent, Belarus by 27 per cent and Kazakhstan by 14 per cent. Overall, the fall in non-CIS imports reflected slow or negative GDP growth (in Kazakhstan, Ukraine and Russia) and weak domestic demand (in Belarus, Kyrgyzstan, the Republic of Moldova, Russia and Ukraine) exacerbated by depreciating national currencies. Russia's experience was rather typical in that GDP fell, the national currency depreciated, and retail trade was down. The large fall in the value of Russian non-CIS imports was the result of lower import prices and reductions in volume. In volume terms, Russia's non-CIS imports fell in virtually all major categories, with the largest declines in raw materials (wood, minerals and energy) and machinery. Turkmenistan was the only country going against this trend: its GDP increased by 15 per cent, with large increases in the output of natural gas, cotton and crude oil, and this led to increased imports from non-CIS countries.

Intra-CIS trade

In the first six months of 1999, compared with the same period of 1998, the dollar value of intra-CIS merchandise trade declined dramatically (table 1.2.9). As noted above, the financial crisis in Russia and the rouble devaluation in particular adversely affected economic performance and trade throughout the region. Overall, intraregional exports and imports decreased by about a third with significant declines in virtually every CIS country except Tajikistan and Turkmenistan. Tajikistan's value of CIS exports increased by 14 per cent partly due to greater aluminium shipments, while Turkmenistan boosted natural gas sales to Ukraine[100] and increased output of cotton fibre and crude oil – other significant export commodities – by 50 and 14 per cent.[101]

Russia's exports to the CIS, in dollars, fell by almost 40 per cent in the first six months of 1999 – this was due to falling export prices as the aggregate export

TABLE 1.2.9

CIS countries' trade with CIS and non-CIS countries, 1998-1999
(Value in million dollars, growth rates in per cent)

	Export growth		*Import growth*		*Trade balances*		
	1998	*1999 [a]*	*1998*	*1999 [a]*	*1998*	*1998 [a]*	*1999 [a]*
Armenia							
Non-CIS	-12.9	31.0	13.2	-7.0	-552	-248	-206
CIS	-15.0	-47.6	-23.0	-10.0	-150	-50	-64
Azerbaijan							
Non-CIS	-7.2	53.7	51.8	-6.2	-299	-187	-102
CIS	-38.6	-39.5	15.3	-22.3	-173	-57	-66
Belarus							
Non-CIS	-0.7	35.9	4.3	-26.9	-1 085	-741	-13
CIS	-4.1	-38.1	-4.5	-34.9	-394	-144	-183
Georgia							
Non-CIS	-17.4	18.5	12.7	-49.6	-592	-312	-129
CIS	-23.5	-16.8	11.3	-30.4	-274	-106	-67
Kazakhstan							
Non-CIS	-7.9	-9.4	13.8	-14.1	999	597	589
CIS	-29.6	-57.6	-14.2	-29.6	99	224	-207
Kyrgyzstan							
Non-CIS	-0.7	-2.7	46.8	-18.7	-118	-42	-12
CIS	-27.7	-15.8	1.1	-41.0	-210	-100	-33
Republic of Moldova							
Non-CIS	-23.9	3.2	2.9	-60.1	-381	-254	-48
CIS	-29.5	-62.0	-27.2	-52.3	-11	36	-9
Tajikistan							
Non-CIS	-16.7	-7.9	-1.2	-4.7	129	62	53
CIS	-25.7	14.3	-7.4	-5.0	-243	-142	-115
Turkmenistan							
Non-CIS	47.3	36.6	-0.2	49.1	-88	-46	-92
CIS	-66.3	443.3	-26.8	-26.1	-326	-213	204
Ukraine							
Non-CIS	-2.4	-7.7	-6.5	-40.5	1 657	743	1 843
CIS	-24.8	-41.0	-20.1	-19.3	-3 695	-1 859	-2 008
Uzbekistan							
Non-CIS	-9.8	-8.0	-26.1	-7.3	169	194	171
CIS	-40.7	-12.6	-23.7	2.5	-75	9	-66
Total above							
Non-CIS	-4.4	-1.6	-1.9	-26.7	-161	-234	2 054
CIS	-22.0	-35.6	-14.3	-25.1	-5 452	-2 402	-2 614
Russian Federation							
Non-CIS	-15.8	-6.3	-16.8	-44.7	25 343	8 495	15 523
CIS	-17.9	-37.8	-20.9	-46.6	2 391	662	1 008
CIS total							
Non-CIS	-13.3	-5.1	-12.0	-39.0	25 182	8 261	17 577
CIS	-20.0	-36.7	-16.9	-33.7	-3 061	-1 740	-1 606

Source: CIS Statistical Committee, *Ekonomika Stran Sodruzhestva Nezavisimykh Gosudarstv, Express-Doklad*, August 1999 and direct communication to the UN/ECE secretariat. For Turkmenistan and Uzbekistan: UN/ECE estimates and *Reuters*, 16 August 1999 and 28 July 1999, respectively. For the Russian Federation: Russian Federation Goskomstat, *Sotzial'no-ekonomicheskoe polozhenie Rossii*, January-July 1999 and Russian Federation State Customs Committee, *Tamozhennaya statistika vneshnei torgovli Rossiiskoi Federatsii*, No. 2 (Moscow), 1999.

[a] January-June.

[100] Gas sales were suspended in the second quarter of 1999 because of Ukraine's financial difficulties and its inability to pay for the purchases. Ukraine has begun repaying its natural gas purchases in kind. Turkmenistan, a cotton and grain growing country, will accept $100 million worth of nitrogen fertilizers in partial payment for natural gas deliveries. BBC Monitoring, *Summary of World Broadcasts*, 20 August 1999.

[101] *Interfax News Agency*, 20 August 1999.

volumes were roughly flat. Exports of Russia's most valuable CIS trade commodity – natural gas – declined by 17 per cent in volume while exports of machinery and equipment to the CIS almost halved. Volumes of crude oil, gasoline, diesel fuel and heating oil increased between 12 and 85 per cent, but export revenues declined between 23 and 45 per cent. Russia's CIS imports fell by about 50 per cent in value, with sharp declines in machinery and equipment, coal, steel products and most agricultural products.[102] Overall, import volumes were down by 28 per cent and prices by 26 per cent.

Among the other CIS countries, the value of Azerbaijan's CIS exports fell 40 per cent largely because of a 60 per cent decline in the volume of oil products. Imports from the CIS fell 22 per cent in value with large falls in steel products and machinery and equipment. Belarussian CIS exports, predominantly oil products, steel products and machinery, fell by 38 per cent in value (exports of oil and steel products fell considerably but machinery and equipment increased). The exports of the most important products from Kazakhstan to the CIS – crude oil, coal and grains – fell by more than half in volume which, together with falling prices, led to an almost 60 per cent decline in total export earnings. The value of Kazakhstan's CIS imports declined by a third with falls in all major product groups except natural gas and cars. The economic situation in Russia, the Republic of Moldova's largest export market, led to a virtual collapse of the country's exports. The Republic of Moldova depends predominantly on exports of agricultural products and the collapse of the Russian import demand was largely responsible for the 62 per cent fall in Moldova's CIS exports. In turn, its imports fell by over 50 per cent mainly because of much lower imports of energy products.

(vi) Current accounts and external financing

In early 1999, there were concerns that the current account balances of many European transition economies would come under pressure. About two thirds of them had already posted relatively high current account deficits in 1998. While the projected financing needs of many of these countries appeared manageable, this was not the case for all, especially those whose financial position had noticeably weakened in 1998. Significantly, aggregate economic growth in western Europe, the largest single market for eastern goods, was expected to slow, and it appeared unlikely that the severely depressed demand in many CIS and certain east European countries would recover quickly. Moreover, several countries showed signs of real exchange rate appreciation and declining competitiveness, a trend which probably accelerated with falling productivity at the end of 1998. In early 1999, too, oil prices turned up, partially eroding the benefits which fuel-importing countries had realized in 1998.

In the financial sphere, the transition economies continued to experience the repercussions of the Asian and Russian financial crises. Borrowing costs remained above pre-crises levels and in general access to new funds was more difficult than before. At the same time, a number of countries faced heavy debt service burdens. In several cases revenues from the privatization of strategic assets were counted on to provide much of the needed financing, but the unsettled investment climate cast uncertainty over the completion of sales. In other cash-strapped countries privatization prospects remained poor and, at most, they could rely only on official flows or short-term credits. A resurgence of financial market turbulence continued to pose a risk for the whole area.

On top of this, the onset of the Kosovo conflict in late March promised to further exacerbate current account imbalances and/or tighten financing constraints, particularly for the countries of south-east Europe. The disruption of trade routes and the collapse of Yugoslav trade adversely affected merchandise exports and net earnings from services (including tourism receipts). Investor confidence, never high in the area, seemed to suffer.

(a) Current account developments

The expectations of early 1999 have been broadly confirmed by data for January-June. Balance of payments statistics indicate that the value of east European, Baltic and European CIS *exports of goods and services*[103] declined by 4 per cent, 15 per cent and 15-18 per cent,[104] respectively. This is in contrast to the general expansion of such exports in the east European and the Baltic countries (but not the European CIS) in 1998.[105] However, in Hungary exports continued to expand, although at a slower pace than in 1998. Also, Albanian exports of goods and services continued to recover (from the disruption caused by the collapse of the pyramid schemes in 1997), as was also the case in Bosnia and Herzegovina.[106] In the Czech Republic, merchandise exports (but not services) turned up after a sharp drop in the first quarter of 1999. Overall, weak external demand, including among the transition economies themselves, and a variety of domestic factors contributed to the negative export performances.

[102] Russian Federation Goskomstat, *Sotzial'no-ekonomicheskoe polozhenie Rossii* (Moscow), January-July 1999, pp. 111 and 119-120.

[103] This section is based on balance of payments statistics whereas in sect. 1.2(v) merchandise trade data based on customs returns are used.

[104] The value of exports of goods and services from Russia declined by 15 per cent while the combined value of those from Belarus, the Republic of Moldova and Ukraine fell by 18 per cent.

[105] As noted in sect. 1.2(v), the exports of eastern Europe and the Baltic states weakened already in 1998, but the annual changes are still positive.

[106] Merchandise trade results for Bosnia and Herzegovina are given in table 1.2.2. Balance of payments data for January-June 1998 have not been released so comparisons with 1999 are not possible.

Deteriorating export performances placed *current account balances* under increased pressure. The combined current account deficit of eastern Europe rose to nearly $10 billion in the first half of 1999 (table 1.2.10), due to a further increase in the merchandise trade imbalance[107] and a falling surplus on services. Larger current account deficits were reported by Bulgaria, Hungary, Poland and Slovenia, but in all cases they were easily financed (as was also the case in Latvia and Lithuania – see below).[108] In Poland, the imbalance has been exacerbated by the decline in unclassified current transactions, which nonetheless remain a major source of foreign exchange.[109] In some other transition economies, current account balances improved, but the reasons for this vary from country to country. In Croatia, Romania and Slovakia, the reduction of the large imbalances registered in 1998 was an explicit policy objective. The depreciation of real exchange rates and the weakening of internal demand led to falling imports of goods and services (in all cases by more than those of exports). Sluggish economic activity in the Czech Republic further reduced the country's modest deficit. In the Baltic states, the contraction of output reduced the pressure on current account balances, but the deficits of Latvia and Lithuania rose nonetheless. In Lithuania an increase in the fiscal imbalance has kept the merchandise trade deficit high, but in Latvia the balance on services deteriorated sharply.

In Belarus, the Republic of Moldova and Ukraine the impact of the steep fall of exports on the current account was compounded by the stoppage of capital inflows (Ukraine had already experienced capital outflows in 1998 – see below). The resulting decline in domestic demand (or growth slowdown in Belarus) and the depreciation of real exchange rates reduced imports of goods and services by nearly one third, shifting their current accounts into surplus.[110] In 1998 these countries managed to cushion the negative impact of falling exports and weakening capital imports on their current accounts by drawing on official reserves, but their low level in 1999 precluded a repetition of this policy response. It should be noted that there was also a marked deceleration of capital inflows into Romania and The former Yugoslav Republic of Macedonia in the first half of 1999 and that their macroeconomic adjustment in the face of falling exports was similar: a contraction of domestic demand (in Romania) and imports and the elimination of the current account deficit.[111] All these countries faced severe financial constraints (see below).

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[107] It should be noted that the customs statistics cited in sect. 1.2(v) show a decline in the merchandise trade deficit in the first half of 1999.

[108] In Bulgaria official sources, as expected, provided the bulk of new financing.

[109] Unclassified current transactions amounted to $6 billion in 1997-1998. The recent decline is attributed to reduced informal border trade with Belarus, Russia and Ukraine.

[110] The Republic of Moldova moved into current account surplus in the second quarter of 1999.

[111] Romania's large repayments of foreign debt resulted in a net outflow of capital in the second quarter of 1999 and the current account moved into surplus in July.

TABLE 1.2.10

Current account balances of the ECE transition economies, 1996-1999
(Million dollars and per cent)

	Million dollars						*Per cent of GDP*				
				January-June						*January-June*	
	1996	*1997*	*1998*	*1998*	*1999*	*1999*	*1996*	*1997*	*1998*	*1998*	*1999*
Eastern Europe [a]	-13 498	-15 021	-17 507	-7 666	-9 717	..	-3.8	-4.3	-4.6	-4.3	-5.6
Albania	-107	-272	-45	-99	31	..	-4.0	-11.9	-1.5	-6.5	1.8
Bosnia and Herzegovina	-748	-1 060	-1 097	..	-835[b]	..	-26.9	-31.7	-26.8	..	-37.1[b]
Bulgaria	16	427	-376	-87	-507	-654[d]	0.2	4.2	-3.1	-1.6	-9.4
Croatia	-1 148	-2 343	-1 551	-1 293	-1 037	..	-5.8	-11.5	-7.1	-12.6	-10.6
Czech Republic	-4 292	-3 211	-1 059	-231	-15	..	-7.4	-6.1	-1.9	-0.9	-0.1
Hungary	-1 678	-981	-2 298	-904	-1 218	-1 200[d]	-3.7	-2.1	-4.8	-3.8	-5.2
Poland	-1 371	-4 312	-6 858	-2 663	-5 001	-6 804[d]	-1.0	-3.0	-4.3	-3.6	-6.9
Romania	-2 571	-2 137	-2 968	-1 037	-721	-711[c]	-7.3	-6.1	-7.8	-6.7	-5.6
Slovakia	-2 098	-1 952	-2 059	-1 095	-731	..	-11.2	-10.0	-10.1	-11.0	-7.9
Slovenia	39	37	-4	-110	-477	-408[c]	0.2	0.2	–	-1.2	-4.7
The former Yugoslav Republic of Macedonia	-288	-276	-289	-147	-40	..	-6.5	-7.5	-8.2	-8.5	-2.3
Yugoslavia [a]	-817	-1 317	-1 300*	..	..	..	-5.1	-6.7	-7.9	..	..
Baltic states	-1 400	-1 890	-2 489	-995	-1 021	..	-8.1	-9.5	-11.1	-9.4	-9.7
Estonia	-398	-563	-478	-266	-138	..	-9.1	-12.2	-9.2	-10.6	-5.5
Latvia	-279	-345	-713	-208	-289	..	-5.4	-6.1	-11.1	-6.8	-9.3
Lithuania	-723	-981	-1 298	-521	-594	..	-9.2	-10.2	-12.1	-10.3	-12.1
European CIS	10 292	1 580	-931	-7 022	9 436	..	2.1	0.3	-0.3	-3.1	9.7
Belarus	-516	-799	-945	-579	25	..	-3.8	-6.0	-7.1	-8.4	0.6
Republic of Moldova	-188	-267	-334	-182	-10	..	-11.1	-13.9	-20.4	-29.6	-2.5
Russian Federation	12 181	3 981	1 643	-5 242	8 978	..	2.9	0.9	0.6	-2.7	11.5
Ukraine	-1 185	-1 335	-1 296	-1 019	443	..	-2.7	-2.7	-3.1	-4.7	3.1
Total above [a]	-4 606	-15 331	-20 928	-15 683	-1 303	..	-0.5	-1.8	-2.8	-3.8	-0.5
Memorandum items:											
CETE-5	-9 400	-10 420	-12 278	-5 003	-7 443	..	-3.3	-3.7	-4.1	-3.5	-5.3
SETE-7 [a]	-4 098	-4 601	-5 229	-2 663	-2 274	..	-5.7	-6.5	-6.6	-7.7	-7.4

Source: National balance of payments statistics; IMF for Bosnia and Herzegovina (1996-1998); UN/ECE secretariat estimates.

a Aggregates exclude Bosnia and Herzegovina and Yugoslavia. Yugoslavia has reported a current account deficit of $1,837 million for 1997. The $1,317 million in the table includes a $520 million upward adjustment of exports to reflect the value of imports used for outward processing.

b Excludes official transfers.

c January-July.

d January-August.

Russia reported a $9 billion current account surplus in the first half of 1999, which represents a $14 billion swing from the first half of 1998. The continuation of current account surpluses implies a transfer of resources abroad, with negative consequences for economic activity. Little of the recent surplus seems to have found its way into official reserves or debt repayment, presumably because of continuing massive capital flight.

During the Kosovo conflict, the IMF estimated that the crisis would cause a (incremental) $0.7-$0.9 billion deterioration in the combined current account balances of six south-east European countries and create a financing gap of $1.1-$1.7 billion.[112] While it is too early to assess the full impact of the conflict on the external sectors of these countries, some preliminary observations are possible from incomplete balance of payments data for January-June 1999.[113] Current account balances improved rather than deteriorated as had been expected, although this was not the case in Bulgaria. Aside from Albania and Bosnia and Herzegovina, these countries reported lower merchandise exports. However, since their exports were declining prior to the beginning of the conflict (due to the other negative factors mentioned above), the conflict itself is likely to explain only part of the contraction observed in the first half of the year. This is particularly true in

[112] IMF, *The Economic Consequences of the Kosovo Crisis: An Updated Assessment* (Washington, D.C.), 25 May 1999. The countries covered by the report are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania and The former Yugoslav Republic of Macedonia. The estimates exclude refugee costs.

[113] Ideally, outcomes should be compared to expectations, but this is not possible here. Below, observations are made comparing 1999 flows with those in the same period in 1998. The conflict lasted from late March to early June 1999.

Bulgaria, Croatia and Romania where the impact of a decline in exports to the CIS was larger than that from export losses in south-east Europe. Overall, exports from Bulgaria and The former Yugoslav Republic of Macedonia declined most,[114] but it appears that the latter's exports to Yugoslavia rebounded after the cease-fire. Although balance of payments data are not available for Yugoslavia, it is likely that the lack of financing and, by some accounts, the exhaustion of foreign exchange reserves contributed to the collapse of the country's external trade.

The impact of the conflict on services was mixed. In Bulgaria the balance deteriorated due to a decline in transport receipts and an increase in expenditures, the latter reflecting the higher costs of importing by alternative routes and/or transport modes. However, following the cease-fire in June transport receipts recovered. This was also true of tourism receipts which were actually higher than in January-June 1998. Croatia's net transport receipts fell by about $80 million in the first half of 1999. Tourism earnings were somewhat higher but nonetheless they may have fallen short of expectations in the second quarter of the year.[115] In The former Yugoslav Republic of Macedonia, expenditures on transport barely changed, but since merchandise imports fell by nearly 28 per cent in the second quarter, unit transport costs increased sharply. On the positive side, travel and telecommunication receipts increased significantly, presumably because of the spending by Kosovar refugees and international relief workers. This and, especially, higher private and official transfers contributed to the current account surplus in the second quarter of the year (the decline in imports was important as well). Similar developments are observed in the travel balance and net transfers of Albania, which also posted a current account surplus (its merchandise exports may also have benefited in the post-conflict period). Data indicate that Romania's net service earnings were largely unchanged from 1998, but river shipping is reported to have been severely reduced.

A number of neighbouring countries were fearful of suffering from a misconception by potential tourists that they were in the conflict zone. For example, some early estimates put the potential losses of Hungary's tourist sector at $250-$400 million. However, balance of payments data suggest considerably smaller reductions in tourism revenues and only small shortfalls in transport receipts. In Slovenia transport and tourism receipts fell slightly but rebounded in June. Part of the decline in the country's merchandise exports is due to the collapse of Yugoslav demand.

Overall, it appears that losses in the external sectors due to the conflict were not always as large as had been anticipated, and in certain cases they were at least partially offset by some gains. Furthermore, in a number of instances receipts recovered quickly after the cessation of air strikes.

(b) External financing

In the wake of the south-east Asian and Russian financial shocks, *total capital flows* to emerging markets were expected to decline due, among other things, to heightened risk aversion among private investors and expectations of slower rates of global economic growth. In the emerging markets as a whole, total capital flows had already declined in 1997,[116] but in eastern Europe and the Baltic states they rose through 1998 (table 1.2.11). Almost two thirds of the decline in capital imports in the first half of 1999 is accounted for by the Czech Republic, Hungary and Poland. By contrast, in 1998 these three countries had attracted larger inflows which presented the authorities with a problem of currency management and resulted in an increase of foreign exchange holdings. Given their abundant official reserves (true of the Baltic states as well) it is unlikely that reduced inflows in the first half of 1999 mark a tightening of external financial constraints. However, in Croatia, Romania, Slovakia, and The former Yugoslav Republic of Macedonia – where the strengthening of financial positions was a policy target for 1999 – the slackening of capital imports seem to have contributed to the narrowing of current account deficits. In Belarus, Russia and Ukraine there was a net outflow of capital (or a slowdown in the case of the Republic of Moldova) in the first half of 1999, in part because of outflows of unrecorded capital.

On the whole, 1999 has been a period of recovery for emerging market bonds. Spreads have fallen somewhat from their post-rouble crisis peaks of August 1998 and the issue of new debt has resumed. Nonetheless bond yields have generally remained high. This is thought to reflect investors' judgement of an increased probability of defaults and the new official policy to "bail-in" private investors in the event of payments difficulties.[117] More tranquil financial markets have also facilitated a limited recovery of bond issuance by creditworthy transition economies. The $4.5 billion raised in January-October 1999 exceeds the pace of issuance in 1998. It should be stressed, however, that this comparison excludes Russia and Ukraine. Together they issued bonds totalling $7

[114] The former Yugoslav Republic of Macedonia is landlocked and depends heavily on direct and transit trade through Yugoslavia.

[115] In April 1999, the official estimates of lost tourism earnings ranged from around 10-15 to 50 per cent (of a total of $2.7 billion in 1998). UN/ECE, *Economic Survey of Europe, 1999 No. 2*, chap. 1. It should be noted that tourism receipts fared better than data on tourists' nights (down 22 per cent – see sect. 1.2(ii)) would suggest. This appears to be the case in Slovenia as well (below). Tourism earnings are concentrated in the third quarter of the year.

[116] Institute of International Finance, *Capital Flows to Emerging Market Economies* (Washington, D.C.), 25 September 1999.

[117] Ecuador's default on Brady bond payments in October (with IMF approval) is the first instance of the new policy in play. Other steps in this direction involve Ukraine, which was asked to restructure a $150 million bond coming due. Romania was requested to obtain $450 million in new private loans as a condition for the release of an IMF tranche.

TABLE 1.2.11

Net capital flows into the ECE transition economies, 1996-1999

(Billion dollars and per cent)

	Capital and financial account flows [a]									*Changes in official reserves* [b]					
	Billion dollars					*Capital flows/GDP*				*Billion dollars*			*Reserves/GDP*		
				Jan.–Jun.				*Jan.–Jun.*				*Jan.–Jun.*			*Jan.–Jun.*
	1996	*1997*	*1998*	*1998*	*1999*	*1997*	*1998*	*1998*	*1999*	*1997*	*1998*	*1999*	*1997*	*1998*	*1999*
Eastern Europe [c]	15.7	21.4	24.9	15.9	9.9	6.1	6.5	9.0	5.7	6.4	7.4	0.2	1.8	1.9	0.1
Albania	0.2	0.3	0.1	0.1	–	13.7	3.5	8.9	2.5	–	0.1	0.1	1.9	2.1	4.3
Bosnia and Herzegovina	1.1	1.1	1.0	..	..	34.3	25.4	..	..	0.1	-0.1	..	2.6	-1.4	..
Bulgaria	-0.8	0.8	0.3	0.2	0.4	7.7	2.3	3.7	6.5	1.2	-0.1	-0.2	11.9	-0.8	-3.7
Croatia	1.7	2.8	1.7	1.3	1.0	13.7	7.8	12.9	10.4	0.4	0.2	–	2.1	0.7	-0.2
Czech Republic	3.5	1.4	3.0	1.5	0.2	2.7	5.3	5.6	0.9	-1.8	1.9	0.2	-3.3	3.4	0.9
Hungary	0.2	0.8	3.1	2.3	1.8	1.8	6.5	9.8	7.7	-0.2	0.8	0.6	-0.4	1.7	2.5
Poland	5.0	7.9	12.6	7.2	5.0	5.5	8.0	9.8	6.9	3.6	5.7	–	2.5	3.6	–
Romania	2.8	3.8	2.1	1.0	–	10.9	5.6	6.3	-0.1	1.7	-0.8	-0.7	4.8	-2.2	-5.7
Slovakia	2.3	2.0	1.5	1.6	1.0	10.3	7.4	15.9	10.3	–	-0.5	0.2	0.2	-2.7	2.5
Slovenia	0.5	1.3	0.2	0.5	0.5	6.9	0.8	5.0	4.5	1.3	0.2	–	7.1	0.8	-0.2
The former Yugoslav Republic of Macedonia	0.3	0.3	0.3	0.2	0.1	8.4	9.3	10.4	4.2	–	–	–	1.0	1.2	1.9
Baltic states	1.7	2.4	2.9	1.3	1.1	12.0	13.1	12.2	10.2	0.5	0.4	0.1	2.5	2.0	0.6
Estonia	0.5	0.8	0.5	0.3	0.1	16.4	9.4	13.1	5.2	0.2	–	–	4.2	0.2	-0.3
Latvia	0.5	0.4	0.8	0.3	0.5	7.3	11.7	11.3	15.6	0.1	–	0.2	1.2	0.6	6.3
Lithuania	0.7	1.2	1.7	0.6	0.5	12.7	15.8	12.3	9.4	0.2	0.4	-0.1	2.5	3.7	-2.7
European CIS [d]	2.8	2.8	1.0	1.0	-0.3	4.4	1.7	3.4	-1.4	0.4	-1.6	0.2	0.7	-2.8	1.0
Belarus	0.5	0.8	0.9	0.5	-0.1	6.0	6.7	7.0	-1.5	–	-0.1	–	–	-0.4	-0.9
Republic of Moldova	0.2	0.3	0.1	0.1	–	16.6	6.8	17.0	9.9	0.1	-0.2	–	2.7	-13.6	7.4
Ukraine	2.1	1.7	–	0.4	-0.2	3.5	-0.1	1.9	-1.7	0.4	-1.3	0.2	0.8	-3.2	1.4
Russian Federation	-15.0	-2.0	-6.9	3.6	-8.3	-0.5	-2.5	1.8	-10.7	1.9	-5.3	0.6	0.4	-1.9	0.8
Russian Federation [e]	-6.1	6.2	2.8	9.6	-5.0	1.4	1.0	4.9	-6.4	1.9	-5.3	0.6	0.4	-1.9	0.8
Total above [c]	14.1	32.8	31.6	27.8	5.7	3.8	4.3	6.8	2.0	9.2	0.9	1.1	1.1	0.1	0.4
Memorandum items:															
CETE-5	11.6	13.4	20.3	13.1	8.5	4.8	6.7	9.1	6.0	3.0	8.0	1.0	1.1	2.7	0.7
SETE-7 [c]	4.1	8.0	4.5	2.8	1.5	11.2	5.8	8.2	4.6	3.4	-0.7	-0.8	4.7	-0.9	-2.7

Source: UN/ECE secretariat estimates, based on national balance of payments statistics.

a Including errors and omissions.

b A negative sign indicates a decrease in reserves.

c Aggregates exclude Bosnia and Herzegovina and Yugoslavia.

d Excluding Russian Federation.

e Excluding errors and omissions.

billion in 1998, but neither currently enjoys access to the markets.[118] In 1999 there have been sovereign bond issues by Croatia, Hungary, Kazakhstan, Latvia, Lithuania, Slovakia and Slovenia, and corporate and/or municipal issues by entities in Bulgaria, the Czech Republic, Poland and Slovakia. Margins ranged from 87 basis points for Slovenia to 875 basis points for Kazakhstan, the only CIS country to issue a bond this year. These margins underline the huge differences in the cost of borrowing facing most transition economies rated by the international rating agencies. In fact about 13 countries are currently excluded from the markets by their lack of (or very low) credit ratings. They are therefore bound to continue to experience severe constraints in obtaining foreign capital. It may be noted that the Kosovo conflict temporarily unsettled international markets causing bond yields to rise and prompting several transition economies to postpone new issues. Towards the end of October 1999, concerns associated with the possible impact of Y2K and poor market liquidity derailed the bond issuance plans of several borrowers from the transition economies.

FDI flows to the emerging market economies have held up much better than had been expected immediately after the Asian crisis, although a modest downturn is predicted for 1999.[119] Despite earlier fears, the long-term strategic views of international companies appear to have

[118] In January-October 1998, the transition economies issued bonds worth some $11 billion. UN/ECE, *Economic Survey of Europe, 1998 No. 3*, table 4.3.4.

[119] Institute of International Finance, op. cit. Direct equity investment continued to increase through 1998, although at a slackening pace. Estimates for 1999 suggest a drop of about 2 per cent.

TABLE 1.2.12

Foreign direct investment [a] in the ECE transition economies, 1996-1999

(Million dollars)

	1996	1997	1998	January-June 1998	January-June 1999
Eastern Europe [b]	7 701	9 214	13 745	6 100	5 565
Albania	90	48	45	24	15
Bosnia and Herzegovina	–	–	100	50*	30*
Bulgaria	109	505	401	230	220
Croatia	533	487	873	568	234
Czech Republic	1 428	1 300	2 540	1 164	1 313
Hungary	1 983	2 085	1 935	951	672
Poland	2 768	3 077	5 129	2 323	2 329
Romania	263	1 215	2 031	544	584
Slovakia	330	161	508	240	130
Slovenia	186	321	165	33	51
The former Yugoslav Republic of Macedonia	11	16	118	22	18
Baltic states	685	1 142	1 863	563	570
Estonia	151	267	581	158	183
Latvia	382	521	357	181	171
Lithuania	152	355	926	223	216
European CIS	3 096	7 526	3 733	1 610	1 713
Belarus	73	192	144	66	172
Republic of Moldova	24	72	85	44	10
Russian Federation	2 479	6 639	2 761	1 073	1 364
Ukraine	521	623	743	426	166
Total above [b]	11 482	17 882	19 341	8 272	7 848
Memorandum items:					
CETE-5	6 695	6 944	10 277	4 712	4 495
SETE-7 [b]	1 007	2 270	3 468	1 387	1 071

Source: UN/ECE secretariat, based on national balance of payments statistics; IMF for Bosnia and Herzegovina 1996-1998. Data for 1999 are preliminary.

a Inflows into the reporting countries except for Albania and The former Yugoslav Republic of Macedonia, which are net of investments abroad.

b Aggregates exclude Bosnia and Herzegovina.

prevailed over shorter-term concerns while the depressed prices of emerging market assets have proved attractive to foreign investors. In the European transition economies FDI inflows declined somewhat in the first half of 1999 (table 1.2.12), but subsequent signed and scheduled privatizations could raise the inflows for the whole year to the 1998 level. FDI flows into the Czech Republic and Poland remained buoyant in the first half of 1999 and further substantial inflows are expected from the sales of several large assets. In Hungary, which has sold off the bulk of its state property, inflows have fallen (while outflows have reached significant proportions). In Slovakia, privatization and FDI inflows have lagged behind most other transition economies. Since the installation of the new government in late 1998, foreign investors seem to have adopted a wait-and-see attitude. In September 1999, the parliament amended the privatization law to allow the sale of some large state assets, but it is doubtful that the designated banks and telecommunication company will be sold before the end of the year. The investment climate in the European CIS generally remains discouraging and FDI inflows are small. In Russia inflows ran somewhat above the pace of 1998, but the $6 billion received in all of 1997 seems beyond reach.

One of the concerns about the Kosovo conflict was that it would weaken investor confidence and derail privatization programmes throughout south-east Europe. None of the countries in this area has been very successful in attracting FDI and, until recently, they had failed to move ahead with the sale of large state assets. When examining the FDI inflows in the first half of 1999 (table 1.2.12) it should be borne in mind that they reflect decisions taken prior to the conflict and thus are unlikely to reflect its full impact on investment intentions. The experiences range from increased FDI flows into Romania to a cessation of investments in Albania in the second quarter of the year. In Croatia, FDI was sluggish but it did not cease during the conflict. The completion of several key privatizations has been an encouraging development. A consortium of Greek (OTE) and Dutch (KPN) telecommunications companies purchased a 51 per cent stake in Bulgarian BTC in July for some $500 million. Around the same time Romania signed a contract giving Renault a 51 per cent stake in Automobile Dacia SA. In early October a 35 per cent stake in the Croatian state telecommunications company HT was sold to Deutche Telekom for $850 million, and in September the Macedonian parliament approved the sale of a majority stake in the OKTA oil refinery for $190 million. This is the country's largest foreign investment to date, and further deals are reportedly in the pipeline. It should be borne in mind that these sales involved key assets to buyers who generally have strategic regional objectives. Therefore their success may not accurately reflect the degree of investor interest in the area.

(vii) Short-term outlook

In the course of 1999, economic expectations and the short-term outlook for the ECE transition economies have been unusually volatile and have undergone major changes and revisions. At the start of the year, the negative impact of the Russian crisis turned out to be much stronger than expected for a number of transition economies (notably the three Baltic states) which led to weaker expectations and downward revisions of forecasts. However, towards mid-year and especially in the second half, output performance started to improve in many transition economies and this was coupled with a strengthening of the economic recovery in western Europe (whose favourable impact in terms of rising import demand has started to gain momentum). This has brought about a reversal of expectations and forecasts in positive directions, at least in some of the transition economies.

In the Baltic states, the 1999 growth forecasts have been significantly lowered and despite some improvement in expectations in the second half of the year, it is unlikely that the recent strengthening of output can offset the disastrous performance in the first half of the year. Thus while the earlier official forecasts for GDP growth in 1999 were in the range of 4-5 per cent in all three countries, by October they had been reduced to close to zero for Estonia and Lithuania and to 1 per cent for Latvia (table 1.2.1). Forecasts have been revised in a number of central European transition economies as well. Poland is unlikely to achieve the previously forecast 4.5 per cent rate of GDP growth in 1999 (the official projection was later revised to 4 per cent), but there are clear signs of an improvement in economic performance after the very weak first quarter. Most observers agree that the Czech economy has turned the corner and that growth should strengthen in the second half of the year. By October, GDP growth in Slovakia and Slovenia was still expected to be in the range of 3-3.5 per cent, which represents only a slight reduction in earlier forecasts. Hungary will remain the fastest growing among the central European and Baltic economies in 1999, with a revised forecast of 4.5 per cent growth in GDP (slightly below the previously expected 5 per cent).

The Kosovo conflict was an unexpected negative shock for many transition economies, especially those in south-east Europe. Virtually all the south-east European transition economies have lowered their official forecasts in the course of 1999. GDP in a number of these economies (in particular Croatia, Bulgaria and The former Yugoslav Republic of Macedonia) is likely to stagnate in 1999 as a whole (or, at best, to show a marginal increase), while the official growth forecast for Romania (which had been negative before the conflict) was lowered still further (table 1.2.1). Although there are no reliable data on the current economic situation in Yugoslavia, all observers agree that the war delivered an exceptionally hard blow to the economy. The forecasts for 1999 vary widely, but all of them point to a deep fall in GDP ranging from 25 to 50 per cent as compared with 1998.

On balance, the prevailing expectations in October 1999 were that output in the second half of the year would be stronger than in the first half, both in central Europe and in the Baltic states. If this expectation materializes, the growth of aggregate GDP in eastern Europe for the year as a whole could reach 1 per cent (combining a 3 per cent growth rate in central Europe with a 4.5 per cent fall in south-east Europe – table 1.2.1). As to the Baltic states, their aggregate GDP is likely to remain stagnant for the year as a whole.

The short-term outlook for the CIS countries is dominated by that for the Russian economy. While much uncertainty still surrounds the outlook for the Russian economy, the short-term prospects have improved considerably since the beginning of the year. The improvement is reflected in a series of upward revisions to the official 1999 growth forecasts. Thus, at the beginning of the year the official forecast was for a continued fall in GDP in 1999; by mid-October this had been revised to positive growth of 0.5-1.5 per cent.[120] If the unexpectedly strong recovery of industrial output continues through the end of the year, it would not be unrealistic to expect the growth of Russian GDP to come close to the upper bound of this range. Thanks to the recovery in Russia, the short-term outlook for most of the CIS countries has also improved in the second half of 1999. In particular, the official forecasts for Ukraine have been raised and by October they envisaged that GDP would remain flat in 1999, in contrast to the beginning of the year when growth was expected to be negative in 1999. The one major exception to this general improvement is Kazakhstan where the forecast for GDP growth has been lowered to -1.5 per cent for the year as a whole, following the negative outcome in the first half of the year. All in all, by October the aggregate GDP of the CIS countries was being officially forecast to grow by some 1¼ per cent, which represents a major shift towards more optimistic expectations from the earlier forecast of -1.1 per cent (table 1.2.1).

Positive expectations generally prevail in the official forecasts for the transition economies in 2000 as well. In virtually all the countries for which such forecasts are available, the authorities expect positive rates of GDP growth in 2000 and an acceleration as compared with 1999 (table 1.2.1). If these expectations materialize, the growth of aggregate GDP in eastern Europe could reach some 3 per cent in 2000, that in the Baltic states might be in the range of 3.5-4 per cent, while the CIS countries could grow by an average of some 2.5 per cent. These forecasts imply that GDP in the ECE transition economies as a whole would grow by some 2¾ per cent in 2000, an average rate of growth that has not yet been achieved during the past 10 years of economic transformation.

[120] In October the forecast of the Russian Ministry of the Economy was for GDP growth of 0.5-1 per cent in 1999, while the Ministry of Finance envisaged 1-1.5 per cent. *AK&M News*, 19 October 1999 as reported by *Reuters News Service*.