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# **PART ONE**

## **MACROECONOMIC TRENDS AND PROSPECTS IN THE ECE REGION**

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## **CHAPTER 1**

# **THE ECE ECONOMIES IN SPRING 2002**

### **1.1 Introduction**

There was a progressive slowdown in the rate of expansion of the global economy in the course of 2001, and a parallel deterioration of the short-term outlook. World output is estimated to have increased by some 2.5 per cent in 2001 compared with a rise of 4.7 per cent in 2000, and the volume of world merchandise trade stagnated. The dominant feature was the synchronous cyclical downturn – the first since 1974-1975 – in the three major economies, the United States, Japan and Germany, which ended in recession. For the industrialized countries as a whole, real GDP increased by only 1 per cent in 2001, down from 3.7 per cent in 2000, the most rapid deceleration in real GDP since 1973-1974.<sup>1</sup>

In the ECE region, real GDP rose by only 1.7 per cent in 2001, against 4.2 per cent in 2000 (table 1.1.1). This considerable slowdown masks, however, a striking resilience of the transition economies to the deterioration in the external economic environment. In eastern Europe, real GDP rose on average by 3.2 per cent in 2001. In Russia, the economic boom lost some momentum, but the annual increase in real GDP still amounted to 5 per cent, down from 9 per cent in 2000. The strength of the Russian economy was a major factor behind the overall buoyancy of economic activity in the CIS.

Global economic developments were overshadowed by the terrorist attacks in New York and Washington D.C. on 11 September 2001. These occurred at a time when the United States economy and the other major economic regions were in a fragile state and thought to be close to a cyclical turning point. The general effect of the attacks has been to worsen the economic outlook, at least in the short term. However, their generally depressing impact on consumer and business confidence throughout the world economy appears to have waned in early 2002.

There is a broad consensus among economic forecasters that economic growth in the United States will recover in the course of 2002, and that in its wake the rate of economic growth in the rest of the world will strengthen as well. The short-term economic outlook, however, is still highly uncertain, not least because of the persistence of the very large domestic and external imbalances in the United States economy, which pose a major risk to a sustained cyclical recovery.

UNECE argued a year ago that a domestic demand-led recovery in the United States could turn out to be a mixed blessing for the world economy because it would only postpone the inevitable readjustment needed to redress these large imbalances and potentially increase the risk of an abrupt and disruptive adjustment.<sup>2</sup> The ideal environment for a smoother adjustment to take place would, of course, be sustained and strong growth in the rest of the world economy in combination with restrained domestic demand growth in the United States. Given the enfeebled state of the Japanese economy this implies especially a much stronger economic performance in western Europe. This may be difficult to bring about, however, as it would require a more positive attitude of monetary policy towards economic growth as well as a more flexible framework for fiscal policy in the euro area. Nevertheless, it is becoming clear that the macroeconomic imbalance in the world economy is a serious policy concern for the United States.<sup>3</sup> Rather than provide a stimulus to United States exports, the euro area still appears to be looking to domestic demand in the United States as the main source of its own growth.

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<sup>1</sup> Real GDP rose by 0.5 per cent in 1974, down from 6.2 per cent in 1973.

<sup>2</sup> UNECE, *Economic Survey of Europe, 2001 No. 1*, p. 5.

<sup>3</sup> Europe's reliance on the United States as an engine of growth was alluded to also in the controversy about the decision of the United States administration to impose tariffs on steel imports. As was pointed out, the "United States economy appears poised for a recovery that will once again help other nations regain growth, including for steel industries". R. Zoellick, "The reigning champions of free trade", *Financial Times*, 13 March 2002. The author is the United States trade representative. An earlier warning that strains in international trade relations could spread from steel to other commodities if the EU and Japan failed to reflate their economies was made by Grant Aldonas, the United States Under-Secretary of Commerce for International Trade. "We have told people over time that if you don't see stronger growth abroad you end up seeing friction on the trade account. There is only so much patience you have when you are talking about very serious macroeconomic issues that have been out there for a long time", *Financial Times*, 11 March 2002, p. 1.

## 1.2 Western Europe and North America

### (i) The current outlook

In the spring of 2002, there are increasing signs that the pronounced cyclical downturn of 2001 has started to bottom out. The short-run outlook, however, remains very uncertain and the prospects are for only a gradually strengthening recovery in 2002.

In the United States, economic conditions showed signs of improving in early 2002. The sustained fall in industrial activity since the beginning of 2001 petered out into a small increase in output in the first two months of 2002. This improvement is also reflected in a marked rise of the Institute for Supply Management<sup>4</sup> index in February. Consumer confidence has been volatile, but surged in March after a small decline in February. Nevertheless, retail sales growth was sluggish in early 2002, hiring conditions in the labour markets remained weak, and the number of persons claiming unemployment insurance in March remained high. The Conference Board's index of leading indicators stagnated in February 2002, following consecutive increases in the four preceding months.

The consensus of forecasters is now for an annual increase in real GDP in the United States of about 1.5 per cent in 2002. This annual average masks expectations of a somewhat more pronounced strengthening of growth in the second half of 2002. Moreover, such a growth rate is unlikely to lead to any significant reduction in excess capacities in the business sector in 2002. These, in combination with a meagre growth of profits, will continue to depress business fixed investment which, for the year as a whole, is expected to be less than in 2001.

It is not clear what progress has been made in the high-tech sector in adjusting to the sharp decline in business spending on high-technology equipment. The sharp cutback in expenditures on ICT equipment reflects to some extent the downward revisions of expected rates of returns on these assets. This more realistic assessment of profit prospects could also restrain demand for these products in 2002.

In contrast, economic activity will be supported by the completion and partial reversal of the large cuts in business inventories that occurred in the course of 2001 in response to the sharp deterioration in sales prospects. The growth of private consumption is likely to be relatively weak in 2002, partly reflecting the balance sheet adjustments required by the fall in the personal savings rate to a very low level, the loss in net wealth triggered by the fall in equity prices, and the steep rise in the burden of debt-servicing since the mid-1990s (and which is approaching its previous peak of end 1986). In addition, the growth of disposable incomes will be restrained by weak labour market conditions, although this will be partly offset by fiscal policy measures. No significant support is expected from exports given the overall weakness of overseas demand. However, there could be some feedback effects if a gradual strengthening of domestic demand spilled over to other major economies, boosting their growth and, in turn, stimulating demand for United States products.

Domestic demand will be supported by the considerable monetary stimulus which is already in the pipeline, although this has not fed through to interest rates at the longer end of the maturity spectrum and banks have tightened borrowing conditions. On 19 March 2002, the Federal Reserve decided to keep its target for the federal funds rate unchanged at 1.75 per cent judging that the risks are now balanced between the long-run goals of price stability and sustainable economic growth. The background to this decision was information pointing to a stronger rate of economic growth based on a marked swing in inventory investment. In addition, and despite the failure of Congress to agree to the fiscal stimulus package proposed in the wake of 11 September, increased government spending will partly offset the overall weakness of private sector demand.

In the euro area, the fall in real GDP in the final quarter of 2001 is generally expected to be followed by a small increase in economic activity in the first quarter of 2002. The confidence of consumers, industrial managers and producers of services has improved somewhat in the first two months of 2002. This contrasts, however, with increasing pessimism in the retail trade sector. As for the United States, a reversal of the inventory cycle is expected to support domestic demand. The growth of private household consumption is likely to remain weak with the impact of adverse developments in the labour markets on disposable incomes being partly offset by the expected fall in the rate of inflation. Fixed investment is expected to remain sluggish in view of weak sales prospects and relatively large margins of spare capacity in industry. Surveys of business investment plans made in the autumn of 2001 point to a fall in the volume of industrial investment by 5 per cent in 2002.<sup>5</sup> In line with the expected profile of the United States recovery, economic activity is expected to strengthen in the second half of the year. The main assumption behind this scenario for the euro area is a gradual but sustained strengthening of domestic demand in the United States, which will spill over via higher exports to domestic consumption, and subsequently business investment, in the euro area. Euro area exports will

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<sup>4</sup> This index was formerly known as the Purchasing Managers' Index.

<sup>5</sup> European Commission, *Business and Consumer Survey Results*, February 2002 [<http://europa.eu.int>].

also be supported by the relatively strong rate of expansion forecast for the transition economies.<sup>6</sup> For the year as a whole, real GDP in the euro area is forecast to increase by only about 1.25 per cent, down from 1.6 per cent in 2001. As a result of this low rate of growth, the level of employment can be expected to more or less stagnate and the average annual unemployment rate to edge up by about half a percentage point to 8.9 per cent.

Economic growth in Germany, the largest economy of the euro area, was only 0.6 per cent in 2001, the smallest increase since 1993. Little improvement is expected in 2002, with the annual growth rate forecast at about 0.75 per cent (table 1.2.1). The general government deficit rose to 2.7 per cent of GDP in 2001, close to the 3 per cent ceiling established in the Stability and Growth Pact (see below). This narrowly circumscribes any scope for discretionary fiscal measures designed to support economic growth.

Among the other member countries of the euro area, economic growth in France is expected to hold up somewhat better than in Germany and Italy, partly because of a more expansionary fiscal policy. Other national growth rates in 2002 are forecast to range from 1.1 per cent in Austria, Belgium and the Netherlands to some 3.75 per cent in Ireland (table 1.2.1).

In the euro area, the stance of monetary policy was tightened in October 2000 when the first signs of a cyclical slowdown were emerging. This was followed by a long wait-and-see period despite increasing indications of a serious global economic slowdown. The stance of monetary policy was eased only hesitantly, and rather late, in May 2001 followed by further reductions in the main refinancing rate in the second half of the year. The cumulative lowering of the main refinancing rate in 2001 amounted to only 1.5 percentage points, from 4.75 per cent in October 2000 to 3.25 per cent in early November 2001 against the background of the worst global economic downturn since the first oil price crisis of the early 1970s.<sup>7</sup> A more rapid response to the cyclical weakness in early 2001 would have improved growth prospects for 2002. In fact, the ECB's main refinancing rate, which has remained unchanged since November 2001, is still 0.25 percentage points above its level in November 1999. (This change is also reflected in money market rates.) In view of moderate inflationary expectations and a sizeable increase in the output gap,<sup>8</sup> there is still room for a further lowering of official interest rates.

The average general government budget deficit in the euro area rose to 1.1 per cent of GDP in 2001 and a further increase to 1.4 per cent is forecast for 2002. This largely reflects the operation of the automatic stabilizers. The cyclically adjusted deficit is forecast to fall slightly to 1.1 per cent of GDP in 2002, down from 1.3 per cent in 2001. This average masks expansionary measures (mainly tax cuts) in a number of countries (Belgium, Finland, France, Ireland, Luxembourg and the Netherlands), which are offset by tax increases in others (Austria, Germany and Italy). For the euro area as a whole, the fiscal policy stance in 2002 will be broadly neutral. The expected change in the cyclically adjusted primary balance (which excludes interest payments) is in the same direction. In Germany, the budget deficit rose to 2.7 per cent of GDP in 2001, close to the ceiling of 3 per cent prescribed by the Stability and Growth Pact, and is forecast to remain more or less unchanged in 2002. In France, the budget deficit is forecast to rise above 2 per cent of GDP in 2002. German fiscal policy is seen to be broadly neutral in 2002 although the recessionary environment suggests the need for a discretionary fiscal stimulus. Indeed, the same could also be said for the euro area as a whole.

Outside the euro area, in the United Kingdom, a relatively moderate slowdown in the rate of economic growth to 2 per cent is forecast for 2002 (down from 2.3 per cent in 2001). This mainly reflects continued vigorous growth in private household consumption and a large increase in public sector spending. Moreover, there are increasing concerns about the sustainability of the recent surge in private household debt, which is at record levels relative to income. Partly in reaction to this, the Bank of England's Monetary Policy Committee has left its base rate unchanged at 4 per cent since November 2001 in order to avoid any further stimulus to borrowing, although inflation is forecast to continue undershooting its 2.5 per cent target.

In western Europe as a whole, real GDP is forecast to increase by 1.4 per cent in 2002, largely a reflection of weak domestic demand and the external environment.

### ***Risks to the outlook***

The outlook for the global economy, including Europe, is crucially dependent on the assumption that there will be a sustained and gradually strengthening recovery in the United States, led by domestic demand. This is expected to stimulate domestic activity in the rest of the world, including Europe, via exports and the spillover effects from increasing business and consumer confidence in the United States.

However, the signs of a cyclical upturn in the United States economy in early 2002 could well turn out to be a false dawn. The spending behaviour of private households and the balance sheet adjustments that they consider desirable or

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<sup>6</sup> See sect. 1.3 below.

<sup>7</sup> For comparison, the federal funds rate was lowered by a cumulative 4.75 percentage points to 1.75 per cent in the course of 2001.

<sup>8</sup> The OECD estimates that the average annual output gap for the euro area will increase by 1 percentage point to 1.5 per cent in 2002.

necessary in the face of increased job insecurity, high debt service burdens, a very low savings rate and a substantial loss in net financial assets, are crucial for the outcome.

The shallow recession, moreover, has not led to a correction of the sizeable external imbalance of the United States economy. The current account deficit fell only slightly in 2001 and is still more than 4 per cent of GDP. This is, of course, mainly the mirror image of the considerable excess of private sector investment over private savings (which has led to the accumulation of high levels of private sector debt). As a domestic demand-led recovery in the United States can be expected to lead to a further deterioration of the United States external imbalance<sup>9</sup> there is a risk that financial markets will feel increasingly uncomfortable with such a tendency. This could trigger a sudden reversal of capital flows and a sharp fall in the exchange rate of the dollar which, on a trade-weighted basis, is close to a 16-year high against other major currencies. The other side of the coin would be a strong appreciation of the euro, which would act as a brake on export growth and be likely to bring a cyclical upswing in western Europe to a premature end.

Another major uncertainty is how spending on high-technology goods will respond to an improved outlook for growth. There is increasing scepticism about the contribution of ICT goods to the increase in United States productivity in the second half of the 1990s. This performance appears to have been not broadly based but rather concentrated in a few sectors.<sup>10</sup> It is also not clear to what extent the massive spending on these products has generated the expected high rates of return or, in some cases, any return at all. The frustrated expectations of companies could lead to a much lower growth of IT spending in the year ahead with subsequent repercussions on profitability and equity valuations in the IT sector. This, in turn, is likely to have negative feedback effects on private consumption and business investment.

More generally, current levels of private sector indebtedness in the major industrial countries are quite high given the stage of the business cycle. A weak or aborted recovery in the second half of 2002 would test the profit expectations built into current equity prices. Any disappointment could trigger a sharp fall in these prices and a further deterioration in the balance sheets of households, the corporate sector and financial institutions in the major industrial countries.<sup>11</sup>

Other sources of downside risks come from the lingering financial sector problems in Japan and uncertainty over the evolution of the price of crude oil. The price of Brent crude rose above \$24 a barrel in the first half of March 2002 for the first time since the events of 11 September. This reflects the discipline of OPEC member countries in adhering to their agreed cuts in production as well as expectations of a strengthening of world output growth in the second half of 2002. In addition, there has been upward pressure on oil prices due to fears of interruptions to oil supplies in the Middle East as a result of a possible conflict between Iraq and the United States. The reaction to such developments of Russia, the second largest exporter of crude oil behind Saudi Arabia (Russia is not member of OPEC), could also have an impact on global oil supply and prices.

## **(ii) EMU: the currency changeover and the macroeconomic policy framework**

The changeover to euro-denominated coins and notes in the 12 member states of the euro area at the beginning of 2002 was very successful from a logistic point of view.<sup>12</sup> Until the end of February 2002, the traditional national currencies circulated alongside the euro.<sup>13</sup> However, by mid-January 2002, virtually all cash transactions were already being conducted in euro notes and coins.<sup>14</sup> This strong demand for euro notes and coins reflected the high transaction costs involved when using the old national currencies alongside the new common one. The approximately 300 million inhabitants of the euro area can now use the same notes and coins for all payments across the member states.<sup>15</sup>

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<sup>9</sup> This reflects the empirical finding that United States imports respond more strongly to a strengthening of domestic activity than United States exports to changes in foreign economic activity. This "income asymmetry" implies that even if the United States and its major trading partners have the same rate of economic expansion, there will still be a widening of the trade deficit. C. Mann, *Is the U.S. Trade Deficit Sustainable?* (Institute for International Economics, Washington, D.C., 1999), p. 124.

<sup>10</sup> According to a McKinsey study, most of the productivity gains between 1995 and 1999 originated in only 6 out of 59 economic sectors and the role of information technology was relatively small with the most important factors being innovation (including, but not limited to, IT and its applications), competition and, to a lesser extent, cyclical demand factors. McKinsey Global Institute, *US Productivity Growth 1995-2000*, [<http://www.mckinsey.com>], and R. Gordon, "Does the "new economy" measure up to the great inventions of the past?", *Journal of Economic Perspectives*, Vol. 14, No. 4, Fall 2000, pp. 49-74.

<sup>11</sup> IMF, *Global Financial Stability Report* (Washington, D.C.), March 2002 [[www.imf.org](http://www.imf.org)].

<sup>12</sup> Some 10 billion euro banknotes were printed to replace the national banknotes of the 12 participating states. In addition some 5 billion notes were printed as logistical stocks to ensure a smooth banknote changeover in 2002. The total value of these nearly 15 billion banknotes amounted to some €633 billion. In addition, to replace the national coins in the 12 countries, about 52 billion coins were minted with a total value of €15.75 billion.

<sup>13</sup> In the Netherlands, this changeover period lasted only until 28 January 2002. In Belgium and France, the corresponding deadlines were 9 February and 17 February 2002, respectively.

<sup>14</sup> ECB, "Update on the euro cash changeover", *Press Release*, 18 January 2002 [[www.ecb.int/press/02/](http://www.ecb.int/press/02/)].

<sup>15</sup> The euro has also become the legal tender of Andorra, Monaco, San Marino and the Vatican.



The smooth introduction of euro banknotes and coins was the final step in the long and difficult process of creating the EMU. Although this changeover has received much attention from the media and the public at large, its economic significance has been more limited. Since 1 January 1999, with the irrevocable fixing of national exchange rates, the national currency units were already nothing more but non-decimal subunits of the (then virtual) euro.

Overall, the macroeconomic effects of the changeover are likely to have been small and, in any case, difficult to gauge. An immediate economic effect is the increased transparency of prices across countries of the euro area. This, it is believed, is likely to increase competitive pressures faced by companies and could potentially reduce the observed variation in prices for internationally traded products across the euro area. Prices will continue to vary, however, given the differences in national indirect tax rates, transport costs and other costs of wholesale and retail distribution. In addition, prices reflect competitive conditions in local markets. And prices for non-tradeable goods and services will continue to reflect the relative levels of productivity in the tradeable sectors and the related real wage levels in the various countries. Similarly, inflation in the euro area will continue to diverge across countries, partly reflecting differential rates of growth of demand in the short run and, in the longer run, the differential impact of real income convergence across countries on the prices of non-tradeables – the so-called Balassa-Samuelson effect.<sup>16</sup>

The common currency could, moreover, by abolishing exchange rate volatility in bilateral trade among member states of the euro area and through other channels such as reduced transaction costs and closer integration of product markets, have a significant effect on bilateral trade among the member countries of the euro area. Although recent empirical research has found a strong expansionary impact of currency unions on trade among their members, there is considerable uncertainty about the order of magnitude involved.<sup>17</sup> It may also be surmised that this more intensive trade reflects not only the influence of the common currency but also of other factors. In any case, these findings suggest that membership in a monetary union is likely to significantly affect the level and composition of intraregional trade in the longer run.

Apart from its economic dimension, the currency changeover has also been seen as a tangible symbol of European integration that could help to foster a sense of common identity among Europe's citizens and be a catalyst for further economic and political reforms in the European Union. In this sense, the euro is much more than a means of payment – it is seen as propelling further progress in European integration. This notion, of course, is consistent with the tradition that the integration of Europe has progressed mainly through economic initiatives.

The first three years of EMU have not been easy from a macroeconomic policy perspective. At the start of EMU, monetary policy had to cope with the fall-out from the 1998 financial crises and the marked depreciation of the euro. In addition, there was a surge in oil prices which gathered momentum in the course of 1999 and, when this shock abated, the global economy was hit first by the abrupt ending of the United States economic boom and thereafter by the terrorist attacks of 11 September 2001. But this series of shocks also serves to highlight one of the advantages of EMU compared with the hard EMS. It may be surmised that these events could have created considerable tensions within the ERM, the former exchange rate mechanism that linked the national currencies of the EU member states, with the risk of severe exchange rate crises as in 1992-1993.

This does not mean, of course, that everything was fine with the operation of macroeconomic policy during the first three years of EMU. The macroeconomic policy framework is, in fact, quite complex, combining a single monetary policy with (currently) 12 national fiscal policies. Many implications of this framework still need to be better examined and understood. This pertains especially to the interaction of fiscal and monetary policy and the implications of tight fiscal rules for the process of economic adjustment to asymmetric shocks at the individual country level.

The reliance of the ECB on a two-pillar monetary policy strategy, moreover, has not contributed to transparency and public understanding of the ECB's interest rate decisions (see chapter 2.3 below). In fact, the first pillar – the reference value for M3 – has, not surprisingly, been a poor guide for monetary policy in the short run. This reflects, *inter alia*, the unstable demand for money in the short run and special factors such as the recent flight to liquidity. Indeed, the first pillar has been more of a barrier to effective communication with the public. It has also created confusion about the effective role of changes in money supply in the conduct of monetary policy; repeated efforts were made, for example, to explain that the overshooting of the reference value was due to special factors and therefore did not require a policy reaction.

The second pillar of the ECB's monetary strategy – the “assessment of the inflation outlook” – suffers from the lack of an explicit inflation forecast although, in view of the weakness of the first pillar, the ECB must be pursuing *de facto* a policy of inflation targeting. This also affects the transparency of policy and weakens the accountability of the

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<sup>16</sup> UNECE, “Inflation and interest rate differentials in the euro area”, chap. 2.5, pp. 59-63, and “Economic transformation and real exchange rates in the 2000s: the Balassa-Samuelson connection”, chap. 6, pp. 227-239, *Economic Survey of Europe, 2001 No. 1*.

<sup>17</sup> It has been estimated that a common currency expands trade within a range of 50 to 300 per cent. For the higher estimate see A. Rose, “One money, one market: the effect of common currencies on trade”, *Economic Policy*, Vol. 30, April 2000, pp. 7-45. For the lower estimate see T. Persson, “Currency unions and trade: how large is the treatment effect?”, *Economic Policy*, Vol. 33, October 2001, pp. 435-448.

Bank. Moreover, the lack of clarity of monetary policy is enhanced by the ECB's asymmetric definition of price stability as a year-on-year increase in consumer prices for the euro area "of below 2 per cent". The ECB has, however, excluded *deflation*, i.e. a fall in the price level. This would imply that the target range is between 0 and 2 per cent, but there is no evidence that policy is focused on the middle of the range. An inflation target of 1 per cent would in any case be rather low for at least three reasons: the downward rigidity of nominal prices and wages; upward biases in the price index due to a lack of adequate adjustments for quality improvements of products; and finally the need to allow for relative price changes between the European countries on account of the Balassa-Samuelson effect. Also, with a fixed base index, low rates of inflation could reflect a large proportion of relative price changes, apart from the Balassa-Samuelson effect. Taking all these factors into account suggests that the annual inflation target should be raised to 2.5 per cent.<sup>18</sup>

The ECB could not be expected to inherit the Bundesbank's credibility and it has to build its reputation by a clear justification of its policy decisions and by demonstrating that it is not subject to political pressures. The lack of a transparent framework and strategy for monetary policy, however, has created considerable uncertainty about the ECB's policy reaction function, i.e. whether and when it will react to deviations of inflation from its target and to changes in output gaps. This was especially striking in the first half of 2001, when there was a broad consensus that the ECB reacted "too little, too late" to counter the cyclical slowdown in the euro area. One way to improve the transparency and communication of monetary policy would be to set a symmetric inflation target. Another would be to integrate the monitoring of changes in money supply into the second pillar. A good understanding of the ECB's policy reaction function is also important for EU governments. Efforts to further reduce structural budget deficits within the framework of the Stability and Growth Pact (SGP) need to find an appropriate offset in a correspondingly more accommodative interest rate policy in order to ensure an appropriate policy mix for the euro area as a whole.

In the EMU, individual countries no longer possess the exchange rate as an instrument of adjustment to asymmetric shocks. This means that macroeconomic stabilization at the national level has to rely entirely on fiscal policy. This is a cause for concern since the rules of the SGP may constrain the flexible use of this instrument when most needed. At the same time, the SGP is also seen as a coordination device to help ensure an appropriate policy mix for the euro area as a whole, but the extent to which this can be effective is an open question.<sup>19</sup>

The SGP, which was adopted by the European Council in Amsterdam in June 1997, is unique in that sovereign countries have committed themselves to adhere to a set of common fiscal rules and a multilateral surveillance mechanism.<sup>20</sup> The main rationale for the SGP is to provide additional protection for the ECB from political pressure for an inflationary debt bailout as a consequence of profligate fiscal policies and an unsustainable rise in public debt. This would suggest the need for limits to be placed on levels of public debt, but the SGP focuses exclusively on budget deficits.<sup>21</sup> Another reason for the SGP is that excessive borrowing by a member country could lead to higher interest rates for the euro area as a whole and affect the exchange rate of the euro.<sup>22</sup>

The SGP stipulates that the national general government budgetary positions should in the medium term be "close to balance or in surplus". Only under "exceptional and temporary" conditions is the government budget deficit allowed to exceed a ceiling of 3 per cent of GDP. This would be the case if the deficit results from a severe economic downturn, for which an annual decline in real GDP by 0.75 per cent will, as a rule, be taken as a reference point. In "normal times" a deficit larger than the reference value is regarded as excessive and will trigger the "excessive deficit procedure", which can lead to sanctions and financial penalties. The implicit assumption is that a budgetary position of close to balance or in surplus will provide sufficient room for the operation of the automatic stabilizers without breaching the 3 per cent reference value during normal cyclical fluctuations. The Pact therefore makes an implicit distinction between the cyclical and structural components of the deficits. The conclusion is that the medium-term target for budgetary positions should de facto be a target for the cyclically adjusted budget balance.<sup>23</sup> This is widely regarded as a better measure of the short-term fiscal policy stance than the actual deficit.

Calculations based on postwar business cycles suggest that a budgetary position close to balance or in surplus should, in principle, provide sufficient room for the operation of the automatic stabilizers during normal cyclical

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<sup>18</sup> H. Sinn and M. Reuter, *The Minimum Inflation Rate for Euroland*, NBER Working Paper, No. 8085 (Cambridge, MA), January 2001.

<sup>19</sup> For a detailed discussion, see A. Brunila, M. Buti and D. Franco (eds.), *The Stability and Growth Pact* (New York, Palgrave, 2001).

<sup>20</sup> The Pact includes, besides the European Council resolution adopted in Amsterdam, two Council regulations: one on the surveillance of budgetary positions and the coordination of economic policies; the other dealing with the procedure for responding to excessive deficits.

<sup>21</sup> M. Canzoneri and B. Diba, "The SGP: delicate balance or albatross?", in A. Brunila et al., op. cit., pp. 53-74.

<sup>22</sup> S. Eijffinger and J. de Haan, *European Monetary and Fiscal Policy* (Oxford, Oxford University Press, 2000), chap. 4.

<sup>23</sup> It has been pointed out, however, that a structural budgetary position close to balance or in surplus does not necessarily imply that the fiscal position is sustainable because it may still not exclude the risk of a rising debt-to-GDP ratio. P. Brandner, L. Diebalek and H. Schuberth, *Structural Budget Deficits and Sustainability of Fiscal Positions in the European Union*, Österreichische Nationalbank Working Paper, No. 26, February 1998.

downturns.<sup>24</sup> However, alternative estimates based on stochastic simulations suggest that the medium-term fiscal target stipulated by the Pact is unnecessarily restrictive in countries where the budget deficit is less sensitive to the cycle. The conclusion is that a structural deficit target of around 1 per cent of GDP would be adequate for almost all countries in the EMU.<sup>25</sup> Such a less restrictive target would at the same time alleviate a constraint on borrowing to finance public investment, which has been one of the main victims of fiscal consolidation in the 1990s.

In any case, all such calculations are surrounded by large margins of uncertainty, if only because the ongoing structural changes in an economy can significantly affect the sensitivity of changes in government net revenues to cyclical conditions. Past experience may also be a poor guide to present policy because in the monetary union the exchange rate is no longer available as an adjustment instrument and this puts a correspondingly larger burden on fiscal stabilization. All this points to the need for a flexible interpretation of the Pact. (It should also be recalled that the 3 per cent ceiling was based on the ratio of public investment to GDP in the 1980s.) It would also be appropriate to shift the focus of the Pact away from targets for actual budget balances to explicit targets for cyclically adjusted balances.<sup>26</sup> This would require, however, agreement on how to calculate them.

Recent developments in Germany have illustrated that progress in fiscal consolidation is strongly dependent on where the country stands in the business cycle. Any attempt in the past year by the German government to adhere to the fiscal targets established in the Stability Programme would have had procyclical effects with the risk of making the budgetary position even worse.

Given its focus on the medium term of balanced budget targets in the individual member countries, the SGP is more restrictive than the fiscal convergence criteria of the Maastricht Treaty.<sup>27</sup> In fact, the rules of the SGP are tantamount to a medium-term “one-size-fits-all” fiscal policy with the same fiscal rule applying to each country.<sup>28</sup> This is combined with a one-size-fits-all monetary policy.

This framework has important implications for the adjustment that is necessary in the event that a balanced budget is incompatible with domestic macroeconomic balance in a given country.<sup>29</sup> In the case of Germany, which has to cope with weak domestic demand and has difficulties in meeting the rules of the SPG, there will have to be a change in relative competitiveness, notably in relative wage levels, and associated changes in the current account balance (possibly a large surplus), if the economy is to achieve macroeconomic balance and grow at its potential rate. This may, however, be difficult to achieve (especially if other euro area countries are keen to maintain their competitiveness relative to Germany) and involve rising unemployment, the political costs of which may be difficult to sustain. This adjustment burden could be eased with a more flexible fiscal policy framework.

Changing the rule-based macroeconomic policy framework of EMU may be difficult however as any such suggestion will be interpreted by many as a threat to credibility. But ultimately, the credibility of EMU will depend on its ability to raise economic well-being for all its members and to avoid prolonged periods of anaemic growth and high unemployment. An appropriate moment to introduce changes to the macroeconomic policy framework might be during the preparations for EMU enlargement, not only to the east but also to other west European countries such as the United Kingdom. Enlargement might in fact be easier and more attractive to those currently outside if a less rigid approach were evident.

### 1.3 The transition economies

#### (i) Recent developments

Despite the negative repercussions of the global economic slowdown, 2001 turned out to be a relatively successful year for the ECE transition economies: with the exception of The former Yugoslav Republic of Macedonia, all of them posted positive rates of GDP growth and in some of them they were higher than in 2000. The transition economies’ aggregate GDP increased by 5 per cent, making them one of the fastest growing regions in the world. The main factor behind this outcome was buoyant growth in the Commonwealth of Independent States where a strong recovery continued for a third consecutive year.

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<sup>24</sup> M. Buti and A. Sapir (eds.), *Economic Policy in EMU* (Oxford, Oxford University Press, 1998), pp. 102-137.

<sup>25</sup> R. Barrell and K. Dury, “Will the SGP ever be breached?”, in A. Brunila et al., op. cit., pp. 235-255.

<sup>26</sup> A first step in this direction was taken at the Göteborg European Council when it was agreed that: “Cyclically adjusted budgetary positions should move towards, or remain, in balance or surplus in the coming years ...”, *Presidency Conclusions*, Göteborg European Council, 15 and 16 June 2001, item 34 [<http://europa.eu.int/council/>].

<sup>27</sup> This should also be considered by the accession countries given the urgent need to improve their public infrastructure.

<sup>28</sup> C. Allsopp, “The future of macroeconomic policy in the European Union”, speech to the Austrian Institute of Economic Research (WIFO), 23 January 2002 [[www.bankofengland.co.uk](http://www.bankofengland.co.uk)].

<sup>29</sup> *Ibid.*, pp. 21-29.



As in 2000, Russia remained the principal engine of growth for the CIS countries in 2001 (see chapter 3.1(iv)) with a 5 per cent increase in GDP. After the 1998 financial crisis, the Russian government introduced sweeping policy reforms, which have led to major structural adjustments in the economy and have moved it on to a path of strong growth. Considerable progress has been made in strengthening the Russian fiscal and judiciary systems, in rehabilitating the banking sector and the payments system in general, and in reducing administrative interference in the economy. The exchange rate realignment after the August 1998 financial collapse – equivalent to a competitive, real devaluation – provided an important stimulus to local producers, encouraging import substitution on a large scale. In addition, from mid-1999 until the fall of 2001, the Russian economy benefited substantially from the surge in world oil prices. Between 1999 and 2001, Russia's GDP increased by almost 21 per cent giving a much needed boost to popular support for the reforms. All the indications are that the Russian economy has crossed an important threshold in its systemic reforms, making the process of its transformation to a market economy now look irreversible.

Despite these positive developments, there are a number of uncertainties regarding Russia's economic prospects. Notwithstanding the recent progress in market reforms, Russia is far from the end of this process. Besides, it is not yet clear whether the institutional environment will be capable of implementing and enforcing efficiently all the newly adopted laws and regulations. In addition, the heavy dependence of the Russian economy on oil exports entails significant risks for macroeconomic performance in general due to the persistent volatility of international oil prices. Hence, some caution is needed in assessing the prospects for high and sustainable growth in Russia.

Another important development in the CIS region has been the continuing strong recovery of two of the larger economies, Kazakhstan and Ukraine, both of which had some of the highest rates of GDP growth in 2001. In the case of energy exporting Kazakhstan, the recent record rates of growth (13.2 per cent in 2001 after 9.8 per cent in 2000) reflect both the impact of a favourable external environment and balanced policies, which have helped to broaden the base of the recovery while maintaining macroeconomic stability. In Ukraine, strong domestic demand contributed to the 9.1 per cent GDP growth in 2001: the recent disinflation effort (which reduced the year-on-year inflation rate to single digits for the first time since independence), coupled with growing real incomes, has given a boost to consumer and investor confidence.

Although an important growth engine for the neighbouring CIS countries, Russia was not in fact the fastest growing economy in the region: 8 of the remaining 11 CIS member states in 2001 had annual rates of GDP growth higher than that of Russia (table 1.3.1). In most cases (Armenia, Kazakhstan, the Republic of Moldova, Turkmenistan, Ukraine and partly Tajikistan), strong growth was underpinned by the expansion of exports: commodity exporters benefited from favourable external market conditions while others were able to take advantage of rising import demand within the CIS itself. However, the surge in economic activity was mostly confined to the first half of 2001; in the second half of the year, there was a notable deceleration both in output and export performance throughout the CIS.

In 2001, strong rates of growth prevailed in most of the east European and Baltic states as well. In Croatia, the Czech Republic, Romania, Slovakia, Latvia and Lithuania the rate of GDP growth not only accelerated from 2000 but was also above expectations at the start of the year (table 1.3.1). Economic activity remained high, and in line with expectations in Albania, Bosnia and Herzegovina, Bulgaria and Estonia. In contrast, growth decelerated in Hungary and, especially, in Slovenia; in these two economies the effects of weakening west European import demand were probably most pronounced. Nevertheless, in both countries the annual rates of GDP growth were considerably higher than the west European average.

Two economies, Poland and The former Yugoslav Republic of Macedonia, have recently encountered serious economic difficulties. After nine years of uninterrupted and rapid expansion, the Polish economy came to a near standstill in 2001. The reasons for this are complex and deep-seated (see chapter 3.1(iii) for details) but they are indicative of the continuing fragility of the transition economies and the fact that even the more advanced reform countries are prone to unexpected setbacks. Some of the current problems in Poland stem from policy complacency: the reluctance by the authorities to undertake important but unpopular reforms during the boom period, when the excellent macroeconomic performance tended to mask some chronic economic problems. One of the lessons from the Polish case is that postponing policy reforms not only fails to resolve a pending issue but makes it more difficult to tackle later on when it may have escalated out of control, especially in a cyclical downturn, which may be exacerbated by the chronic structural weakness.

The former Yugoslav Republic of Macedonia was the only transition economy with falling GDP in 2001. This was not surprising against the background of widespread disruption caused by the internal military conflict; however, given the country's past record, it is likely that this can be regarded as a one-off setback. A relatively strong postwar recovery has continued in neighbouring Yugoslavia; however, this economy still faces formidable difficulties in implementing much needed but painful economic reforms.

In view of the increasing openness of the transition economies (chapter 3.2(iii)) and given the considerable weakening of global trade in 2001, their relatively strong performance in 2001 comes as a surprise. It is therefore

instructive to compare the reaction of the transition economies to the negative external shock in 2001 with their handling of the consequences of a similar global recession at the beginning of the 1990s. Although in both cases the external impact was broadly similar, the outcomes could not have been more different. A decade earlier, the weakening of global and, especially, west European demand coincided with the initial shocks of the transition and at that time the external shock considerably amplified and prolonged the transformational recession. In contrast, in 2001 a shock of a similar or even stronger magnitude<sup>30</sup> has so far had only a marginal impact on the transition economies. Although a detailed analysis of the factors behind this outcome remains a task for the future, it is worth drawing attention to the likely importance of two recent developments in the region.

First of all, thanks to the successful implementation of reforms which have bolstered consumer and investor confidence, domestic demand in the transition economies has generally been growing steadily in recent years. The recent global downturn has affected domestic demand (both private consumption and investment) in these economies to a lesser extent than in most of the industrialized countries. This relatively robust domestic demand helped to cushion the transition economies from the effects of the deteriorating external environment. As discussed in more detail in chapter 3.2 of this *Survey*, in many countries in 2001 there was a shift from external towards predominantly domestic sources of growth. An interesting aspect of this development – and a significant sign of the growing maturity of these economies – is the fact that, with a few exceptions, it was private domestic demand that played the key role in bringing about this shift; the fiscal stance of governments remained generally neutral in 2001 (chapter 3.1(ii)). Another sign of resilience was the fact that so far there were virtually no negative repercussions for the transition economies from the crisis in Argentina (for details see chapter 3.1(v)). Moreover, the flow of inward FDI to the transition economies was unabated, in many cases giving a further boost to final domestic demand.

Secondly, thanks to recent productivity gains, most east European transition economies have been able to improve their cost competitiveness vis-à-vis their main trading partners. Due to the fact that the productivity differential vis-à-vis western Europe was apparently retained in 2001, the transition economies held on to these gains or even enlarged them (chapter 3.1(i) and 3.3(ii)). The on-going improvement in their competitive position obviously helped east European exporters to perform better on west European markets in 2001 than some of their competitors. Thus, the negative repercussions on eastern Europe from the weakening in west European demand had a less than proportionate effect on east European exports (chapter 3.5(ii)). While the total volume of west European imports in 2001 increased by a little over 1 per cent, the volume of total exports from the central European and Baltic countries increased by some 11 per cent. The gains in competitiveness and the improved export performance also led to an increase in eastern Europe's share of the EU's extra-EU imports from 9.9 per cent in 2000 to 11.1 per cent in 2001.<sup>31</sup>

Although these are rather positive developments for the transition economies, their significance should not be overestimated. While being able to provide a temporary shield against a negative external shock, domestic demand has only limited potential as a leading factor of growth in the majority of the transition economies. The problem is that a number of these countries suffer from persistently large current account deficits (chapter 3.5(i)); excessive reliance on domestic absorption could drive these deficits out of control with consequent risks for their macroeconomic stability. As for their trade performance, it is not yet clear whether the negative repercussions from the weakening of global and west European demand will be confined to 2001; it may well be that due to lags in the economic system there will be negative carry-over effects in 2002 as well. In this regard, it should be emphasized once again that there is no room for policy complacency for the economies in transition; most of them still have a long way to go before they reach the stage of the mature market economies of western Europe.

## **(ii) The short-term outlook**

It is generally expected that growth will moderate somewhat in the transition economies in 2002: according to the available official forecasts, aggregate GDP in the CIS will grow by close to 5 per cent, in the Baltic states by slightly more than 4 per cent and in eastern Europe by some 2.75 per cent (table 1.3.1). The average figures for the subregions are very much dominated by the expected developments in two of the largest economies in the region: Russia and Poland. In Russia, the 2002 budget assumes a 4.3 per cent rate of GDP growth. It should be noted though that the Russian Ministry of Economic Development drafted three possible growth scenarios for 2002, depending on the expected development of world oil prices, and the one that underlies the 2002 budget corresponds to the “optimistic” scenario in this set.<sup>32</sup> Private forecasters seem to be more conservative about Russia's growth prospects in 2002:

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<sup>30</sup> At the beginning of the 1990s the cycles in the world's major economies diverged and there was no synchronous downturn in the global economy.

<sup>31</sup> Based on the EU's imports from the 15 east European and Baltic states; full year data for 2000, and January-September data for 2001 (excluding Greece). UNECE secretariat computations on the basis of Eurostat, CD-ROM Theme 6: External Trade, *Intra- and Extra-EU Trade*, Monthly Data, No. 1, 2002.

<sup>32</sup> According to the report prepared by the Ministry of Economic Development, if the price for Russia's oil exports in 2002 averages \$23.5 per barrel, GDP is expected to increase by 4.3 per cent; if oil fetches on average \$18.5 per barrel, GDP growth in 2002 is estimated at 3.5 per cent; and if the price falls to \$16.5 per barrel, GDP growth is expected to slow down to 3.1 per cent. *Interfax News Agency, Daily Financial Service*, 6 February 2002 as

according to a compendium of private forecasts collected and published by the World Bank, the rate of GDP growth in 2002 ranges between 1.6 and 3.8 per cent.<sup>33</sup>

In Poland, after prolonged consultations and policy debates, a revised 2002 budget reflecting the government's anti-crisis programme was finally voted in March. The budget contains a number of austerity measures aimed at reducing the fiscal deficit and these are expected to dampen further domestic demand. This adjustment is expected to have a negative impact on economic activity: the rate of GDP growth in 2002 incorporated in the budgetary framework is just 1 per cent, similar to the outcome in 2001. In contrast to Russia, however, some private forecasters seem to be more optimistic about the short-term outlook for the Polish economy.<sup>34</sup>

In the rest of eastern Europe, the governments in Bulgaria, Croatia, the Czech Republic, Hungary, Romania and Yugoslavia envisaged some deceleration of growth in 2002 as compared with 2001 (table 1.3.1). The most frequently quoted reason for this expected slowdown are the lagged effects of the global and west European slowdown. Nevertheless, the annual rates of GDP growth in most of these countries are expected to remain in the range of 3 to 4 per cent. In contrast, according to the official forecasts, GDP growth in Slovakia is expected to accelerate in 2002, consolidating the adjustment effort undertaken in 1999-2000, while The former Yugoslav Republic of Macedonia envisages a return to growth after the 2001 downturn.

After two years of robust economic growth, some slowdown is expected in the Baltic states in 2002. The deceleration is likely to be more pronounced (with GDP growing by some 4 per cent or even less) in Estonia and Lithuania, both of which are rather dependent on external factors (a very high degree of openness in the case of Estonia and a strong reliance on oil processing and exports of refined products in the case of Lithuania). In Latvia, where strong GDP growth in 2001 was mainly underpinned by buoyant domestic demand, aggregate output is likely to continue to grow at a high rate (around 5 per cent) in 2002.

Despite a certain slowdown, the CIS is likely to remain the fastest growing subregion within the ECE area in 2002. According to the official forecasts, Ukraine's GDP is expected to grow by 6 per cent in 2002, although some private forecasters are less optimistic.<sup>35</sup> In February, Kazakhstan's parliament approved a medium-term economic programme, which envisages GDP growing at an average annual rate of some 5 to 7 per cent in 2002-2004;<sup>36</sup> the country's 2002 budget is based on a 7 per cent growth rate assumption. In Georgia the budget projections envisage GDP growth of 3.5 per cent in 2002, although the Ministry of Economy, Industry and Trade is more optimistic and expects GDP growth to be in the range of 4.9 to 7.1 per cent.<sup>37</sup> In the majority of the other CIS countries, governments are expecting GDP growth rates in the range of 5 to 8 per cent in 2002.

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reported in *Reuters Business Briefing*, 12 February 2002. For more details on the impact of oil prices on Russia's economic performance see chap. 3.1(iv).

<sup>33</sup> *Interfax International, Weekly Business Report*, 19 February 2002 as reported by *Dow Jones Reuters Business Interactive* (Factiva).

<sup>34</sup> According to the forecast of the Centre for Socio-Economic Research (CASE), GDP in Poland may grow by close to 2 per cent in 2002. *Polish News Bulletin*, 15 March 2002 as reported by *Dow Jones Reuters Business Interactive* (Factiva).

<sup>35</sup> In February the International Center for Policy Studies forecast that the rate of growth of GDP would slow down to 4.5 per cent in 2002. *Ukrainian News*, 25 February 2002 as reported by *Dow Jones Reuters Business Interactive* (Factiva).

<sup>36</sup> *Interfax International, Daily Business Report*, 26 February 2002 as reported by *Dow Jones Reuters Business Interactive* (Factiva).

<sup>37</sup> *Black Sea Press*, 8 January 2002 as reported by *Reuters Business Briefing*, 18 January 2002.