PART ONE

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

CHAPTER 1

THE ECE ECONOMIES IN AUTUMN 2002

1.1 The global context and western Europe

(i) The global context

Global economic recovery loses momentum

The strengthening of global economic activity in the first quarter of 2002 progressively lost its momentum in the second and third quarters. This reflected to a large extent the renewed weakness of economic growth in the United States, which spilled over to other regions of the world economy. In western Europe, the rate of economic expansion remained moderate in the first two quarters, due to the weakness of domestic demand. Short-term economic indicators for western Europe suggest that, as in the United States, activity was sluggish in the third quarter of 2002. In contrast, and based on data for the first half of the year, growth in the transition economies has so far remained surprisingly resilient to the weaker than expected growth in the rest of the world, especially in western Europe.

International trade in 2002 started to recover from the downturn of 2001, when the global volume of goods and services fell by 0.1 per cent, the first contraction in two decades. The upturn was mainly due to stronger import demand from the United States and emerging Asia. The rise in United States imports stimulated bilateral trade with most regions of the world, including western Europe, whereas in Asia, the impact was more regional (notably benefiting Japan).

Stock markets plummet with adverse effects on private sector spending behaviour

The short-term economic outlook has become more uncertain, with downward risks, increased by further steep falls in equity values on international stock markets, following those which had already occurred since the first quarter of 2000, when the speculative bubble in stock prices burst (chart 1.1.1). This has led to considerable losses of financial wealth for private households and businesses. In western Europe, these losses amounted on average to some 40 per cent at the end of September 2002 compared with the beginning of the year and to some 60 per cent since the peak of the stock market bubble in March 2000. On average, the declines were actually somewhat less pronounced in the United States, except for the NASDAQ composite index, with a large "high-tech" component, which has fallen by 75 per cent since its last peak in March 2000 (table 1.1.1).

Falling stock markets in 2002 can be attributed to worries about the faltering economic recovery in the United States and disappointing corporate profits, actual and expected. Selling pressures on the equity markets were further intensified by a series of corporate financial scandals, notably in the United States, which have eroded investors' trust in profit statements and company valuations. In addition, the uncertainty created by the prospect of a military conflict in Iraq has also played an increasing role in the second half of the year. But, this further fall in share prices can also be interpreted as the continuation of the post-bubble adjustment required to bring equity valuations in line with more plausible longer-term profit expectations and price-earnings ratios.

The substantial loss in financial wealth due to lower equity values will tend (with a lag) to dampen private consumption expenditures. The direct and indirect impact on economic activity will depend on the importance of equities in households' total assets, the marginal propensity to consume out of financial wealth and the extent to which households and businesses regard the changes in equity valuations as temporary or permanent. Falling share prices will also adversely affect fiscal revenues from capital gains taxes.

The international economic consequences of a stock market collapse will be amplified if, as is currently the case, the fall in equity prices is not limited to a single country but rather occurs simultaneously in all the major economies. Estimates suggest that the marginal propensity to consume out of equity wealth is about 4-7 per cent in the United States.[1] For the United Kingdom, the corresponding figure is estimated to be some 4 per cent but only 1 per cent in Japan and the euro area. But there are also estimates pointing to higher spending propensities of up to 3 per cent in France and Italy.[2]

The OECD[3] estimated that a 20 per cent simultaneous fall in real equity prices in all the major economies reduces real GDP in the OECD area by 0.6 per cent in the first year. The impact is much larger – a

[1] OECD, *Economic Outlook,* No. 64 (Paris), December 1998, pp. 167-168.

[2] IMF, *World Economic Outlook* (Washington, D.C.), September 2002, p. 6, box 1.1 (www.imf.org); ECB, *Monthly Bulletin* (Frankfurt am Main), September 2002, p. 27, box 3.

[3] OECD, op. cit.

decline of 1 percentage point – in the United States. The negative impact on the four major western European economies is much smaller, amounting, on average, to some 0.25 percentage points of real GDP. These are only orders of magnitude given the large margin of error surrounding estimates of the marginal propensity to consume out of financial wealth and the assumptions postulated in such analysis. Estimates for the euro area – assuming a marginal propensity to consume of 1 per cent and a fall of share prices as above – point also to a lowering of GDP growth by a quarter of a percentage point.[4] It goes without saying that a larger spending propensity would lead to a proportionally larger decline in the rate of economic growth. Taking into account the possible adverse effects of the fall in equity prices on the cost and availability of company finance will further amplify these negative effects. Simultaneous changes in monetary conditions, i.e. in real short-term interest rates and the real exchange rate can also affect the outcome.[5]

Renewed cyclical weakness in the United States but monetary policy remains on hold

In the *United States*, recent revisions to the national accounts data show that real GDP rose by only 0.3 per cent in 2001, which is substantially lower than the previous estimate of 1.2 per cent. The revised data significantly alter the pattern of quarterly changes in real GDP in 2001, which is now seen to have declined in each of the first three quarters of the year.[6] This means that the United States economy was already in recession, albeit only a shallow one, in 2001.[7] These revisions are in line with the assessment of the NBER, which announced in November 2001 that a peak in the economic cycle had occurred in March 2001.[8] The new data confirm that the adverse overall economic effects of the September 11 events were relatively small and short lived.[9]

The rate of economic expansion in the United States slowed markedly after the first quarter of 2002, when there had been a significant rebound in economic activity (table 1.1.2). In the second quarter, real GDP rose moderately by only 0.3 per cent, equivalent to a seasonally adjusted annual rate of 1.3 per cent. Growth of private consumption expenditures weakened significantly, reflecting a combination of smaller increases in real disposable incomes and a rise in the savings ratio. Business fixed investment in equipment and software edged upward, following six consecutive quarters of decline. The rate of expansion of residential investment slowed significantly. Overall, the United States housing market has remained quite robust through September 2002, supported by historically low mortgage rates. In fact, the continued rise in house prices has to some extent offset the negative wealth effects stemming from the sharp drop of equity prices. A strong rebound in real exports of goods and services in the second quarter was more than offset by a surge in real imports. As a result, changes in real net exports continued to be a drag on overall domestic economic activity (table 1.1.3).

The changes in trade volumes in combination with the relative price changes of exports and imports led to a surge of the United States merchandise trade deficit to $122.6 billion in the second quarter of 2002, up from $106.4 billion in the preceding quarter. The current account deficit rose to a level corresponding to 5 per cent of GDP in the second quarter, up from 4.4 per cent in the preceding period.

The available short-term indicators point to only moderate growth in economic activity in the third quarter. Consumer confidence fell in each consecutive month between May and September 2002 (chart 1.1.2) against the background of turbulent equity and weak labour markets. Personal consumption expenditures virtually stagnated in August, when there was also a slight fall in industrial output compared with July. Despite its steady rise during the first seven months of the year, industrial production in August was just 0.4 per cent higher than in the same month of 2001 (chart 1.1.3). Capacity utilization rates in manufacturing industry broadly stagnated between June and August and were more than 10 percentage points below their previous high in 1988-1989 and more than 6 percentage points below the average of 1967-2001. Furthermore, the Institute for Supply Management (ISM) index fell below the threshold level of 50 per cent in September, indicating that manufacturing activity was generally contracting (chart 1.1.2). This was accompanied by declines in the index of leading business cycle indicators in July and August, which also signal weakening economic conditions.

Against this background, inflation in the United States has been modest throughout 2002, fluctuating between a monthly low of 1.1 per cent at the beginning of the year and 1.7 per cent in August. The decline in consumer price inflation in 2002 in comparison with

[4] European Commission, *Quarterly Report on the Euro Area,* No. III/2002 (ECFIN/431/02-EN) (Brussels), 25 September 2002, pp. 7-8; IMF, op. cit.

[5] The IMF estimates that lower real interest rates and the real effective depreciation of the dollar in 2002 will tend to fully offset the negative wealth effects stemming from the fall in equity prices since March 2002. In contrast, the real effective appreciation of the euro witnessed in 2002 will amplify the negative wealth effect. IMF, op. cit.

[6] Previous estimates showed slowing growth in the first two quarters and a fall in real GDP – partly associated with the disruptions caused by the September 11 attacks – only in the third quarter of 2001.

[7] This is based on a widely accepted definition of recession as a decline in real GDP in two consecutive quarters (compared with the preceding quarter).

[8] NBER, *The Business Cycle Peak of March 2001*, 26 November 2001 (www.nber.org).

[9] This relates to the short-term macroeconomic effects only and does not take into account the potential longer-term implications of higher business and government expenditures on security, which channel financial funds from investment to less productive uses.

2001 is largely the result of a moderating trend in services inflation and falling energy prices. Core inflation was below 2.5 per cent in August (chart 1.1.4). In the same month, the producer price index was 1.5 per cent lower than in August 2001.

In the labour markets, the fall in non-farm employment during 2001 bottomed out in early 2002 but this has been followed by only a moderate upturn in recruitment. Job gains in construction, services and government were largely offset by losses in manufacturing and retail trade. The monthly unemployment rate stood at 5.7 per cent in August 2002, down from 6 per cent in April (chart 1.1.5).

The sharp cyclical downturn was accompanied by a considerable slowdown in labour productivity growth in 2001: output per hour in the non-farm business sector rose by only 1.1 per cent, in contrast to 2000 when it increased by 2.9 per cent. The quarterly pattern of productivity growth in the first two quarters of 2002 was similar to that for output, a strong rebound in the first quarter being followed by a marked slowdown in the second. Growth in compensation per hour edged up in 2002, but this was offset by the gains in labour productivity. Despite some upward tendency during the first two quarters of 2002, unit labour costs in the first half of 2002 were still some 2.5 per cent lower than a year earlier.

Against the background of weaker economic growth and increased uncertainty about short-term economic prospects, the very accommodative stance of United States monetary policy has so far remained unchanged in 2002. Since December 2001, the target for the federal funds rate has been 1.75 per cent, marking the lowest short-term interest rate in 40 years. Consequently (three-month) short-term interest rates in the money market remained broadly unchanged during the first nine months of 2002 (chart 1.1.6). Real short-term interest rates (based on the total CPI) were only about 0.5 per cent in the third quarter of 2002. Moreover, overall, monetary conditions were further eased by the real effective depreciation of the dollar. The fall in long-term interest rates since May 2002 (see below), which became more pronounced in the third quarter of 2002, should, in principle, bolster interest sensitive demand.

The stance of United States fiscal policy has also remained quite loose in 2002, reflecting the combined impact of the tax cuts enacted in June 2001 and a surge in government expenditures, partly related to the combat of terrorism and military action in Afghanistan. Moreover, weakening economic activity has led to a sizeable shortfall in tax revenues. As a result, the general government budget deficit is estimated to have reached a level corresponding to 2.6 per cent of GDP in 2002, up from 0.2 per cent in 2001. The structural balance is estimated to have moved into deficit corresponding to 1.9 per cent of GDP, a swing of 2 percentage points from 2001.[10] There has also been a substantial deterioration in the medium-term fiscal outlook.

Robust growth in Canada

In *Canada*, economic growth was very robust in the first two quarters of 2002, and was much stronger than anticipated given the weaker growth in the United States, its major trading partner. The pace of economic expansion moderated to a still very strong rate of 1.1 per cent in the second quarter after an increase of 1.5 per cent in the first, equivalent to a seasonally adjusted annual rate of 6.1 per cent. In both the first and second quarters of 2002 this was the highest rate of growth among the G-7 economies. Economic growth continued to be underpinned by strong private household spending on consumer durables, reflecting rising disposable incomes resulting from large employment gains and a 12-year high in consumer confidence. These factors, in combination with low mortgage rates, also help to explain the continued buoyancy of the housing market. Business confidence has also improved and this was reflected in an upturn of spending on machinery and equipment. But export growth weakened in the second quarter, while import demand remained strong as a result of domestic demand. Core inflation reached 2.5 per cent in August 2002, drifting towards the upper limit of the central bank's target range of 1 to 3 per cent. Against the background of rapid economic growth and high and rising capacity utilization rates, the Bank of Canada twice raised official interest rates by a quarter of a percentage point in June and July 2002. In early September, the central bank left its key interest rates unchanged, reflecting a trade-off between potential inflationary risks associated with robust domestic demand, especially in the market for housing, and concerns about the effects of enduring economic weakness in the United States on Canada.

Japan continues to struggle with deflation and non-performing loans

In *Japan*, revised data show an increase in real GDP by 0.6 per cent in the second quarter compared with the first quarter, when economic activity stagnated. Exports, stimulated by increased demand in other Asian markets and the United States and by the sizeable real effective depreciation of the yen since autumn 2001, were the main source of growth in the first half of 2002. Moderate growth in private consumption expenditures was offset by further declines in fixed investment. But the appreciation of the yen against the dollar in 2002 has partly reversed the earlier gains in competitiveness. The strong growth of exports during the first half of 2002 led to a steady rise in industrial production, which in August was 3.2 per cent higher than 12 months earlier (chart 1.1.3). Deflationary pressures have persisted, with both

[10] IMF, op. cit., p. 15, table 1.5

consumer and wholesale prices continuing to fall. Equity prices in September came close to their lowest level in two decades. The unemployment rate in July 2002 was 5.4 per cent, close to the record level of 5.5 per cent reached seven months earlier.

Economic performance continues to be restrained by the lingering crisis of the financial system caused by the considerable amount of non-performing loans held by the banks. The Japanese authorities have indicated that they intend to take more decisive action to tackle these problems. The Bank of Japan announced in September that it would buy shares held by banks in order to strengthen their balance sheets and inject liquidity into the financial system. However, concrete details of these plans are not yet known or finalized. Such a measure is unlikely to be sufficient to solve the balance sheet problems of the banking system, which may require more direct measures, including the use of public funds to recapitalize financial institutions and additional expansionary measures to arrest deflation.

Ebbing capital inflows hit Latin America and Turkey

The large falls in equity prices in the industrialized countries, concerns regarding corporate governance and the worsening of the international economic outlook have all helped to erode the confidence of investors in the international financial markets and to heighten their risk aversion. This has led to the avoidance of riskier investments, including those in emerging markets.[11] This trend has been further reinforced by economic turbulence and political uncertainties in South America, the Middle East, Turkey and more recently in Asia. As a result, net private flows to emerging markets are forecast to fall slightly in 2002 to $123 billion down from $126 billion in 2001 and one third below the net inflows of 2000. These figures are well below the average of $187 billion in the 1992-2002 period.[12] The downturn has affected mainly portfolio, bond and loan flows, which are usually very volatile. Even FDI flows into emerging markets – which have been relatively more stable throughout the financial turbulence of recent years – are expected to fall by 16 per cent in 2002 from their level in 2001. However, the aggregate figures mask strong differences among regions. There were large increases in net private capital flows to central and east European countries,[13] which contrast with more moderate increases to emerging Asia and a substantial fall (by one third) in flows to Latin America. This will have a significant adverse impact on the latter region, which is strongly dependent on foreign capital.

In *Latin America*, the combination of an external financing shortfall, falling exports, domestic financial turmoil and contagion from the Argentine crisis is forecast to lead to a 0.8 per cent fall in real GDP in 2002.[14] In South America some countries have suffered from a mutually reinforcing combination of financial market turbulence and political uncertainty. This has led domestic and international investors to dispose of their assets in these countries, thereby contributing to the fall of share and international bond prices (thus raising the international financing costs) and to the depreciation of domestic currencies, accompanied by rising domestic interest rates. In many cases, this situation has increased the difficulties of managing the public finances and raised the prospect of default, which is partly generated by self-fulfilling expectations. The economic situation of Argentina deteriorated strongly after it defaulted on its foreign debt and abandoned its currency board in December 2001. Unemployment and poverty rose sharply and inflation soared, causing real incomes to tumble. The sharp fall in domestic demand is expected to lead to a collapse of GDP of some 15 per cent in 2002 (compared with 2001). The country has not been able to renegotiate its foreign debt with either private creditors or multilateral institutions. The Argentine crisis has had a strong impact on neighbouring Brazil, Paraguay and Uruguay and, to a lesser extent, Chile. In Brazil, contagion from the Argentine crisis has added to the uncertainties arising from the outcome of the elections of October 2002 and surrounding the economic policies to be adopted by the new government. These have come on top of market concerns regarding the sustainability of the country's public and foreign debt. All these factors have led to turbulent financial markets, which have in turn, contributed to a near 40 per cent depreciation of the real during the first three quarters of 2002. In these circumstances, economic growth has, not surprisingly, slowed sharply. In order to strengthen the country's capacity to contain financial instability and to prevent further contagion of other emerging markets, in August 2002 the IMF authorized its largest loan package ever, $30 billion, to Brazil, but even this was not enough to restore stability. Market concerns are unlikely to be subdued until the new government introduces a credible policy to deal with the country's financial market troubles and debt difficulties.

Turkey made progress during the first three quarters of 2002 in implementing the adjustment programme agreed with the IMF. However, since May 2002 the economy has been shaken by political instability and by uncertainties concerning the outcome of the November general election. These have raised concerns regarding the future course of economic policy, as well as the sustainability of public debt. These, in turn have led to financial market turbulence, with currency depreciation, falling equity markets and a rise in domestic interest rates and international financing costs. Nevertheless, the

[11] IMF, *Global Financial Stability Report* (Washington, D.C.), September 2002.

[12] IIF, *Capital Flows to Emerging Market Economies* (Washington, D.C.), 18 September 2002 (www.iif.com).

[13] Sect. 1.2 below.

[14] ECLAC, *Current Conditions and Outlook* (Santiago), August 2002.

annual rate of consumer price inflation fell from 73 per cent in January to 37 per cent in September, although the deceleration partly reflects a statistical base effect. Despite financial market instability, the adjustment programme targets for 2002 may be achievable; real GDP growth is forecast to reach nearly 4 per cent, reflecting a recovery from the deep recession of 2001 (table 1.3.1).

Developing Asia in the first half of 2002 was recovering from the slump of the previous year, when it was affected by the slowdown in international trade in ICT products. The pick-up in growth has been based on exports and domestic demand, boosted by private consumption, as fixed investment has lagged behind. As the region enjoys large current account surpluses, it has been little affected by the retrenchment in capital flows to emerging markets. Regional GDP growth is forecast to accelerate to 5 per cent in 2002 (up from 3.7 per cent in 2001), driven by the Chinese and the South Korean economies, which are expected to expand by 7.4 per cent and 6 per cent, respectively.[15]

Oil prices rise strongly on the back of heightened geopolitical risks

Commodity prices rebounded strongly between January and September 2002, again a recovery from the slump during the second half of 2001 (chart 1.1.7). Although the trend was driven by oil prices, other commodities also benefited from expectations – during the first half of 2002 – from an early pick-up in world economic activity. Between December 2001 and September 2002, the prices of energy products and of non-energy commodities rose by 47 per cent and 10 per cent, respectively.

Having touched a low of $18 per barrel (spot price of Brent crude) in January 2002, petroleum prices fluctuated around $25 between April and June, well within OPEC's target range of $22-$28 per barrel. They rose even further during the following three months reaching $30, their highest level in over a year. This recent rise reflects, to a large extent, a geopolitical risk premium on account of the uncertainties generated by the prospects of a war in Iraq and, to a lesser extent, market developments. In the absence of unforeseen developments (such as a sustained supply disruption), oil prices are expected to remain at their September level of around $28.5 for the remainder of the year.

Prices of industrial raw materials recovered in early 2002 in anticipation of a global economic recovery during the second half of the year, a tendency that was supported by closures of some metal producing plants. However, prices have stagnated since, as expectations about economic prospects started to weaken. Food commodity prices, however, increased more strongly and in August 2002 were 17 per cent above their trough in October 2001.

The dollar depreciates against major currencies

In the foreign exchange markets, the dollar depreciated markedly against the euro after February 2002. It dropped from a monthly average of $0.87/€ in February to $0.98/€ in September, corresponding to an appreciation of the euro by some 12.5 per cent (chart 1.1.8). In July the exchange rate briefly exceeded parity, reaching $1.02/€. This compares with an average monthly value of $1.16/€ in January 1999. The dollar weakened also vis-à-vis the Japanese yen, which appreciated from an average monthly low of Y134/$ in February to Y121/$ in September 2002, corresponding to a dollar depreciation of some 10 per cent. In contrast, the yen/€ exchange rate fluctuated within a range of Y114/€ to Y119/€ during the first nine months of this year. At the end of September, the euro had appreciated by 3.2 per cent against the yen compared with the end of March.

The dollar's decline appears to have been primarily caused by doubts about the relative strength of the United States recovery and concerns about business profitability as well as corporate governance scandals. Moreover, concerns about the possibility of a military conflict with Iraq may have also played a role. In nominal effective terms, i.e. based on a weighted average of the foreign exchange values of the dollar against the currencies of a large group of major United States trading partners, the dollar depreciated to only 2.8 per cent between February and September 2002. However, against the basket of major currencies the nominal effective exchange rate fell by 7.5 per cent over the same period. The corresponding appreciation of the euro's nominal effective exchange between February and August 2002 (latest data available at the time of writing) amounted to 6.9 per cent. Over the same period, the nominal effective exchange rate of the yen rose by 7.3 per cent.

(ii) Western Europe

Euro area recovery remains subdued

In the *euro area*, the recovery continued at a subdued pace during the second quarter of 2002. Real GDP rose by 0.4 per cent (table 1.1.2) and was only 0.7 per cent above its level one year earlier (chart 1.1.9). Compared with the first quarter of 2001, there was an upturn in private consumption expenditures, which had been very weak since the third quarter of 2001. This rise was supported by a decline in inflation and gains in aggregate incomes. But these impulses were partly offset by a further significant fall in gross fixed investment in the face of a worsening economic outlook. In fact, this was the sixth consecutive quarterly decline of fixed investment, amounting to a cumulative reduction of some 4 per cent. Changes in stockbuilding continued to provide moderate support to economic activity. The combined effect of these changes was a mild strengthening of domestic

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[15] Asian Development Bank, *Asian Development Outlook 2002. Update* (Manila), September 2002 (www.adb.org).

demand, which rose by 0.2 per cent in the second quarter (table 1.1.3). As in the first quarter, changes in real net exports supported overall economic growth. Real exports rose at their strongest pace in one and a half years, but this was largely offset by a recovery of imports, which had fallen steadily, by a cumulative 5.5 percentage points, in the five preceding quarters.

Industrial production recovered slightly during the first half of 2002, having fallen throughout 2001 (chart 1.1.3). This upturn was partly due to the improvement in export orders for manufactured goods. Nevertheless, in the second quarter of 2002, industrial output was still some 1 per cent lower than in the corresponding period of 2001. Capacity utilization in the manufacturing sector was 80.8 per cent in April-June 2002, unchanged from the preceding three-month period but below its recent peak of 84.6 per cent during the fourth quarter of 2000.

Partial and preliminary evidence for the third quarter of 2002 point to a further weakening of economic activity. The OECD composite index of leading business cycle indicators for the euro area fell in June and July and consumer and industrial confidence has weakened since the second quarter (chart 1.1.2). The Reuters eurozone composite output index, an indicator of overall private sector economic growth, fell in September 2002 for the third consecutive month to a level signalling output contraction for the first time since December 2001. In addition, the Ifo business climate index, a key cyclical indicator in Germany, fell in September for the fourth consecutive month.

Inflation remains moderate

Inflation in the euro area was 2.1 per cent in August, up from 1.8 per cent in June but down from 2.7 per cent in January 2002. Core inflation fell below 2.5 per cent in the summer (chart 1.1.10). The volatility in the headline monthly inflation rate reflects the impact of temporary factors such as the "rounding up of prices" after the introduction of euro notes and coins at the beginning of the year and the pass-through of higher prices for fresh food and energy. In the aggregate, goods price inflation fell to very low levels during the first eight months and the tendency for the prices of services to rise appears to have abated or even to have been arrested in late summer, pointing to a further easing of inflationary pressures. The deterioration in economic prospects is likely to bring about a further moderation of inflation in the months ahead, unless there is a further rise in oil prices. Producer prices were flat in the period May-August 2002. The euro's appreciation during 2002 should also have a dampening effect on inflation. Recent polls of consumer price forecasts are for an average annual inflation rate of 2.2 per cent in 2002 and 1.6 per cent in 2003.[16]

Labour markets prove resilient

The economic slowdown has taken only a modest toll on the euro area's labour markets (chart 1.1.11). The marked upward tendency in employment levels since 1997 petered out into broad stagnation in the first half of 2002. The pronounced fall in the unemployment rate since 1997 bottomed out at 8 per cent between February and October 2001 and was partly reversed thereafter. In July 2002, the average unemployment rate had edged up to 8.3 per cent. Growth of labour productivity in the whole economy has slowed down progressively since mid-2000, reflecting to a large extent the lagged adjustment of labour to changes in output. Labour productivity actually fell by nearly 1 per cent in the first quarter of 2002 compared with the same period of 2001. This, in combination with rising levels of compensation per employee, led to upward pressures on unit labour costs, which rose year-on-year by nearly 4 per cent in the first quarter of 2002. This tendency, however, should be reversed as labour input is adjusted to changing production expectations and, later on, once output has started to recover. In any case, in the current weak economic environment firms will have only limited possibilities to pass on these higher costs to the consumer and will instead have to accept a fall in unit profits.

The three major euro area economies suffer from weak fixed investment

Among the three major economies of the euro area, real GDP in *Germany,* expanded at a moderate rate of 0.3 per cent in the first two quarters of 2002. A major reason for the persistently poor overall economic performance is the weakness of private consumption and fixed investment. The support of economic growth in the second quarter of 2002 was a marked swing in inventory investment. Export growth also strengthened somewhat, but this was more than offset by a rise in imports, i.e. real net exports subtracted slightly from overall economic growth in the second quarter. Moderate economic growth was accompanied by falling employment and rising unemployment. Industrial orders fell in July for the second consecutive month. Manufacturing output had recovered somewhat during the first quarter of 2002, but declined by 1 per cent between June and July, falling back to its level of January 2002. Economic performance in the third quarter was adversely influenced by the devastating floods in several regions, but the overall impact is currently difficult to gauge. Consumer price inflation has been hovering around 1 per cent between May and August 2002, about 1 percentage point lower than the average rate for the euro area. This is reflected in above average real interest rates as compared with other member states of the euro area.

In *France*, real GDP rose by 0.5 per cent in both the first and second quarters of 2002 (table 1.1.2), the best performance among the large economies of the euro. This largely reflects robust increases in private and government consumption expenditures. In contrast, the growth of fixed investment weakened markedly in the

[16] As reported in *The Economist*, 5-11 October 2002, p. 108.

second quarter, and inventory investment also brought down the growth rate. But the weakness in investment was partly offset by the growth of exports. In fact, the increase in real net exports was the mainstay of economic activity in the second quarter. Industrial production fell, with declines in both the manufacturing and energy sectors. Manufacturing output shrank by 1 per cent in July, falling back to its level of December 2001. More generally, economic conditions deteriorated in the third quarter of 2002 amidst a weakening of industrial and consumer confidence and rising unemployment.

In *Italy*, real GDP rose by 0.2 per cent in the second quarter of 2002, only slightly more than in the preceding quarter. Total domestic demand stagnated in the second quarter, and the meagre rate of expansion was entirely due to the change in real net exports. Private consumption edged up, but fixed investment fell for the third consecutive quarter. Between April and June 2002 industrial output plunged to its lowest level in almost three years. Industrial and consumer confidence deteriorated in the third quarter.

Among the smaller economies of the euro area for which second quarter 2002 national accounts data were available at the time of writing, economic growth edged up in *Austria* supported by moderate gains in total domestic demand, but mainly because of stronger real net exports. Similarly, in *Finland*, a rebound in economic growth in the second quarter (after falling real GDP in the two preceding quarters) reflected mainly an increase in real net exports. On the domestic demand side, a strengthening of consumption and fixed investment was largely offset by falls in inventory accumulation. In the *Netherlands*, economic growth continued to be weak in the first two quarters of 2002. Domestic demand stagnated in the second quarter, with fixed investment declining. The effect of a rise in exports on activity was largely offset by a parallel increase in imports.

In *Spain*, private and government consumption rose moderately in the second quarter but fixed investment remained relatively robust. But these impulses were fully offset by a swing in inventory investment. In sum, total domestic demand stagnated in the second quarter. But real exports picked up, while imports continued to decline: as a result, the increase in real GDP by 0.4 per cent in the second quarter of 2002 was entirely due to changes in real net exports.

(iii) Monetary and fiscal conditions in the euro area

Monetary stance remains unchanged despite deteriorating growth prospects

In the light of the moderate recovery from the cyclical downturn in 2001 and low inflationary expectations, the ECB has so far held its main refinancing rate unchanged at 3.25 per cent in 2002.[17] Growth of the money supply has remained above the reference value of 4.5 per cent: in June-August 2002, M3 rose at an average rate of 7.1 per cent compared with the same period of 2001. But this strong growth reflected mainly the increasing economic uncertainty, which triggered portfolio shifts towards financial assets included in M3. Such shifts were also encouraged by the low opportunity costs of holding M3 assets. In fact, in the money market, three-month interest rates (EURIBOR) edged up slightly from an average of 3.34 per cent in January to 3.47 per cent in May 2002. But there was a decline by 15 basis points to 3.31 per cent in the period until September (chart 1.1.6). The magnitudes of the initial rise and subsequent decline of money market rates between January and September increased along the maturity spectrum. Thus, for 12-month funds, there was a decline of 72 basis points between May and September, more than reversing the increase of 48 basis points between January and May 2002. This downward tendency of money market rates reflected a progressive shift in market expectations that the anticipated strengthening of the recovery would not materialize and that, accordingly, the stance of monetary policy would not be tightened. Consequently, market expectations shifted towards an easing of monetary policy in response to the deteriorating economic prospects.

The profile of changes in long-term interest rates (yields on 10-year government bonds) reflects broadly the same evolution in market expectations in the period up to September 2002 (chart 1.1.6). But changes in yields were also influenced by portfolio adjustments triggered by investors' concerns about corporate accounting scandals and, in August and September, by the turbulence in stock markets, which led investors to prefer government bonds as safe havens. In the euro area, average long-term yields fell from 5.32 per cent in March to 4.76 per cent in September. This decline was less pronounced than in the United States where comparable yields fell from 5.28 per cent to 3.94 per cent over the same period. Thus, over a period of six months a yield gap of 82 basis points has emerged between euro-denominated and dollar-denominated 10-year government bonds. In late September 2002, United States long-term interest rates fell to their lowest level since the early 1960s.

Changes in overall monetary conditions reflect the combined impact of changes in real short-term interest rates and the real effective exchange rate. Real short-term interest rates in the euro area increased in the first eight months of 2002, reaching 1.5 per cent in August, slightly less than they were a year earlier. Combined with an appreciation of the real effective exchange rate of the euro by some 5 per cent over the same period, this suggests some tightening of monetary conditions in the euro area, somewhat offsetting the accommodative stance of monetary policy.

[17] The main refinancing rate was lowered by half a percentage point to 3.25 per cent on 9 November 2001.

Widening fiscal deficits put pressure on the Stability and Growth Pact

Weaker than expected economic growth has negatively affected net fiscal revenues with the consequence that the budget deficit targets fixed in the national stability and convergence programmes for 2002 and 2003 will not be met by many countries. This is more problematic for France, Germany, Italy and Portugal, which currently have budget deficits that are still far off the balanced budget objective to be achieved by 2004. (The other euro area member countries already have budget positions that are close to balance or even in surplus.)

In fact, in view of the more moderate growth rates that are now forecast for 2002 and 2003, it is unlikely that the goal of being close to budget balance in these four countries can be achieved by 2004 except at the expense of large output losses associated with very restrictive fiscal policies.

Budgetary outcomes were already worse than expected in Germany and Portugal in 2001. In Germany, the general government budget deficit amounted to 2.7 per cent of GDP in view of an unexpected shortfall of tax revenues and higher than planned expenditures related to the labour market. Against this background the German government committed itself in early 2002 to achieve a balanced budget by 2004. But despite tight expenditure policies at all levels of government, the budget target for 2002 will be missed because of a considerable shortfall of tax revenues, largely reflecting adverse cyclical developments. In fact, current forecasts are for a general government budget deficit close to the 3 per cent ceiling fixed in the Stability and Growth Pact, and an even larger deficit cannot be excluded. The government will also have to shoulder the additional expenditures required to finance the repair of the severe damage caused by floods in several regions. In principle, a fiscal deficit above the 3 per cent ceiling that is due to "special circumstances", e.g. natural disasters such as floods, should not lead to the "excessive deficit procedure" being invoked. In any case, the German government has decided to postpone to 2004 a personal income tax cut of 1.5 per cent planned for 2003 and to raise corporate tax rates for 2004 by 1.5 percentage points in order to finance reconstruction projects in the affected regions.[18]

In Portugal, an audit of fiscal statistics by the new government revealed that the general government budget was in deficit to the extent of 4.1 per cent of GDP in 2001, which compares to an earlier estimate of 2.5 per cent. This makes Portugal the first country in the euro area to have an "excessive deficit" as defined in the Stability and Growth Pact.[19] To redress the situation the government has adopted austerity policies.

Budgetary outcomes will also be worse than planned (or targeted) in France and Italy in 2002 and 2003, reflecting adverse cyclical factors but also the effects of tax cuts and additional expenditures. For France, a general budget deficit corresponding to some 2.5 per cent of GDP is currently expected for 2002 and possibly for 2003 as well. A budget deficit of more than 2 per cent of GDP is also forecast for Italy.

In the face of downgraded growth forecasts for 2002 and 2003 (as compared with those prepared in the spring of 2002) and the likely procyclical effects of restrictive polices in the current weak economic environment, the European Commission has proposed postponing the deadline for these four EU countries to meet the commitment of broadly balanced budgets by two years to 2006.[20] It was also proposed that the "close-to-balance" medium-term objective should take the effects of the business cycle into account; in other words, the target should be a balanced, cyclically adjusted general government budget, while at the same time the 3 per cent threshold for the actual financial balance remains a binding constraint. But countries that had not yet reached a cyclically adjusted balanced fiscal position are required to reduce the structural deficit by a minimum of 0.5 per cent of GDP every year.[21] At a meeting of euro area finance ministers in early October there was no agreement about the proposal to postpone the date for achieving "close-to-balance" budgets, but a broad majority was in favour of starting to reduce cyclically adjusted deficits by at least 0.5 per cent of GDP per annum as from 2003. This objective, however, risks running into the problem that restrictive fiscal policies, especially if pursued simultaneously by a group of large countries in an already weak economic environment, may have procyclical effects and therefore actually make fiscal positions worse.[22]

(iv) Other western Europe

United Kingdom experiences moderate growth but the surge in house prices remains a major concern

Outside the euro area, economic activity picked up in the *United Kingdom* in the second quarter of 2002, when real GDP rose by 0.6 per cent. This followed two quarters of only very moderate growth. In any case, this

[18] It should be noted that Austria was also severely affected by floods with similarly large reconstruction costs (corresponding to 0.5 per cent of GDP) as in Germany.

[19] The Commission adopted a report on government finances in Portugal in September 2002 as a first step in the Excessive Deficit Procedure.

[20] *Financial Times*, 24 September 2002.

[21] European Commission, "Preparation of Eurogroup and Council of Economics and Finance Ministers, Luxembourg, 7-8 October 2002", *Press Releases Rapid*, Memo/02/205 (Brussels), 7 October 2002.

[22] For a more detailed discussion of the Stability and Growth Pact see UNECE, *Economic Survey of Europe, 2002 No. 1*, pp. 7-10.

was the tenth year of uninterrupted quarter-to-quarter growth of GDP. The upturn in the second quarter largely reflects the continuing growth of private consumption, which was fuelled by strong earnings gains, continued increases in house prices and, partly related to the latter, increased household borrowing. Changes in real net exports also supported domestic activity, with strong gains in exports – reflecting the pick-up in international demand for ICT products – outpacing imports. In contrast, government consumption declined and fixed investment stagnated in the second quarter. Inventory changes also subtracted from overall economic growth. Short-term indicators currently available for the third quarter point to some slowing in the growth of retail sales. Also manufacturing activity remained weak. The second quarter of 2002 witnessed the sixth consecutive quarterly fall in manufacturing output – the longest decline in the postwar period – leading to a cumulative fall of 8 per cent. In July, manufacturing activity edged upward slightly to equal its level of April. The situation in the labour market was little changed, with insignificant gains in employment and an unemployment rate at 5.2 per cent in May-July 2002, a relatively low level. Nevertheless, wage cost pressures have remained weak. During the first eight months of 2002, the annual inflation rate (based on RPIX) remained well below the government's target ceiling of 2.5 per cent. The stance of monetary policy has remained unchanged since November 2001, when the base rate was lowered to 4 per cent. A major concern remains the rate of increase in house prices: this is regarded as unsustainable by the Monetary Policy Committee and may have influenced the decision to keep interest rates unchanged despite the deterioration in the short-term economic outlook. Industrial confidence weakened markedly in September 2002, but consumer confidence remained very strong.

Among the remaining member states of the European Union, the pace of economic activity in *Denmark* strengthened markedly in the second quarter of 2002 and in *Sweden*, it remained above the EU average. Outside the EU, growth also strengthened in *Norway* in the second quarter of 2002, in contrast to the first quarter when real GDP declined. Economic activity broadly stagnated in *Switzerland* in the first two quarters of 2002, with GDP actually falling in the first half of 2002 compared with the same period of 2001.

1.2 Eastern Europe, Baltic states and the CIS

Adjusting to the weakened global markets

Most transition economies managed to preserve some of their dynamism during the first half of 2002, defying concerns about a possible sharp downturn caused by the continuing weakness in the global and western European economies. Although the worst case scenario for the region as a whole has so far not materialized, there was a general moderation of the pace of growth in many countries. The aggregate GDP of the transition economies increased by 3.6 per cent year-on-year in the first half of 2002, 1.4 percentage points below the rate in 2001 (table 1.2.1). At the same time it is worth mentioning that the rates of GDP growth in most transition economies (in the majority of countries they were above 3 per cent) were considerably higher than those in western Europe in the same period. After a widespread slowdown in the first quarter of 2002, the pace of growth accelerated (in terms of year-on-year rates) in a number of transition economies during the second quarter.

The factors that contributed to these relatively positive outcomes varied considerably across countries and subregions, often reflecting country-specific developments. In general, the shift towards domestically driven growth – which became apparent already in 2001 – strengthened in the first half of 2002, but the combination of growth enhancing factors differed from country to country. In one large group of economies (Croatia, Hungary, Russia and Slovakia, as well as most of the other CIS countries), the main impetus came from booming private consumption. The latter largely reflected improved consumer confidence resulting from several years of strong growth, enhanced by the progress in disinflation. In other countries (Bulgaria, Romania and the Baltic states), both private consumption and fixed investment made a positive contribution to growth while in some cases (Armenia and Azerbaijan), the surge in investment probably outweighed the other domestic factors of growth. The continuing expansion of FDI inflows – which in itself is an important sign of confidence in the prospects of the transition economies – also contributed to the strength of fixed investment in a number of countries. Despite the general weakening of foreign trade, net exports still made a positive contribution to growth in the first half of the year in a few countries (notably in Romania and Slovakia but also in the Czech Republic and Slovenia). However, even in cases where exports were generally subdued, exporters from a range of transition economies managed to divert some sales from traditional to new markets, not only in Europe but also in Asia and other parts of the world. In addition, faced with weakening external markets, some exporters also benefited from the robust domestic demand and managed to redirect some of their sales to the local markets.

One of the important positive messages of these recent developments is that local producers in the transition economies have demonstrated an increasing responsiveness to market opportunities, behaving more and more like genuine market agents. Moreover, since most transition economies have already liberalized their markets to a considerable extent, this expansion was achieved in an environment of growing market competition. By capitalizing on emerging market niches, local producers have not only displayed their viability in difficult and changing market conditions but have also contributed to the strength of economic activity in individual countries and in the region as a whole.

The shift away from export-led growth, however, places the transition economies in a somewhat vulnerable position. Most of these economies have chronically large current account deficits and any eventual weakening of their merchandise trade balances will pose certain risks for the sustainability of these deficits. In the first half of 2002, the negative effect of weakening exports in most cases was largely mitigated by an improvement in their terms of trade; nevertheless, in a number of transition economies there was a further deterioration of their trade and current account deficits. In addition it should be noted that the surge in domestic demand in some economies was underpinned by a notable fiscal loosening (often related to election cycles), a policy that is clearly unsustainable. In general, excessive reliance on domestically driven growth cannot be regarded as a viable medium-term strategy for the majority of the transition economies, with the possible exception of Russia which runs a massive current account surplus.

The majority of the transition economies made further progress in disinflation in the first half of 2002 (double-digit inflation rates are already more the exception than the rule), and the most advanced among them have already achieved a large degree of macroeconomic stability. However, structural factors of a long-term nature (such as the ongoing adjustment in regulated prices and the catch-up inflation typical of fast growing economies) are likely to feed inflationary pressures in these economies for a long time to come. The persistently high unemployment rates remain one of the major sources of strain in many transition economies. Due to the ongoing painful labour market adjustments, output growth in the first half of the year had a positive effect on unemployment rates in only a limited number of countries; in general, these rates increased in most countries, in some cases reaching record levels. Despite the deteriorating international environment, most transition economies were not subject to external financing constraints in this period: current account deficits were easily financed and capital inflows were on the rise. The increasing tendency for international investors to differentiate among countries has clearly been beneficial for those transition economies that have made the most progress in the process of market reforms.

(i) Output and demand

Growth is decelerating but is still high

During the first half of 2002 the dynamics of aggregate output in the transition economies remained under the influence of an unfavourable external environment, especially in western Europe. Accordingly, growth in the CIS – a region which is not so dependent on trade with western Europe – was generally faster than that in eastern Europe. Overall the average rate of GDP growth in the transition economies as a whole slowed to 3.6 per cent year-on-year during the first half of 2002,[23] down from 5 per cent in both the first half and the full year of 2001 (table 1.2.1). Continued low or waning growth in the two largest economies in the region, Poland and Russia as well as a notable deceleration of growth in Ukraine largely contributed to this outcome.[24]

While the overall downward trend prevailed, this was not the case for all individual transition economies during 2001 and the first half of 2002 (table 1.2.2). Thus, GDP growth has been accelerating, albeit slightly, in Slovakia since mid-2001, while in Hungary and Poland the downward trend was arrested in the second quarter of 2002. In general, aggregate output in the CIS region was somewhat more volatile during this period. However, in most east European and Baltic countries (except Bulgaria, Croatia, Slovakia, The former Yugoslav Republic of Macedonia and Lithuania), and in the majority of CIS economies[25] GDP growth declined between the first halves of 2001 and 2002.

As the external conditions have been deteriorating for some time, the general downward trend was not unexpected. Only a few economies have so far remained below or at the lower end of the forecasts made in early 2002, mostly due to disappointing results in key sectors, such as transport in Latvia,[26] and industry in Poland and Slovenia. Also, post-conflict recovery has proceeded more slowly than expected in The former Yugoslav Republic of Macedonia and in Yugoslavia. On the contrary, GDP growth exceeded the expectations of governments in Bulgaria, Croatia, Slovakia, Estonia and Lithuania. GDP growth in the CIS region as a whole was broadly in line with the official forecasts,[27] with Armenia and Kazakhstan performing above expectations, while Belarus, Ukraine, and especially Kyrgyzstan posted disappointing results.

As was already the case last year, weak external demand has in a number of economies been partly offset by domestic demand, specifically by consumption, as a source of growth (table 1.2.3). The factors behind this development vary across the region and include increases

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[23] All growth rates referring to the first half of 2002 presented in this section are year-on-year rates. It should be noted that the absence of seasonally adjusted quarterly national accounts statistics prevents a more accurate assessment of the short-term dynamics of aggregate output in the transition economies.

[24] The slowdown in these three economies together subtracted 1 percentage point from the average growth rate for the transition economies as a whole compared with the same period of 2001.

[25] The exceptions are Armenia, Azerbaijan, Belarus, the Republic of Moldova and Uzbekistan.

[26] Transit shipment of crude oil via Latvian ports decreased by 25 per cent during the first half of 2002. BOFIT, *Baltic Economies – Bimonthly Review,* 5/2002 (Helsinki), 12 September 2002.

[27] UNECE, *Economic Survey of Europe*, *2002 No. 1*, p. 11, table 1.3.1.

in consumer confidence and expectations after several years of rising real incomes, continuing disinflation (often more than expected) giving a further boost to real incomes, and election cycles often accompanied by significant increases in public expenditures, especially in some central European and Baltic countries. The retail trade pattern across the region also confirms the strong support of private consumption (table 1.2.4): the volume of retail sales in the region as a whole increased by 8 per cent during the first six months of 2002.[28] In contrast, preliminary data suggest that investment did not follow a uniform pattern across countries. Investment remained strong in the region, but slowed down in most of eastern Europe and in the CIS,[29] and considerably so in Russia, but not in the Baltic countries.

The connection between the external environment and economic activity is particularly strong for industrial output. Compared with the first half of 2001, industrial output weakened in most transition economies: growth was negative in Poland, The former Yugoslav Republic of Macedonia, Yugoslavia and Kyrgyzstan, and there was a pronounced slowdown in Hungary, Romania, the Baltic states, Kazakhstan and Ukraine. Exceptions are to be found only in some of the smaller economies such as Armenia, and Georgia, where output is generally more volatile.

The sensitivity to the deteriorating external environment varied substantially across industries in the first half of 2002. In eastern Europe, output in the chemical, textiles and basic metals industries was generally falling (year-on-year), while the engineering industry faired better than the average.[30] Thus, the overall slowdown in industrial output was less pronounced in the Czech Republic and Slovakia, which are specialized in automobile production and other transport equipment. The general pattern was less clearly followed in the Baltic countries,[31] except in Lithuania, while industrial performance in the CIS was more differentiated: the engineering branches were generally on the decline, textiles output declined in the Republic of Moldova and Ukraine, but grew faster than the average in Azerbaijan and Kazakhstan.

(a) Eastern Europe and the Baltic states

Economic activity is bolstered by domestic demand

Overall, the impact of the global slowdown on growth in eastern Europe and the Baltic region has been less pronounced than it was initially feared. Predictably, given the comparatively strong trade links, the adverse impact has been strongest on *central Europe*, where GDP growth dropped to 1.8 per cent in the first half of 2002, making it the slowest growing subregion among the transition economies. However, this was largely due to the weak performance of the Polish economy, which is undergoing a period of structural adjustment and has been in a state of near stagnation since the second quarter of 2001.[32] Central Europe without Poland (that is, the Czech Republic, Hungary, Slovakia and Slovenia) grew by some 3 per cent in the first half of 2002. On the back of strong consumption and investment demand, the *Baltic states* averaged 5.2 per cent GDP growth in the same period, a notable achievement for a group of very small, open economies in the face of a global downturn. In *south-east Europe*, a strong recovery continued in Albania, but growth was much weaker in Bosnia and Herzegovina and Yugoslavia, while the economy of The former Republic of Macedonia stagnated. Combined with strong growth supported by buoyant domestic demand in Bulgaria, Croatia and Romania, the rate of growth of aggregate GDP in this subregion reached 4.1 per cent in the first half of 2002 (table 1.2.1).

According to quarterly figures for the first quarter of 2002, industrial production in many east European and Baltic countries had almost come to a standstill or even declined compared with the same quarter in 2001. Second quarter data suggest a selective upturn in industrial output, notably in Bulgaria, Slovakia and the Baltic states (table 1.2.2). However, it remains to be seen whether this will be sustained in the rest of the year.

As indicated by the available national accounts data,[33] the prime source of growth in the region has been domestic demand and in some countries (particularly Estonia and Lithuania) net trade made a sizeable negative contribution to GDP. The main exceptions were Romania, due to its surprisingly good export performance (section 1.2(iv)), and Slovakia, mostly due to the reduced imports of goods and services.[34] Domestic demand in eastern Europe and the Baltic states was underpinned by strong total final consumption which, in most countries, contributed some 2 to 3 percentage points to GDP growth

[28] Compared with 6.5 per cent in the first half of 2001. UNECE secretariat calculations, based on PPP-adjusted, GDP-weighted data from the UNECE Common Database.

[29] This is consistent with the observation that producer price inflation and unit labor cost developments imply declining unit operating profits in many countries of the region (sect. 1.2(ii)).

[30] Romania is an exception, as output strengthened mainly in food processing and metal processing and to a lesser extent in textiles and the chemical industry.

[31] Estonian industry received strong support from textiles, while the chemical industry made a substantial contribution to Latvian industrial output growth.

[32] For more details see UNECE, *Economic Survey of Europe*, *2002 No. 1*, pp. 63-69.

[33] At the time of writing, quarterly national accounts data for the first half of 2002 were only available for a limited group of countries shown in table 1.2.3.

[34] There was also a small positive net trade contribution to GDP growth in the Czech Republic and Slovenia. The Slovenian net trade position profited from both industrial exports and receipts from transport services. Czech exports of industrial goods withstood a large real currency appreciation, but the consequences of the August floods, however, may have negatively affected Czech industrial output in the second half of the year.

in this period. The largest contributions of total consumption to GDP growth (above 4 percentage points) were in Slovakia, the three Baltic countries, and especially in Hungary.

For the first six months of the year, there were double-digit rates of increase in the volume of retail trade sales in Croatia (supported by booming tourism), Hungary (fed, *inter alia*, by very large real wage increases originating in the public sector), Yugoslavia, and the three Baltic countries. In a regional perspective, the volume of retail sales increased by 4 per cent in the south-east European transition economies, but by more than 14 per cent in the Baltic states. There was a notable acceleration of sales in the central European transition economies, where their aggregate volume increased by about 5.5 per cent, after growing by barely 1 per cent in 2001.[35] The Polish consumer market seems to be recovering, perhaps sending the very first signal of recovery after stagnating during the whole of 2001.

In addition to strong private consumption, fiscal policies appear to have provided a further stimulus to domestic demand in a number of countries. In Hungary, government consumption rose by 3.8 per cent during the first half of 2002, contributing some 0.8 percentage points to GDP growth. Data for the Czech Republic, Slovenia and Estonia imply similar contributions, while in Slovakia government consumption accounted for 1.2 percentage points of real GDP growth.[36] Too heavy a reliance on fiscal stimuli, however, may endanger the internal and external equilibrium of these generally small, open economies before an export-led recovery is able to set in again.

Except for Slovakia, where gross fixed capital formation shrank slightly, and Poland, where it fell by 10.6 per cent during the first half of 2002, reflecting uncertainties about the country's future performance, fixed investment continued to grow rapidly in most east European and Baltic countries. Investment was strong in Bulgaria, Croatia, Hungary, Latvia and, especially, in Estonia and Lithuania where FDI inflows underpinned double-digit rates of growth of fixed investment. The available national accounts data indicate, however, that investment generally subsided somewhat in early 2002. In most cases gross fixed capital formation contributed around 1 percentage point to real GDP growth, while in Croatia, Estonia and Lithuania the corresponding figures were 2.1, 3.9 and 5.2 percentage points, respectively.

(b) The Commonwealth of Independent States

The Russian growth engine loses some steam

Overall, growth in the CIS economies in the first half of 2002 was significantly weaker than a year ago; nevertheless, the average GDP growth rate was still 4.3 per cent. This deceleration largely reflects developments in Russia and Ukraine which together, account for about 80 per cent of the CIS aggregate GDP. In the first half of 2002, GDP growth in most countries was between 3 and 5 per cent (table 1.2.1). Intercountry variations were mainly due to specific conditions related to key commodities in some of the Caucasian rim and central Asian economies. With oil and gas but little diversification, Azerbaijan and Kazakhstan managed to remain in the high growth group with GDP increasing by 8.4 and 9.2 per cent, respectively. The fast growing CIS countries include two of the lower income economies – Armenia and Tajikistan – with GDP growth of 10.1 and 8.3 per cent, respectively, the former benefiting from large increases in exports of jewellery and precious stones, and the latter from a larger output of processed cotton. At the lower end of the range, Kygryzstan's GDP fell by 4.9 per cent during the first six months of 2002.[37]

The slowing pace of the Russian economy has been central for recent CIS performance. While Russia still posted a comparatively strong GDP growth of 3.9 per cent in the first half of 2002, the main sources of growth following the 1998 crisis (such as high real export revenues followed by an investment boom) appear to have been gradually exhausted. Personal consumption has now taken over as the main driving force of growth in Russia, as is evidenced by the slowing rate of investment, coupled with the strong growth of retail trade, and by the fact that in the second quarter of 2002 the output of services grew faster than the production of goods.[38]

Total industrial output in the CIS grew by 3.9 per cent in the first half of 2002, about half its rate in the corresponding period of 2001, the slowdown being quite notable in the three largest economies, Kazakhstan, Russia and Ukraine. Kazakhstan, however, managed to maintain high growth rates of output in both the extractive and manufacturing industries. The deceleration of output was especially pronounced in Ukraine, due to the weakening of output in metallurgy and metalworking, especially steel. Much of this, however, reflects a high base level in the first months of 2001, when the expected imposition of value added tax on Ukrainian products sold to Russia scheduled

[35] UNECE secretariat calculations, based on PPP-adjusted, GDP-weighted data from the UNECE Common Database.

[36] Slovak government consumption has increased for seven consecutive quarters, in part reflecting the ongoing reform of state administration, which adds a new regional layer of government.

[37] This decline was expected to be temporary, due to low construction activity and a fall in agricultural output caused by bad weather. IMF, *Kyrgyz Republic. First Review Under the Three Year Arrangement Under the Poverty Reduction and Growth Facility,* (Washington, D.C.), 17 June 2002, p. 10. However, the situation cannot be expected to improve significantly for the remainder of the year, as mining and processing at the Kumtor gold field came to a standstill in early July after an accident.

[38] This pattern, however, may have already been reversed in the third quarter: in August the fastest growing industries were the export-oriented ones such as fuels, chemicals and non-ferrous metals, all of which grew by about 7 per cent. BOFIT, *Russian and Baltic Economies – The Week in Review,* 38/2000 (Helsinki), 20 September 2002.

for mid-2001 had led industrial producers and exporters to accelerate a proportion of planned deliveries. The growth of Russia's industrial output slowed down to 3.2 per cent in the first half of 2002, one of the lowest in the CIS; however, there have been signs of some acceleration after the first quarter and, especially, in July and August.

In consequence of a worsening intra-CIS trade performance and, specifically, the sharp drop in Russia's imports from the CIS (section 1.2(iv)), the region has switched from external to domestic sources of growth, as in eastern Europe and the Baltic states. The changes in the main components of domestic demand, however, were quite uneven. Personal consumption, as measured by the volume of retail trade, continued to increase at high rates in most of the CIS, reaching an average growth rate of 9.2 per cent in the first half of the year, only slightly lower than a year ago.[39] With the exception of Georgia, Kyrgyzstan and Uzbekistan, in all the CIS countries the volume growth of retail sales was close to or above 10 per cent in the first half of 2002.

According to the monthly statistics on investment outlays, fixed investment in the CIS as a whole increased by about 6 per cent in the first half of 2002, down from 9 per cent a year ago, and 10 per cent for all of 2001.[40] In Russia it increased by only 2 per cent over the first six months of 2002, partly reflecting a slump during the first quarter that was mainly due to cuts in government financed investment in transport infrastructure.[41] Investment outlays in the first half of the year grew strongly in Armenia (25 per cent), Kazakhstan (9 per cent) and the Republic of Moldova (12 per cent). In Azerbaijan, the volume of investment even doubled during the same period, mainly due to the start of work on three major energy sector investments.

(ii) Costs and prices

Disinflation continues

The downward trend in consumer price inflation, which generally resumed in eastern Europe, the Baltic states and the CIS in early 2001, continued in the first half of 2002. Lower food and domestic fuel prices were the main factors behind this performance, particularly in the second quarter when disinflation gained momentum. Thus, as in 2001, the lower inflation in the first half of 2002 was not the result of more moderate domestic cost-push and/or demand-pull factors but in general the reflection of good harvests and the real appreciation (in some cases significant) of exchange rates which alleviated external supply-side cost pressures. Furthermore, due to transmission lags, the effect of rising world commodity prices (which have been recovering from the lows of the last quarter of 2001), particularly of crude oil, had not yet worked through into domestic prices.[42] In fact, in many of the east European economies for which such data are available, the rates of core inflation (CPI excluding food and energy) remained rather stable in the first half of 2002 reflecting continued relatively strong growth in service prices. The core rate fell only in Poland, largely due to the lagged effects of a long period of tight monetary policy and a strong zloty.

Among all these economies, in the first half of 2002, the CPI accelerated over the same period of 2001 only in Albania, Latvia, Lithuania and Azerbaijan, but in the latter two rates remained low (table 1.2.5). In Slovenia, inflation fell only slightly and remained relatively high (at nearly 8 per cent) compared with most other transition economies: this was mainly due to a further strengthening consumer demand and continuing labour cost pressure. Also in Hungary both demand-pull and labour cost-push factors put strong pressure on prices. However, the nominal effective exchange rate of the Hungarian forint appreciated sharply in real terms, alleviating to a large extent the external cost pressures. In Bulgaria, the year-on-year inflation rate in the first half of 2002 reached 7.6 per cent, but this was driven mainly by sharply increased domestic energy prices and one-off increases in excise duties and administrative fees in the first quarter. In the first half of 2002, inflation rates remained in double digits only in Romania, Yugoslavia, Belarus, Russia and Tajikistan. However, there was a significant slowdown in price increases in these countries as well, particularly in the second quarter, mainly thanks to food price disinflation, which was accompanied by relative wage discipline in Romania and the appreciation of the rouble in Russia.

On the side of domestic costs, wage inflation remained strong and rose much faster than labour productivity in industry, particularly in those countries where the slowdown in industrial output was accentuated by declining foreign demand. Consequently, with few exceptions (mainly Croatia, the Czech Republic, Poland, Lithuania and Armenia), unit labour costs continued to rise rapidly in the first half of 2002. In Romania, Yugoslavia, Belarus and Russia, the rate of increase in unit labour costs declined from 2001 but still remained quite high. The growth of unit labour costs accelerated in Bulgaria, Hungary, Latvia and most of the CIS. In contrast, there was a significant fall in industrial producer price inflation in most of the east European and Baltic economies. This suggests that much of the rising labour cost pressure has been absorbed by unit operating profits. Producer price inflation also decelerated in the CIS economies in the first

[39] CIS Statistical Office, "Economies of the countries of the Commonwealth of Independent States in 1st half-year of 2002", *Press Release* (Moscow), 1 August 2002.

[40] Ibid.

[41] Russian European Centre for Economic Policy, *Russian Economic Trends,* Vol. 11, Issue 3 (Moscow), September 2002, p. 64. However, Russian investment in this period was more diversified than in previous years when it was dominated by the energy sector.

[42] World energy prices in dollars rose by 29.6 per cent between December 2001 and June 2002. Over the same period the "total HWWA index excluding energy" and the "industrial raw materials" index had risen by 6.7 and 8.1 per cent, respectively.

half of 2002, however, the rate remained relatively high. Nevertheless, the rise in industrial unit labour costs in these countries was significantly greater than the increase in producer prices (with the main exception of Armenia), which suggests a severe squeeze on unit operating profits in industry and probably reflects growing competition on the domestic markets.

On the demand side, the strong growth in private consumption, boosted by rising real household incomes since mid-2001, so far does not appear to have been inflationary. Monetary policy in a number of economies (Poland being the main exception) remained expansive or started to ease; despite that, nominal exchange rates in most cases rose more slowly than inflation, and in some countries even appreciated, partly due to a surge in capital inflows (see below). This has further abated the effect of imported inflation on the dynamics of domestic prices. Only in a few economies such as Bulgaria (fiscal retrenchment) and Poland (tight monetary policy), is it possible to trace a direct link between the tight stance of domestic macroeconomic policies and lower inflation; in the other countries the favourable inflation performance in the first half of 2002 was largely due to a favourable external environment and profits adjustment in the enterprise sector.

In the short term, unless an external shock, such as a surge in world energy prices caused by a war in the Middle East, leads to large increases in material input costs, a further slowdown in inflation rates can be expected.[43] As the inflationary expectations of household have moderated in many of the transition economies in recent quarters and rising job insecurity has started to erode sentiment among consumers, the major domestic pressure on industrial producer prices in the second half of 2002 is likely to come from unit labour costs if there is a further slowdown in export-led industrial output and productivity. However, the recent deterioration in the labour markets and growing fears of rising unemployment may check wage demands in many of these economies. Consequently, the inflation forecasts or targets incorporated in the budgets for 2002 as a whole and probably for 2003 can be expected to be achieved or in some cases actual rates may even turn out to be lower.

(iii) Labour markets

Unemployment in the region stays high

In the first half of 2002, the labour markets in the majority of transition economies, particularly in eastern Europe, remained rather tense with a number of countries facing problems with persistently high levels of unemployment. In eastern Europe unemployment has been worsening, since 1999, when it started rising in the aftermath of the Russian financial crisis and then continued as a result of intensified enterprise restructuring in most countries. Consequently, between June 1998 and June 2002, the average regional unemployment rate increased by more than four percentage points to nearly 16 per cent, the highest mid-year rate since the start of transition (table 1.2.6). In the Baltic states, the situation also deteriorated considerably over this period and despite some improvement in the first half of 2002, the unemployment rate averaged 9 per cent in June, more than 3 percentage points higher than four years earlier. The statistics on registered unemployment in the CIS countries do not present a reliable picture of the situation in their labour markets; nevertheless, the available data from labour force surveys indicate a further fall in the rate of joblessness in Kazakhstan, Russia and Ukraine where the strong recovery in recent years has finally led to the creation of new jobs.[44]

The negative social consequences of the high rates of unemployment are exacerbated in many transition economies by specific problems such as the disproportionately large rise in youth unemployment,[45] the increasing duration of unemployment (with the share of the long-term unemployed in some countries reaching 50 per cent or more of total unemployment), and the continuing fall in the number of people eligible for unemployment benefits.[46] The situation, however, still differs considerably among countries and subregions.

In *central Europe*, unemployment worsened in the first half of 2002.[47] Hungary was the only country where the unemployment rate declined in the 12 months to June 2002 (table 1.2.6).[48] In Slovakia and Slovenia, the rate was basically unchanged from a year ago, but it increased in the Czech Republic and, particularly, in Poland. But the situation varied considerably: while the unemployment rate in June was between some 8 and 11 per cent in Hungary, the Czech Republic and Slovenia, it

[43] There has already been, however, a sharp rise in crude oil prices in September (see sect. 1.1).

[44] The three largest economies in the CIS account for nearly 80 per cent of the region's labour force and conduct regular quarterly labour force surveys.

[45] For a more detailed discussion see UNECE, *Economic Survey of Europe, 2002 No. 1*, pp. 118-120.

[46] The current situation with unemployment in many east European countries is considerably worse than it was in 1993 when unemployment in the region peaked for the first time. Unemployment benefit systems were originally set rather generously, but in most countries they have been substantially tightened in the course of transition. The regulations determining access to such benefits have become considerably more restrictive, both in terms of eligibility and in terms of the amount and duration of benefits. Thus, in June 2002, in countries such as Bulgaria, Croatia, Poland and Slovakia where unemployment rates were above 17 per cent, some two thirds or more of the unemployed were no longer eligible for unemployment benefit.

[47] In assessing the situation in central Europe it should be kept in mind that regional averages are heavily dependent on Poland's performance, which accounts for nearly 60 per cent of the region's labour force and where unemployment has increased substantially since 1999.

[48] Unlike the situation in 2000 and 2001, it seems that the slight year-on-year drop in unemployment in Hungary in the first half of 2002 was caused mainly by the decline in the labour force rather than by job creation, as employment actually stagnated in the first half of the year. For a more detailed discussion see, for example, PlanEcon, *Country Report,* Vol. XVIII, No. 9, 5 June 2002, pp. 31-32.

was over 17 per cent in Poland and Slovakia. In Poland, sluggish growth combined with the ongoing restructuring of unprofitable industries and the increased numbers of newcomers entering the labour market, led to a sharp rise in joblessness. The rate of unemployment in Poland has been growing by nearly two percentage points a year since 1999 and in March 2002 it reached a post-communist high of 18.1 per cent of the labour force. Despite the efforts of the government[49] the situation is not expected to improve in the short run as economic growth is likely to remain weak in 2002 and some state owned companies have already announced large lay-offs. The 2002 budget assumes that the unemployment rate will reach 18.5 per cent by the end of the year. National analysts, however, are less optimistic and believe that the rate could rise to 19-20 per cent of the labour force.[50]

There has also been a further deterioration in the labour markets of the *south-east European* transition economies. The average unemployment rate in this region in June 2002 is estimated at 17.5 per cent, 1 percentage point more than a year earlier. In the 12 months to June, unemployment increased in all countries of the region except Albania,[51] and with the exception of Romania, the unemployment rate was above 14 per cent and reaching some 30 per cent or more in Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia. Chronic joblessness has been a persistent problem in south-east Europe for more than 10 years and is one of the causes of the region's volatility. Moreover, the extremely high levels of unemployment in some of these countries pose serious risks to the possibility of successful programmes of economic transformation.

There are signs that dynamic economic growth in the *Baltic states* since 2000 has resulted for the first time in some easing of labour market tensions. In June 2002, their average unemployment rate stood at just above 9 per cent,[52] nearly 1 percentage point below that of a year earlier (table 1.2.6); however, the situation differed among the three countries. In Latvia the unemployment rate was basically unchanged from June 2001, but in Estonia and particularly in Lithuania, it was on a downward trend. In the 12 months to June, the unemployment rate in both countries was 1 percentage point or more below that of a year earlier. For both countries, this is the first year-on-year drop in the rates of unemployment since 1998.

Despite the continuation of relatively strong growth in the majority of the *CIS countries*, the official unemployment figures do not suggest any major changes in the first six months of 2002. The statistics of registered unemployment continue to be unreliable as a large proportion of the jobless do not register for various reasons. Estimates of unemployment based on labour force surveys, however, suggest improvement in the three CIS largest economies. In June 2002, the unemployment rate in Russia was 7.7 per cent and 8.8 and 9.7 per cent in Kazakhstan and Ukraine, respectively. In all three countries the rates were lower than in the first quarter of the year and 1 percentage point lower than a year earlier.

(iv) International trade

(a) Eastern Europe and the Baltic states

After a weak start, trade picks up in second quarter

After rapidly losing momentum in the last quarter of 2001 and a poor performance in the first months of 2002, the foreign trade of the east European and Baltic countries picked up noticeably in the second quarter, confirming to some extent the improved business and consumer confidence in the early spring in an imminent recovery of the global economy.[53] As a result, the region's export and import volumes rose on average by 3-4 per cent in January-June 2002, year-on-year,[54] while their aggregate dollar values increased 5 per cent for exports and 4 per cent for imports, according to preliminary data (table 1.2.7).[55]

On the import side, the growth rates in dollar terms varied considerably: imports from western and, especially, from developing countries increased, while those from the CIS declined; on the export side, growth was broadly similar across the major markets (table 1.2.8). The increased presence of east European producers on western markets in spite of the sluggish demand and, often, the marked real appreciation of their

[49] The Polish Sejm (the lower house of Parliament) adopted earlier in the year a multi-faceted "anti-crisis" government programme where fighting unemployment is given a high priority. In June, the Labour Ministry launched a "First Job" programme whose cost is estimated at 330 million zloty and which is aimed at reducing the very high rate of unemployment (more than 40 per cent) among young people. Also, the recently adopted Labour Code aims at introducing more flexibility to the Polish labour market.

[50] *Interfax Poland Weekly Business Report*, 21 June 2002, quoted in *Dow Jones Reuters Business Interactive* (Factiva).

[51] The decline in unemployment, however, occurred against a background of declining employment which suggests departures from the labour force (the "discouraged" unemployed).

[52] In interpreting the unemployment figures in the Baltic states, one should take into consideration that the official figures for registered unemployment tend to underestimate the actual levels of unemployment although to a lesser extent than is the case in some of the CIS countries. In the second quarter of 2002, unemployment rates derived from labour force surveys were at 9.4 per cent in Estonia, 13.3 per cent in Latvia and 13.4 per cent in Lithuania, whereas the registered rates were 7, 7.9 and 12.6 per cent, respectively.

[53] In fact, between the first and second quarters of 2002, the volume of imports of goods and services into western Europe rose by 1.6 per cent (table 1.1.3).

[54] UNECE secretariat estimates, based on preliminary data from several east European and Baltic countries (table 1.2.9).

[55] The growth in euro terms was similar to that in dollars, since the euro strengthened significantly after March, pushing the average euro-dollar rate for January-June 2002 close to that in the same period of 2001.

domestic currencies, was most likely due in part to the strong intrafirm sales of multinational companies.[56]

In the first half of 2002, the terms of trade improved for a number of countries as import unit values in dollar terms declined, dampened by lower year-on-year world market prices for energy and some other commodities, while average export dollar prices remained flat or increased moderately under the impact of the evolution of manufactured goods prices and dollar depreciation.[57] Thanks in part to this improvement in the terms of trade, eastern Europe's aggregate merchandise trade deficit narrowed by $0.6 billion in the first half of 2002, to $19 billion. The Czech, Hungarian and Slovene trade deficits fell considerably from their levels of a year earlier, thus lowering substantially the ratio of merchandise trade deficits to GDP (table 1.2.7). In the Baltic states, on the contrary, trade deficits widened substantially, to $2.4 billion.

The nearly 6 per cent rise in the aggregate dollar value of central European *exports* (CETE-5 in table 1.2.7) in the first six months of 2002 was driven mainly by the Czech and Hungarian performance, in spite of the sharp appreciation of their currencies in nominal and real effective terms.[58] In both countries, according to the national data, total export growth was backed by strong exports to the EU (growing some 7-8 per cent in dollar value and 4-5 per cent in volume) and by large increases of sales to developing countries, in particular to Asia (up 26-35 per cent in dollar value). Polish, Slovak and Slovene exports grew somewhat less by 2-4 per cent in dollar value, while their exports to their major EU market – Germany – actually fell. All the central European countries have increased exports to less traditional EU markets (Sweden, the Netherlands and the United Kingdom) generally on the basis of a limited range of manufactured goods (electronic equipment, road vehicles and furniture, as well as beverages).

Among the south-east European countries, Romania's exports were surprisingly strong in the second quarter of 2002 given external demand conditions and the appreciation of the leu in real effective terms: their dollar value grew by 17.5 per cent year-on-year thanks to increased sales to western and developing markets; in contrast, exports to the transition economies fell. Sales of apparel and footwear to the EU, mainly under OPT arrangements,[59] increased sharply, generating 46 per cent of Romania's exports to the EU in the first half of 2002. Yugoslavia, too, reported a double-digit growth of export value in the second quarter of 2002, albeit from low levels, raising the average increase for January-June to 7 per cent. In contrast, half-year exports from other south-east European countries were either lower in dollar value (Albania and The former Yugoslav Republic of Macedonia) or flat (Bulgaria and Croatia) when compared with January-June 2001. As regards export destinations, performance was quite diverse: Bulgaria, similarly to Romania, reported a sharp decline of exports to the transition economies, including a fall of nearly 30 per cent to CIS partners,[60] while in the case of Croatia the substantial fall of exports to developing countries dragged down the overall increase although exports to all its other major markets were on the rise.

In the Baltic states, national statistics for the second quarter of 2002 generally indicate a substantial improvement on the first quarter of 2002; in Latvia and Lithuania, exports were also higher than in the same period of 2001, while Estonia's remained below the level of the previous year.[61] According to preliminary data for the first half of 2002, Lithuanian exporters improved their position in all their major markets, with a 30 per cent rise

[56] According to Eurostat data, the share of the three largest central European economies – the Czech Republic, Hungary and Poland – in total extra-EU imports increased from 6.1 per cent in the first half of 2001 to 6.9 per cent in January-June 2002. Eurostat, Euro-indicators, *News Release*, No 113/2002, 20 September 2002 (http://europa.eu.int/comm/eurostat/).

[57] Although picking up in recent months, world market prices in dollars (HWWA index) for energy resources were lower by 12 per cent on average in the first six months of 2002 as compared with January-June 2001; world commodity prices excluding energy were down by 7 per cent, while those for industrial raw materials were down 9 per cent (HWWA). According to national statistics, in January-June 2002, export unit values for manufactured goods in dollar terms were virtually unchanged in the Czech Republic and increased 2-3 per cent in Hungary and Poland. In the EU, export unit values in dollars for manufactured goods declined in January-March by 2.6 per cent, year-on-year (United Nations Statistical Division, *Monthly Bulletin of Statistics On-line*, http://unstats.un.org/unsd/mbs).

[58] In the Czech Republic, the value of exports expressed in current koruna actually fell by 2 per cent year-on-year in the first half of 2002, while in Hungary, the current domestic value of exports stagnated. Over the same period, the Czech koruna and Hungarian forint appreciated by some 9 to 12 per cent, year-on-year, in real effective terms, based on a unit labour cost deflator (UNECE secretariat calculations), although the full impact of this appreciation on exports might be felt only with a certain lag. Partly because of the pressure from major exporters, the Czech National Bank has tried to slow down the appreciation of the koruna by intervening several times in the currency markets and by cutting interest rates on 26 April 2002. In Hungary, too, the rapid appreciation of the forint along with the rapid growth of wages prompted appeals for government action. In September, five of Hungary's biggest exporters (Richter-Gedeon, Raba, Arago, Graphisoft and Wallis, with joint exports of $900 million in 2001) joined forces to lobby policy makers to curb the forint's strength by lowering interest rates and introducing some tax breaks, asserting that their attempts to offset the impact of a strong forint by improving their performance and hedging currencies had reached its limit (E. Bartha, "Hungarian exporters bemoan strong forint policy", *Reuters*, 11 September 2002).

[59] The EU-Romanian OPT transactions picked up in the second half of the 1990s and have continued to rise, due to the abundance of skilled labour and low wages: the average monthly wages in Romania's industry amounted to $163 in the second quarter of 2002, two to three times lower than in central European and Baltic countries and just slightly higher than in Bulgaria.

[60] This was partly due to the product structure of these exports: not only the demand but also the dollar prices for industrial raw materials and chemicals, as well as foodstuffs exported to the CIS, were substantially down, year-on-year.

[61] During the first half of 2001, Elcoteq – a major exporter in 2000 – had been closing down its production operations in Estonia, but maintained a high level of reported export sales, probably in part by inflating unit values for intrafirm transactions (UNECE, *Economic Survey of Europe, 2001 No. 2*, p. 22). This generated a high base-year effect that will dissipate in the second half of the year, and the average rate of export growth in July-December 2002 is likely to be positive.

in exports to the CIS and a 12 per cent increase to the EU. The latter occurred despite the repegging of the litas from the dollar to the euro on 1 February 2002 which created some strain as the euro appreciated against the dollar in the months that followed. A moderate rise of Latvian exports was mainly based on a 12 per cent increase in sales to the CIS and more than a doubling of exports to North America, whereas exports to the EU remained flat.

In the second quarter of 2002 *imports* into eastern Europe and the Baltic states gained some momentum, as a result of strong domestic demand. In Croatia, Estonia and Lithuania, they grew more rapidly than exports in both volume and value, boosted by surging private consumption and investment, and resulting in a considerable rise in their merchandise trade deficits.[62] Rapidly rising imports were also reported in Albania, Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Latvia. In most other east European countries, the growth of dollar imports in the first half of 2002 was more subdued, and generally less than that of exports**.** Imports from western partners grew on average by some 3 per cent in dollar value, whereas those from the CIS shrank by 10 per cent or more.

The weaker growth of the dollar value of imports was not only due to improved terms of trade and the appreciation of domestic currencies: except for Poland, import growth in volume terms was also rather moderate (table 1.2.9). The relatively slow growth of industrial activity, which in much of the region is highly dependent on imported inputs, was another important factor. Also, with a rather narrow range of goods accounting for the current growth in exports, part of local capacity that had earlier been allocated to exports was reoriented to the domestic market, substituting domestic sales for imports.

Recent data underline the fragility of expectations for euro area recovery, and there are growing concerns about the poor performance of the three major economies, particularly Germany and Italy. As a result, the export expansion of eastern Europe and the Baltic states seems to have slowed down in July and August. However, this not only reflects a further weakening of business and consumer confidence in western Europe, but also the impact of the August floods in central Europe, which temporarily halted production in several important industrial regions, damaged agricultural output and disrupted road and rail transport. In turn, imports seem to be picking up, boosted in some countries by the buoyancy of private consumption or the recovery of investment (Hungary, Romania and the Baltic states), or in others in anticipation of the implementation of already announced fiscal measures.[63]

(b) International trade of the CIS countries

Lower commodity prices affect export earnings

In the first six months of 2002, the dollar value of *total merchandise exports* from the CIS decreased by 6 per cent, year-on-year, largely due to lower commodity prices (table 1.2.7). Prices of virtually all major CIS natural resource exportables declined, except the gold price, which rose by 6 per cent.[64] The continuing economic rebound in the CIS region – still driven by strong demand for consumer and capital goods – as well as exchange rate appreciations in real terms against the dollar and the euro helped to boost imports from the non-CIS area. Intra-CIS regional trade, in contrast, decreased by some 12 per cent in dollar value, largely mirroring the lower values of trade with Russia.

In Russia, the largest CIS natural resource exporter, oil producers sought to boost their export revenues by increasing the volume of crude oil and oil products shipped (by 15 and 17 per cent, respectively). Shipments of Russian natural gas also increased albeit by a much smaller amount (3 per cent). Despite the volume increases of these three key items the dollar value of Russia’s exports declined by 7 per cent.[65] There were similar declines in Azerbaijan, Kazakhstan and Uzbekistan where the decreases ranged from between 9 per cent in Kazakhstan to 22 per cent in Azerbaijan.[66]

All other countries, except Georgia which has continued to face problems in shipping its goods to Russia and has banned scrap metal sales abroad (see below), increased their dollar value of their total exports. The increases ranged from 1-2 per cent in Belarus, the Republic of Moldova and Ukraine to 41 per cent in Armenia, which posted the largest increase within the CIS on the strength of doubling its exports of jewelry and precious stones. In the Republic of Moldova, strong sales of foodstuffs offset declines in other sectors while Belarus and Ukraine managed small increases in export

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[62] According to preliminary data for January-June 2002, the ratio of merchandise trade deficits to GDP in all three countries rose some 3 percentage points, reaching 24 per cent in Croatia, 20 per cent in Estonia and 17 per cent in Lithuania.

[63] For example, this introduces the new tighter registration measures including higher fees on imported second-hand cars introduced in Poland in October 2002.

[64] Relative to the first six months of 2001, crude oil prices fell by 13 per cent, gasoline prices by almost a fifth and the average export price of Russia’s natural gas by an estimated 17 per cent. The price of cotton – a major export commodity in central Asia – was down by a third, while prices for base metals such as aluminium, copper and nickel were between 1 and 11 per cent lower.

[65] All volume data are based on the first five months of 2002, and changes are year-on-year.

[66] In Kazakhstan, despite the volume of crude oil exports increasing by 11 per cent, revenues declined by 15 per cent. Similarly, the increased volumes of foreign sales of steel and zinc did not result in revenue increases. *Sotzial’no-ekonomicheskoye razvitye, Kazakhstan*, 6/2002, pp. 51-52. All data are for January-May 2002.

earnings as a result of considerably greater shipments of oil products.

The value of *total CIS imports* increased by 3 per cent in the first six months of 2002 on the strength of the continuing output growth in the region. In particular, increased import demand in Russia, reflected in a 20 per cent increase in the value of imports of machinery and equipment, contributed to this outcome.[67] There were also large increases in Azerbaijan and Kyrgyzstan where imports rose by about a third in value. Only in Turkmenistan and Uzbekistan did total imports fall significantly (by 11-15 per cent), while in Georgia and Kazakhstan there were only slight falls (of 3 per cent). In the first half of 2002, the CIS area's merchandise trade surplus fell by about $5 billion compared with the same period of 2001, mainly because of lower commodity prices.

In the first half of 2002, the dollar value of *CIS exports to non-CIS countries* fell by 4 per cent (table 1.2.10). The value of exports of traditional commodity exporters such as Azerbaijan, Kazakhstan, Russia and Uzbekistan fell by between 1 to 24 per cent, depending on the combination of volume changes and much lower export prices. The largest decline was in Azerbaijan (down 24 per cent) where technical problems with the oil pipeline compounded the impact of falling prices, while the smallest was in Uzbekistan where higher gold prices likely helped to cushion the impact of lower prices for other commodities.[68] In Russia, there was a 7 per cent decline in the value of non-CIS exports and Georgia's exports to non-CIS markets decreased by 11 per cent affected by the introduction of a temporary ban on sales of scrap metal (traditionally shipped to Turkey).

Other CIS countries' exports to the rest of the world increased. Armenia had the highest growth in export revenue from non-CIS sales (up 64 per cent) driven by a doubling of foreign sales of precious stones and metals, mostly to Belgium. Belarus, Kyrgyzstan, Tajikistan and Ukraine recorded strong gains in the 15-25 per cent range. In Belarus the gains were based on a $200 million increase in the value of sales of oil products largely achieved by redirecting shipments away from the CIS markets. Similarly, the value of Ukrainian oil product exports increased strongly (by 40 per cent), more than offsetting the effect of flat steel sales. Kyrgyzstan benefited from the rising gold price despite reduced volumes. In contrast, increased volumes of aluminium and cotton offset lower commodity prices and contributed to the growth of Tajikistan's non-CIS exports by 25 per cent.

Strong domestic demand boosts imports from the non-CIS area

The total value of *CIS imports from non-CIS countries* rose by 15 per cent (table 1.2.10); dollar imports increased in most countries ranging from 10 per cent in the Republic of Moldova to 28 per cent in Tajikistan. Higher non-CIS imports were often related to increased imports of machinery and equipment to upgrade capital stock in the oil, natural gas and metal sectors. This was the case in varying degrees in Azerbaijan, Kazakhstan and Russia where imports of machinery and equipment from non-CIS markets in January-May increased, year-on-year, by 42, 9 and 29 per cent, respectively. In addition, real personal disposable incomes in Russia increased by about 10 per cent in the first half of 2002, leading to increased imports of consumption goods. In contrast, lower non-CIS imports into Uzbekistan reflected reduced spending (by about 10 per cent) on foreign capital goods. The government also intends to introduce a number of measures that will further discourage imports on non-food consumer goods.[69] The value of non-CIS purchases also fell in Armenia, Georgia and Turkmenistan by 1-6 per cent, partly influenced in the first two countries by weaker national currencies against the dollar.

The real appreciation of national currencies in some CIS countries such as Belarus, Kyrgyzstan, the Republic of Moldova, Russia and Ukraine coincided with increases in non-CIS imports. In the first six months of 2002, the national currencies of these countries appreciated by up to 8 per cent in real terms against the dollar and the euro. In Armenia, Azerbaijan and Georgia, however, their currencies depreciated by about 4 per cent in real dollar terms.

In the first half of 2002, the value of *intra-CIS trade* decreased by some 12 per cent. The relatively strong growth of domestic demand in Russia does not appear to have led to increased demand for imports from the neighbouring economies; on the contrary, in the first half of 2002, year-on-year, Russia's imports from the CIS area fell by a quarter in value.[70] About half of the reduction was accounted for by lower imports from Ukraine, probably due to last year's imposition of VAT by Russia on Ukrainian imports. The total value of Russian exports to the CIS region also fell despite an 80 per cent increase in shipments of crude oil in the first five

[67] The capital goods sector accounts for about a third of the Russian total. All data are for January-May 2002.

[68] Export revenues from cotton in Uzbekistan – 85 per cent of which goes to non-CIS markets – are reported to be about 20 per cent lower than in the first six months of 2001. Uzreport.com, quoted in *Reuters Business Briefing*, 25 September 2002.

[69] On 1 August 2002 the government imposed a 30 per cent tariff on non-food consumer goods (in addition to VAT) by enterprises and registered traders. Individuals importing these items are required to pay a 90 per cent custom tariff, payable in hard currency. EIU, *Country Report: Uzbekistan,* September 2002 (London), p. 31.

[70] Similarly in 2001, despite a 5 per cent growth in GDP in Russia, its imports from the CIS area declined by 4 per cent in value, but this was due to lower import prices as the volume increased by 3 per cent. In the first half of 2002, the volume of Russian exports to CIS countries increased by a quarter, while the volume of its imports from the area fell by more than 10 per cent (table 1.2.9).

months of 2002. Belarus, Kazakhstan and Ukraine, together with Russia – where half of intraregional exports originate – account for 95 per cent of intra-CIS exports. As noted above, the 10 per cent decline in Belarus was partly the result of shifting gasoline exports to western Europe from the CIS area, while the 27 per cent cut in Kazakh exports was due to lower volumes of crude oil and generally lower prices for the country's key exports.

Overall, the value of almost all the CIS countries' intraregional exports decreased, the declines ranging from about a third in Kazakhstan, Ukraine and Uzbekistan to 5-6 per cent in the Republic of Moldova and Russia. Only two countries increased such exports: in Azerbaijan the change was small (2 per cent) while Turkmenistan's 21 per cent growth reflected continued sales of natural gas to Ukraine.

All CIS currencies depreciated in real terms against the Russian rouble, by some 4-17 per cent in the first six months of 2002. Armenia, Azerbaijan and Georgia's national currencies weakened the most (by 15-17 per cent), while those of Belarus, Kazakhstan, Kyrgyzstan and the Republic of Moldova depreciated by about 10 per cent. These changes do not appear to have had a significant influence on bilateral trade with Russia, as a large proportion of such trade is either based on long-term contracts (including barter arrangements) or is settled on a dollar basis.

(v) Current accounts and external financing

(a) Current account balances

Deficits remain high but are easily financed

In the first half of 2002, the combined current account surplus of the transition economies continued to decline, to $2 billion (table 1.2.11),[71] due to the diminishing surplus of Russia and larger current account deficits of many other countries. Even though these deficits are often large by widely accepted criteria, they generally appear to have been easily financed and are likely to remain so. In particular, FDI, largely a non-debt creating inflow, has remained a major source of finance.

On balance the external economic conditions facing the transition economies continued to worsen in 2002. Economic activity in western Europe remained subdued while the slower rate of expansion of the Russian economy translated into lower CIS exports to this major market. However, the decline in international oil prices was reversed in the second quarter of 2002 and that slowed the fall in the export earnings of several fuel producers, especially Russia. These factors resulted in considerable differences in the movement of current account balances among the countries of the region, changes that also reflect differences in the growth of domestic demand, export performance and movements in real exchange rates.

Data for the first half of 2002 indicate a marginal increase in the combined deficit of eastern Europe and the Baltic states, to nearly $13 billion (although the current account-GDP ratio fell to 5.4 per cent). During the first six months of the year there was a notable slowdown in the value of exports of services while imports of services accelerated, which is in contrast to developments in this sector in 2001. Another negative development was the rise in net income payments abroad, boosted by the increasing repatriation and reinvestment of profits by foreign investors. At the same time, net transfers to these countries from abroad continued to rise, mostly due to remittances from the increasing number of east Europeans working abroad.

The majority of east European and Baltic countries had larger current account deficits in the first half of 2002. In Hungary, the rapid growth of imports of goods and services (boosted by an expansionary fiscal policy) and smaller tourist revenues caused the officially reported current account deficit to double, despite relatively buoyant export growth.[72] In Slovakia, recent merchandise trade data suggest that the deterioration of the current account deficit has been arrested. Preliminary estimates for south-east Europe show that larger merchandise trade deficits were mainly responsible for the worsening of current account deficits (Romania is an exception, see below)[73] but Croatia benefited from a surge in revenues from tourism. In the Baltic states there was a rapid expansion of domestic demand and to varying degrees these economies were affected by weak exports of goods and services, all resulting in larger current account deficits. However, Latvia and Lithuania benefited from larger surpluses on service transactions, and Latvia from considerably larger transfers.

The Czech Republic, Poland and Slovenia had better current account results than in the first half of

[71] This section is based on national balance of payments statistics. Some of the results for merchandise trade may differ from those discussed in sect. (iv) which is based on customs data. Only fragmentary data are available for the non-European CIS and some south-east European countries, particularly as regards the financial account. Turkmenistan ceased to publish balance of payments data in 1998.

[72] It should be borne in mind that the country's officially reported current account deficit as shown in table 1.2.11 has been understated because of the national practice of excluding reinvested earnings from FDI. The OECD has estimated that reinvested earnings amounted to some $2 billion in 2001. OECD, *Economic Surveys: Hungary*, Vol. 2002/10 (Paris), June 2002, tables 5 and 6. Inclusion of this outflow raises the current account deficit in 2001 from $1.1 billon to around $3.1 billion (alternatively, from 2.1 to 5.9 per cent of GDP). Hungary's current account deficit is expected to rise to about $2.5 billion in 2002, but the inclusion of reinvested earnings (assuming little change from 2001) would raise the deficit to about $4.5 billion (about 7.4 per cent of GDP). It should be noted that the inclusion of reinvested earnings (a debit) in the current account does not change the overall balance of payments because these earnings also enter the financial account (as credit). Accordingly, Hungary's official data on net financial and FDI inflows (tables 1.2.12 and 1.2.13) are also understated.

[73] It is likely that the current accounts deficits of many of these countries are understated because of various deficiencies in customs reporting, smuggling, and so on. The larger deficits are financed by cash inflows that are also underreported. The same pattern is likely to hold in some other transition economies, particularly in the CIS.

2001. In the Czech Republic, buoyant exports of goods and services (but not tourism) more than offset the impact on imports of a loose fiscal policy, but there was further growth of profit repatriation. Poland's current account deficit continued to shrink in 2002 with tight monetary policy curbing domestic demand and imports of goods and services. Slovenia is one of the few transition economies to post a (larger) current account surplus, thanks to the growth of merchandise exports and receipts from transport services. In Romania, the continuing strong growth of exports of goods and services and increasing transfers more than offset a larger outflow of income abroad. Imports of goods and services were held down by a tight fiscal policy.

In the CIS there was considerable variation in country experiences. In the second quarter of 2002, the sharp upturn in oil prices slowed the downward trend in the current account surplus of Russia. Whereas projections made early in the year pointed to an expected surplus of around 5 per cent of GDP for 2002 as a whole, the surplus in January-June was nearly twice as large. Despite the recent upturn in fuel prices, Russian merchandise exports declined in the first half of 2002, but revenues from a broad range of services continued to rise. Although the expansion of imports of goods and services slowed sharply, service imports, in particular expenditures on tourism, were very buoyant. Imports have been boosted by domestic demand and the real appreciation of the rouble.

Against the backdrop of a subdued climate for CIS exports of goods and services, fragmentary data and estimates indicate some deterioration in the current account balances of most CIS countries. However, Belarus and Ukraine, two countries with limited access to external finance, reported current account surpluses. As regards the fuel producers, the higher oil prices have slowed the growth of Kazakhstan's current account deficit. However, the balance of Azerbaijan deteriorated sharply because of a boom in imports of goods and services, the latter presumably oilfield services associated with foreign investment. Trade data for Turkmenistan indicate an upturn in natural gas exports that has generated a trade surplus and probably a current account surplus as well.

(b) External financing and FDI

Capital inflows increase despite the global environment

Preliminary data for the first half of 2002 indicate a further marked increase in *net capital and financial flows* into the transition economies (table 1.2.12). This is noteworthy as it occurred despite the unfavourable global economic environment and heightened risk aversion among investors.[74] However, several factors such as the progress towards macroeconomic stabilization, the continuing structural reforms, comfortable (or improving) external financial positions and approaching EU membership for a large group of candidate countries, have also worked in favour of the transition economies, reducing international investors' perception of risk. This, together with the willingness of investors to differentiate among countries, has contributed to the improving creditworthiness of some transition economies (see below) and brought down borrowing costs in the past two years. In consequence, the transition economies have largely avoided financial contagion, although the situation varies considerably across countries: while some of the advanced reformers even tend to be considered as safe havens by investors during periods of market turbulence, the situation in many of the CIS and some south-east European countries has tended to discourage private (and in some cases even official) inflows.[75]

About half of all the east European and Baltic countries attracted more capital in the first half of 2002, in particular the Czech Republic. FDI strengthened its position as the leading source of finance. Net portfolio investment declined due to the sell-off in the equity markets of several countries, although this was partially offset by the stronger demand for local bonds and an increase in new international bond issues. Medium and long-term borrowing remained marginal, but there was a surge in short-term flows, following several years of large outflows. In general financial inflows exceeded current account deficits and most countries continued to accumulate official reserves.

Although remaining substantial, the net outflow of capital from Russia declined further in the first half of 2002.[76] Among other things, this reflects a reversal of the substantial build-up of residents' deposits abroad, the cessation (on a net basis) of new medium-term lending to foreigners, a steep decline in the net repayment of medium-term funds and a sharp reduction in unrecorded capital outflows (as reflected in the errors and omissions item of the balance of payments). The overall outcome was a smaller net outflow of private capital (including less capital flight), *inter alia,* due to diminishing non-repatriation of export income and reduced prepayments for imports. The better-than-expected current account surplus and the slowing of net financial outflows raised official reserves to $44 billion in early October (nearly five months' of import cover); projections for end-of-year

[74] The IIF has estimated that capital flows to a selection of emerging market economies will stagnate at some $140 billion in 2002, which reflects a further decline in private capital flows. IIF, *Capital Flows to Emerging Market Economies* (Washington, D.C.), 18 September 2002.

[75] Concerns persist regarding the debt sustainability of Armenia, Georgia, Kyrgystan, the Republic of Moldova and Tajikistan. IMF and World Bank, *Poverty Reduction, Growth and Debt Sustainability in Low-income Countries* (Washington, D. C.), 3 February 2002. Several of these countries have recently benefited from the restructuring of their official debt obligations.

[76] The Russian stock market was one of the best performing in the world in the first half of the year.

reserves have been raised to $47 billion. This, and provisions in the draft budget for 2003, have boosted confidence that Russia will meet its sharply higher debt servicing obligations in 2003 and beyond.

Among the European CIS, net capital outflows, financed at least in part by current account surpluses, continued from Belarus and Ukraine,[77] accelerating sharply in the latter. Both countries appear to have experienced substantial capital flight that has limited the accumulation of official reserves. The Republic of Moldova received only small amounts of FDI and short-term funds and had to draw heavily on its reserves.

Bond issuance by the transition economies picked up in the first nine months of 2002, the $7.7 billion raised exceeding the $6.3 billion in all of 2001. Margins generally improved for sovereign borrowers, which accounted for the bulk of all the issues. There was an increase in corporate issues (to over $2 billion), primarily by energy producers in Estonia, Kazakhstan and Russia (Sibneft, Gasprom and Tyumen Oil). The Republic of Poland was the largest individual borrower (raising about $2.1 billion), partly because of its need to finance a widening fiscal gap. Bulgaria swapped $1.3 billion of Brady Bonds for eurobonds, an operation that also resulted in a small reduction in external debt. The international *credit ratings* of many transition economies improved in 2000-2001,[78] but there has been little further change in 2002. However, Kazakhstan reached a major milestone in September 2002 when Moody's upgraded the country by two notches to investment grade (Baa3), the first CIS country to be so rated.[79] Currently 10 transition economies (mostly candidates for EU accession) are rated investment grade risks and eight are rated sub-investment grade.[80] During the summer of 2002, a period of mounting concern about the political direction of Brazil, spreads on the bonds of several transition economies, rated as sub-investment grade, widened temporarily. However, investment grade bonds seemed to have been hardly affected.[81]

Despite the generally unfavourable international climate for *FDI*,[82] inflows into eastern Europe and the Baltic states increased moderately in the first half of 2002 (table 1.2.13). The dominant transaction involved the €4 billion privatization of Transgas, the Czech natural gas monopoly. Other large privatization deals have been completed, or are planned, in the second half of 2002. Foremost among them is the sale of SPP, the Slovak natural gas monopoly, for $2.7 billion.[83] The 2002 budgets of the Czech Republic, Hungary, Poland and Slovakia foresaw combined revenues of some $12 billion from the sale of property, but except for Slovakia, the privatization proceeds so far are below the original plans, most notably in the case of Poland.[84] In many CIS countries the persisting perception of a poor investment climate appears to have deterred foreign investment,[85] despite several consecutive years of economic growth.

On average, net FDI inflows in 2000-2001 exceeded the current account deficits of the east European countries (table 1.2.13), suggesting a relatively low vulnerability of current account financing to potential disruptions in the capital markets. In the first half of 2002, the results so far have been influenced by the large FDI flows into the Czech Republic, but there are several countries where FDI has financed only a relatively small share of the current account deficit. However, privatizations in the second half of 2002 should improve the proportion in several countries, as has already occurred in Slovakia.

1.3 The short-term outlook

Global recovery has become increasingly fragile

At the beginning of the final quarter of 2002, the economic situation in the world economy was looking increasingly fragile. Growth forecasts for 2002 and 2003 were markedly down in the third quarter of 2002 against a backdrop of only modest rates of economic growth, after the rebound in activity in the first quarter of the year and the sharp fall in equity values. Earlier expectations, that economic activity was set to strengthen in the second half of the year, have been disappointed. The consensus of forecasters is now that the recovery has been postponed until the second half of 2003. But this appears to be merely a mechanical rescheduling of the upswing, which ignores the restraints on growth and the considerable downside risks associated with the persistent imbalances in the global economy. Whether these will be overcome without severe disruption is one of the major sources of uncertainty.

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[77] Ukraine was able to obtain some medium and long-term credits and FDI in the first half of 2002.

[78] UNECE, *Economic Survey of Europe, 2002 No. 1*, table 3.5.14.

[79] In addition to larger oil exports expected in the medium term (due to the construction of a new oil pipeline), Moody's cited key accomplishments such as the creation of an oil stabilization fund, a stable banking sector with a deposit insurance scheme and the implementation of a pension scheme, as justification for the upgrade.

[80] Ibid.

[81] For example, the spread on Poland's $400 million add-on bond in September (150 basis points over treasury bills) was lower than that on the initial $1 billion offering in June (158 basis points).

[82] The IIF has estimated that net direct investment in the emerging markets will fall in 2002, which is attributed to the weak global economy, concerns about prospects for profitability, limited privatizations and perceptions of a greater risk associated with investing in emerging markets. IIF, op. cit.

[83] The receipts from this sale were received in July, boosting official reserves from $4.3 billion to $7.1 billion.

[84] JPMorgan, *Emerging Europe, Middle East and Africa Weekly* (London), 27 September 2002. Poland is likely to collect only about one third of the budgeted amount.

[85] According to various estimates, Azerbaijan and Kazakhstan, two important oil producers, are expected to attract FDI inflows of $1.3 billion and $2-$2.5 billion, respectively, in 2002 as a whole.

World output is now forecast to increase by some 2.75 per cent in 2002, up from 2.2 per cent in 2001. A moderate strengthening of the cyclical momentum is then expected to result in an average growth rate of world output of some 3.5 per cent in 2003.[86]

(i) Western Europe and North America

2003 growth forecasts for North America and western Europe have been cut

In the United States, real GDP is now forecast to increase by somewhat less than 2.5 per cent in 2002 as a whole. The expected outcome for 2003 is only slightly better at 2.6 per cent (table 1.3.1), but nearly 1 percentage point less than forecast in the spring of 2002.

Although activity in the third quarter of 2002 was supported by special financing incentives offered for car purchases, the ending of these can be expected to be reflected in weaker spending in the final quarter. Consumer confidence fell sharply in early October, adding to the general uncertainty about the future direction of economic activity. Falling equity prices have more than offset the continued rise in house prices, leading to a considerable decline in the ratio of households' net worth to disposable income by more than one third from its peak in the second half of the 1990s. At the same time, the household debt-servicing burden remains at a high level. The combined impact of these two factors will be to dampen household's spending propensity in 2003 and possibly beyond, but uncertainty surrounds the magnitude and timing of the adjustment to their savings that households judge desirable or necessary in view of the deterioration of their financial balance sheets. The outlook for business investment is also uncertain in the face of high corporate debt levels, weak profits growth and large margins of excess capacity, especially in the ICT sector. The depreciation of the dollar, especially if it continues in 2003, however, should help to support real net export growth.

Overall economic activity will continue to be supported by low interest rates. Expectations are that monetary policy will be eased further in the event of prolonged economic weakness. But the economic stimulus provided by a further easing of monetary policy may be reduced in an environment dominated by high levels of debt and considerable underutilization of production capacities.

In the euro area, real GDP is now forecast to increase at best, by 1 per cent in 2002, about a quarter of a percentage point less than was expected in the spring of 2002. This mainly reflects the persistent weakness of domestic demand, which is being accentuated by the negative wealth effects of the sharp drop in share prices. Export growth has also been less than expected as a result of the faltering of the global recovery after the first quarter of 2002. In virtually all of the 12 current member states of the euro area, annual growth rates of real GDP for 2002 will be lower than in 2001 (table 1.3.1). A major factor restraining growth in the euro area (and western Europe at large) remains the sluggishness of the German economy, where real GDP is forecast to increase by only 0.5 per cent in 2002, partly reflecting the disruption caused by the floods.

On the basis of an expected strengthening of the international business cycle, led by the United States, the rate of economic growth in the euro area is also forecast to pick up in the course of 2003. The general transmission mechanism is for a strengthening of exports to lead to higher activity levels which, in combination with low interest rates, should stimulate business investment. In addition, households' real disposable incomes will be supported by the forecast decline in inflation, although this will be offset to some extent by reduced erosion of household debt levels in real terms. But the pick up of exports may be dampened by the appreciation of the euro which, together with the general, albeit moderate, upturn in domestic demand will also stimulate import demand. Changes in real net exports are therefore likely to be broadly neutral in their effect on overall economic activity in 2003. The consensus of forecasters is currently for an increase in real GDP of only some 2 per cent in the euro area in 2003. The expected outcome is broadly the same for the European Union and western Europe as a whole (table 1.3.1). Such a modest rate of output growth is unlikely to lead to any improvement in the labour market situation in 2003.

Subdued economic outlook calls for a more supportive policy mix

The subdued rate of economic expansion in the euro area and the widening of the output gap in 2002, which is likely to increase in 2003, will tend to further lower inflation, which is forecast to fall below the ECB's very ambitious ceiling of 2 per cent in 2003. The current economic outlook calls for a more expansionary stance of monetary policy, not least to better offset the dampening economic effects of the appreciation of the euro and the fall in equity values. The change in economic circumstances in the euro area in the course of 2002 has once again highlighted the rigid rules of the Stability and Growth Pact, and the dilemma that arises when the "rosy economic scenarios" underlying political commitments to budgetary consolidation are confronted with unexpected, adverse economic shocks. The intended revision of the Stability and Growth Pact in the euro area needs to provide a more conducive framework for the operation of the automatic stabilizers in the event of a cyclical slowdown by putting the focus of fiscal discipline on structural budget deficits and levels of government debt.[87] But the basic problem now facing the three large economies is how to

[86] IMF, *World Economic Outlook* (Washington, D.C.), September 2002 (www.imf.org).

[87] UNECE, *Economic Survey of Europe, 2002 No. 1*, pp. 7-10.

get to a balanced budget position in the first place without being forced to adopt a procyclical policy stance.

Significant downside risks remain

The short-term economic outlook is anyway subject to a number of important downside risks and uncertainties, which are partly the legacy of the boom years in the United States in the second half of the 1990s. The high levels of debt accumulated in the United States private sector during the second half of the 1990s will have to be reduced sooner or later. The sharp fall in equity values has accentuated the need for this adjustment process, *inter alia,* because the significant loss of net worth means that further borrowing will be difficult to obtain. In view of the deteriorating net worth position and weak labour markets, households may be compelled to make a larger increase in their savings than is currently assumed by forecasters, with concomitant adverse effects on consumer demand, business profits and fixed investment. This would risk triggering a vicious circle, with renewed selling pressure on international equity markets leading to a further deterioration in the balance sheets of households, the corporate sector and financial institutions in the major industrialized countries. Another question is to what extent business investment will be limited because of the necessity to make provisions for their pension fund obligations, which are now insufficiently covered as a result of the sharp decline in equity markets. There are similar concerns in some west European economies, where private sector balance sheets, including those of financial institutions, have also been weakened by the collapse of share prices.

There are, moreover, persistent concerns about the financing of the United States current account deficit (which is simply the mirror image of the excess of spending over incomes in the private sector and the newly emerged government budget deficit) and which is projected to remain very high in 2003. Much will depend on the confidence of foreign investors as to whether the United States corporate sector will be able to generate the relatively high rates of return of recent years. That confidence may have been weakened by the series of corporate financial scandals and the more uncertain prospects for short-term growth. As noted earlier,[88] a sudden reversal of capital flows would trigger a sharp depreciation of the dollar (apart from the likely adverse effects on equity markets), which would shift United States domestic demand away from foreign goods to domestic products. Such a decline of the dollar would be mirrored by a corresponding appreciation of the euro which, via adverse changes in real net exports, would significantly dampen economic growth in the euro area, with adverse spillover effects to the rest of Europe and beyond.

The bad loans problem of the banks in Japan remains severe and, moreover, a priority concern for international financial stability. Also, the upward pressure on the oil price associated with a potential military conflict in Iraq, is likely to have adverse effects on purchasing power in the oil importing countries, apart from the depressing effects on business and consumer confidence.

Moreover, inflation, at the global level has fallen to relatively low levels, reflecting on the one hand the credibility of central banks in shaping inflationary expectations, but mainly the significant growth in potential supply capacities in recent years, which has tended to outpace demand.[89] This expansion reflects technological advances, but also increased capacity in some emerging markets such as China and the Republic of Korea, which has led to intensified price competition. This must be viewed in the light of the considerable overinvestment in sectors such as ICT, automobiles and steel, as well as the persistent weakness of domestic demand in large parts of the global economy, including western Europe and Japan. The associated (albeit moderate) deflationary tendencies will be strengthened by the collapse of financial asset prices since the first quarter of 2000 and they risk being accentuated by the prolonged weakness of economic activity in the United States, which has been the major importer of last resort for the global economy over the last few years. This constellation of factors constitutes a major policy challenge, given that interest rates are already very low in the United States, and that in a context of low and falling inflation, the room for manoeuvre of monetary policy is narrowly circumscribed. This points to the complementary role of fiscal policy in stimulating economic activity**.**

In view of the domestic and external imbalances in the United States economy, there is a need for a switch in an acceleration of expenditure from foreign goods to domestic goods and for export growth via improved price competitiveness. Any domestic demand-led recovery in the United States would risk being short-lived because of the adverse implications for the external deficit and increased risk that foreign investors would be unwilling to continue financing it. The longer the external adjustment is delayed the greater the possibility of disruptive changes in capital flows.

For the inevitable adjustment process in the United States to occur more or less smoothly, a more conducive environment of domestic demand growth is required in the rest of the world, and especially in western Europe. This can certainly be helped by policies aimed at product market deregulation and labour market reforms designed to stimulate job creation.[90] But it will also require a reconsideration of the macroeconomic policy framework in the euro area in order to achieve a better coordination between fiscal and monetary policy.[91] More generally, the low inflation target pursued by the ECB, in

[88] Ibid., p. 6.

[89] BIS, *72nd Annual Report* (Basel), 8 July 2002, p. 143.

[90] See Part Two of this *Survey*.

[91] UNECE, *Economic Survey of Europe, 2002 No. 1,* pp. 7-10.

combination with the procyclical policies triggered by the rules of the Stability and Growth Pact, introduce a deflationary bias to economic policy which is particularly dangerous in the present economic context.

(ii) Eastern Europe, Baltic states and the CIS

A stronger external impetus is needed to sustain a high rate of economic expansion

The uncertainties surrounding the global economic outlook and the weak economic performance of western Europe cast a shadow over the short-term prospects for the east European economies and the CIS. Most of these economies rely on exports to support their economic growth and hence, a state of prolonged weakness in the economies of their main trading partners is hardly a conducive environment for sustaining their growth. The transition economies have so far avoided the immediate effects of the global economic downturn largely due to the continuing recovery in their domestic demand, which has underpinned the relatively high level of economic activity in the first half of 2002. However, it is unlikely that these economies will be able to escape for long the negative effects of a protracted weakness in the global and west European economies. At present this appears to be the most serious risk for the eastern European and Baltic economies. Moreover, a number of countries in the region have chronically large current account deficits, which rule out an extended reliance on domestic demand as an alternative source of growth. As for the commodity exporting CIS countries, their short-term prospects have improved somewhat due to the U-turn in some commodity prices (particularly oil and gold) in the course of 2002.

Overall, the performance of the transition economies in the first six months of 2002 and, especially, the acceleration of growth in some countries in the second quarter, suggest on average a favourable outcome in 2002. In fact, despite the moderation of growth since 2001, the transition economies as a whole are likely to remain among the fastest growing regions in the world in 2002. Given the considerable uncertainties, however, more caution is needed with regard to the outlook for 2003.[92] In terms of the envisaged rates of GDP growth (table 1.2.1) some of these forecasts appear to be quite optimistic so their realization will probably be conditional on a speedy reversal of the current negative trends in the global economy.

According to the forecasts available at the time of writing this *Survey*, aggregate GDP in the transition economies as a whole is expected to increase by some 3¾ per cent in 2002 and some 4 per cent in 2003. With average rates of GDP growth of 5 per cent in 2002 and 5¼ per cent in 2003, the Baltic states are expected to be the fastest growing subregion in the short run. GDP growth is expected to remain strong in all three Baltic states with rates of some 5-5.5 per cent in 2003. Aggregate GDP in the CIS is forecast to increase by 4½ per cent in 2002 and by slightly less, 4¼ per cent, in 2003. The average rate of GDP growth in eastern Europe – which is heavily influenced by Poland – is expected to be 2½ per cent in 2002, improving to 3¾ per cent in 2003.

In general, growth in the central European transition economies is likely to be moderate, as these countries are the most affected by economic weakness in western Europe due to their strong dependence on trade with the latter. According to the official forecasts, however, all of these economies expect an acceleration of growth in 2003. The most substantial upturn – after two years of sluggish output – is forecast in Poland. When debating the outline of the budget for 2003, the Polish government raised its GDP growth forecast to 3.5 per cent from 3.1 per cent.[93] The central bank, as well as most independent analysts, has criticized this revision as unrealistic.[94] There have also been accusations that this change is a move which, at least on paper, would increase tax revenue in the 2003 budget, thus narrowing the projected fiscal shortfall. In any case, despite the debates over the exact numbers, there is a general expectation that Poland's economic performance in 2003 will be considerably better than in the previous two years. The severe August floods have had a negative impact on economic activity in the Czech Republic and, compared with the figure at the beginning of the year, the official forecast of GDP growth in 2002 has been lowered by 1 percentage point, to a range of 1.5 to 2.5 per cent. However, most analysts believe that reconstruction and renewal work will have a positive effect on Czech economic performance in 2003 and thus to an acceleration of growth. In Hungary, it is widely expected that by next year the present economic slowdown will have come to an end and that GDP growth will pick up to reach some 4 per cent in 2003. A similar acceleration of growth in 2003 is envisaged in Slovakia and Slovenia. These forecasts, however, assume a substantial improvement in the export performance of these economies; in addition it should be noted that both Hungary and Slovakia are facing fiscal restraints, which have a negative effect on output in the short run.

Recently there has been increased dynamism in the economic performance of some of the south-east European transition economies and this is expected to continue in the short run. Thus, Bulgaria and Romania expect rates of GDP growth of more than 4 per cent in both 2002 and 2003, partly reflecting their recent policy

[92] At the time of writing this *Survey*, the budgetary process for 2003 was still underway in most of the transition economies and so governments were still adjusting their targets for the coming year. As a result, in a number of transition economies no official growth forecasts for 2003 were available; in these cases UNECE secretariat estimates are included in table 1.2.1.

[93] *Reuters News*, 9 September 2002, reported in *Dow Jones Reuters Business Interactive* (Factiva).

[94] Most independent analysts, as well as the central bank's Monetary Policy Council, expect Poland's GDP to grow by some 2.5-3 per cent in 2003.

prudence and progress towards macroeconomic stability. Relatively strong growth is also expected to continue in Croatia; however, as it has so far been predominantly fuelled by domestic demand, the sources for a further acceleration are limited. The short-term outlook in The former Yugoslav Republic of Macedonia is somewhat less favourable. The post-conflict recovery in 2002 has been rather sluggish and it is still not clear whether GDP for the year as a whole will actually increase at all; nor is any substantial improvement expected in 2003. The Yugoslav economy is undergoing a fundamental restructuring and the difficult reform agenda will continue to have a negative effect on economic activity in the short run.

Despite some moderation, it is widely expected that the pace of growth will remain relatively high in most of the CIS countries in the short run. At the start of 2002, there was a marked slowdown in the Russian economy but recently there have been signs that this is coming to an end: since the second quarter economic activity has been picking up, especially in manufacturing and services. Russia's growth continues to be predominantly led by the ongoing recovery in domestic demand (in the first place private consumption), but the upturn in world oil prices in 2002 has also been highly beneficial for the economy.[95] Thanks to the recent strengthening of output, the growth of Russia's GDP in 2002 as a whole is likely to reach 4 per cent or even more, very much in line with the official forecasts at the beginning of the year. Russia's draft budget for 2003 envisages GDP growth in the range of 3.5-4.4 per cent, under conservative assumptions about oil prices.[96] If world oil prices remain at their present high levels, the Russian economy is likely to grow even faster next year.

Rapid economic expansion is expected to continue into 2003 in two of the other oil-exporting countries – Azerbaijan and Kazakhstan – although their forecast rates of GDP growth (7.5 and 6 per cent, respectively) are somewhat lower than those in 2000-2002. Both countries have benefited from large inflows of FDI in the energy related sectors of the economy, and these sectors will continue to be the main engines of growth thanks to increased production and export capacities. During the first half of 2002, Ukraine's economic performance was below expectations and this has prompted the authorities to lower their forecasts of GDP growth for the year as a whole by 1 percentage point, to some 5 per cent, but even this may be difficult to attain. The official forecasts for next year have been lowered several times, and the draft budget for 2003 is based on a conservative assumption of 4 per cent growth of GDP. According to Ukraine's central bank, GDP growth next year may be higher, reaching some 4.5-4.8 per cent.[97] The upturn of economic activity in Belarus in the second quarter of the year has increased the government's confidence in its earlier forecast of GDP growth of more than 6 per cent in 2002.[98] However, as in the case of Ukraine, this may turn out to be overambitious. The official forecast for GDP growth in 2003 (7 per cent, according to the central bank) also appears to be somewhat optimistic. Most of the other CIS economies expect current trends to continue into 2003.

[95] For more details on the impact of oil prices on Russian economic performance see UNECE, *Economic Survey of Europe*, *2001 No. 1*, pp. 69-74.

[96] The forecasts for 2003 are based on the assumption that Urals oil will be priced between $18.5 and $21.5 per barrel, which is considerably below its price in September 2002. Interfax International, *Daily Business Report*, 11 September 2002, reported in *Dow Jones Reuters Business Interactive* (Factiva).

[97] *Reuters News*, 11 September 2002, reported in *Dow Jones Reuters Business Interactive* (Factiva).

[98] *Reuters News*, 9 August 2002, reported in *Dow Jones Reuters Business Interactive* (Factiva).