CHAPTER 2

THE ECONOMIC SITUATION IN THE ECE REGION IN MID-1999

2.1 The global context

World output growth slowed down sharply in the course of 1998 under the cumulative impact of the financial and currency crises in Asia, Russia and Brazil. For the year as a whole, real GDP rose by only 2.5 per cent down from 4.2 per cent in 1997.[59] This was the smallest annual increase in world output since 1991. Current forecasts are for a stabilization of world output growth at a rate of 2.5 per cent in 1999 followed by a strengthening to some 3.5 per cent in 2000.[60]

The prospects for continued economic expansion stand in sharp relief to widespread fears prevailing in the autumn of 1998 that the financial turbulence in the wake of the Russian devaluation and debt moratorium could push the world economy into recession. These fears have receded against the background of restored financial market stability, the recovery of international share prices and the very limited contagion from the currency crisis in Brazil. In addition, the willingness of foreign investors to lend to emerging markets appears to have increased again, although net private capital flows are expected to remain subdued. Yield spreads have fallen from their high levels attained in late 1998, although they remain, in general, above the rates prevailing before the Asian crisis broke in mid-1997.

In the first months of 1999 the real global economy has remained full of contrasts. The United States economy has continued to expand at a robust rate. In western Europe, the marked cyclical slowdown in the second half of 1998 has been arrested but as yet there are no signs of a strengthening in the forces for economic growth. In Japan, the growth effects of a succession of fiscal stimuli have masked a continued depression in the spending propensity of the private sector. In contrast, there is increasing evidence of some strengthening of growth factors in the Asian emerging markets most directly affected by the financial crisis of 1997, although only relatively modest output growth is expected in 1999. In Latin America, the adjustment to the reduced inflow of foreign capital and the adverse effects of the recession in Brazil has been depressing activity levels. In the transition economies, the recession in Russia, the cyclical slowdown in western Europe and the repercussion of the Kosovo conflict are all expected to lead, at best, to only marginal growth in aggregate output in 1999.

Against this background, the volume growth of world merchandise trade is expected to remain subdued in 1999. Forecasts are for an increase of only 3.5 per cent, the same rate as in 1998.[61] This is well below the average increase between 1990 and 1997.

These prospects for moderate growth in world output and trade, however, are still surrounded by considerable downside risks (see section 2.2 below).

In *Japan*, there was a strong and unexpected upturn in real GDP by 1.9 per cent in the first quarter of 1999 (compared with the preceding quarter). This followed five consecutive quarters during which aggregate output fell by a cumulative 4 per cent. The rebound reflects in the main the impact of last year's fiscal packages on public investment and an increase in private consumption expenditures, which is surprising in view of the deteriorating labour market conditions. It is possible that this increase in household spending was influenced by the distribution of consumption vouchers (equivalent to transfer payments) by the government in February, a somewhat unconventional method of stimulating demand. To some extent, business investment may have been supported by the measures introduced in late 1998 to facilitate access to credit in the face of reluctant bank lending. There was a small increase in business fixed investment which, nevertheless, is surprising given the considerable margins of excess capacity. The marked decline in the volume of exports of goods and services during 1998 petered out in the first quarter of 1999. The strong appreciation of the yen against the dollar, which started in autumn 1998 and which depressed export growth, was arrested in early 1999 and has since been partly reversed. Wholesale prices maintained their downward tendency and consumer prices also fell briefly in early 1999, but there has been no evidence of

59 IMF, *World Economic Outlook* (Washington, D.C.), April 1999.

60 Ibid.

61 *WTO Focus*, No. 39 (Geneva), April 1999.

a self-reinforcing deflationary spiral. The first quarter national accounts data are still preliminary and may be subject to a more or less large downward revision. In any case, there are still widespread doubts that the economy has returned to a sustainable growth path. Indeed, there are fears that the waning of the fiscal impulses could lead to renewed downward pressure on domestic activity levels later in the year. It is significant that in early June 1999 the government announced a $4 billion package of measures designed to create employment and foster corporate restructuring. In fact, in April 1999 the unemployment rate rose to 4.8 per cent, a postwar high. The need for comprehensive corporate restructuring and the reduction of excess capacity will continue to weaken business fixed investment and lead to further increases in unemployment. The latter, in turn, will dampen consumer confidence and spending, which are already affected by concerns over the stability of the pension system. The surplus in foreign trade of goods and services rose, falling exports being more than offset by a stronger decline in imports. The deficit on transfers, however, increased. In the event, the current account surplus fell to $25.7 billion, equivalent to 2.5 per cent of GDP in the first quarter of 1999, down from $27.7 billion or 2.9 per cent of GDP in the same period of the preceding year. The scope for further easing of macroeconomic policy to support domestic activity appears now to be virtually exhausted. Since early March 1999, the Bank of Japan's overnight lending rate has been close to zero and fiscal policy faces the problem of high budget deficits and the need to control the potentially explosive dynamics of the debt to GDP ratio. A major unresolved issue is the effective restructuring of the banking sector.

In the *other Asian economies* most affected by the financial crisis of 1997, the deep recession in 1998 appears to have bottomed out, supported by an easing of macroeconomic policies. The general feature is a return to positive output growth rates in 1999. Relatively robust annual output growth of some 4.5 per cent is currently forecast for the Republic of Korea, but more moderate rates, within a range of 0.5-2 per cent, are expected for Malaysia, the Philippines and Thailand. Only in Indonesia is there likely to be another year of falling output. The background to this improved performance is the stabilization of financial markets (strengthening exchange rates, recovery of equity prices and falling spreads on bond yields) and progress, albeit to varying degrees, in financial sector reform including the recapitalization of banks as well as corporate sector restructuring. The general strengthening of economic growth forces, even if, on average, they are only moderate, should stimulate intraregional trade, with positive feedback effects on domestic activity levels. It also appears that the problem of obtaining adequate trade financing, which had been restraining export growth since mid-1997, has lost some of its importance.

In *China*, the rate of economic expansion will slow down in 1999, but for the year as a whole real GDP is still expected to increase by some 6.5-7 per cent, down from nearly 8 per cent in 1998. Economic activity has been supported since the second half of 1998 by additional public infrastructure investments and an easing of monetary policy. Exports started to falter in the second half of 1998 in the face of reduced price competitiveness vis-à-vis producers in South-East Asia and the Republic of Korea. The government expects exports to decline in 1999 in comparison with 1998.[62] The stability of the exchange rate of the renminbi against the dollar remains, however, central to economic policy. The fragility of the financial sector constitutes a major downside risk for the economic outlook.

In *Latin America*, a sharp slowdown in capital inflows and falling commodity prices were the main factors behind the pronounced deceleration in economic growth in 1998. Real GDP rose by 2.3 per cent compared with 5.2 per cent in 1997. Current forecasts are for a decline in real GDP by some 0.5 per cent in 1999, which would be the worst outcome in the current decade. Nevertheless, prospects have improved since the floating of the Brazilian real in mid-January 1999. At that time a much deeper recession was expected, notably in Brazil itself, which accounts for some 40 per cent of total GDP produced in the region. To some extent the improved outlook reflects the strikingly limited inflationary effects of the large depreciation of the real. Against a background of tighter fiscal and monetary policy and depressed domestic demand, there was only a short-lived rise in inflation, which fell back to its pre-crisis level in April. This, and the return of stability to the domestic financial markets, has enabled the central bank to progressively lower official interest rates since late March. The effects of the currency depreciation and the domestic recession in Brazil will be mainly felt in the member states of Mercosur, especially Argentina and Uruguay. Trade links with other countries in Latin America are relatively weak. In Argentina, the economy moved into recession in late 1998. The loss of competitiveness associated with the appreciation of the dollar (and the depreciation of currencies in East Asia and Brazil) has led to continuing concern as to whether the current exchange rate policy (a dollar peg in the framework of a currency board) can be sustained. In mid-May 1999, the peso came under strong speculative selling pressure, which caused temporary instability throughout the region's financial markets. In this context, the Argentine authorities indicated that they were adamant about defending the

[62] "Asian economic recovery hits Chinese exports to Europe", *Financial Times*, 25 April 1999.

dollar peg and announced that they were considering the adoption of the dollar as legal tender, as an ultimate defence against speculative attacks.[63] An alternative proposal has been the adoption of a single currency by the member states of Mercosur, which would, however, probably require a much deeper regional economic integration similar to Europe.[64]

International commodity prices

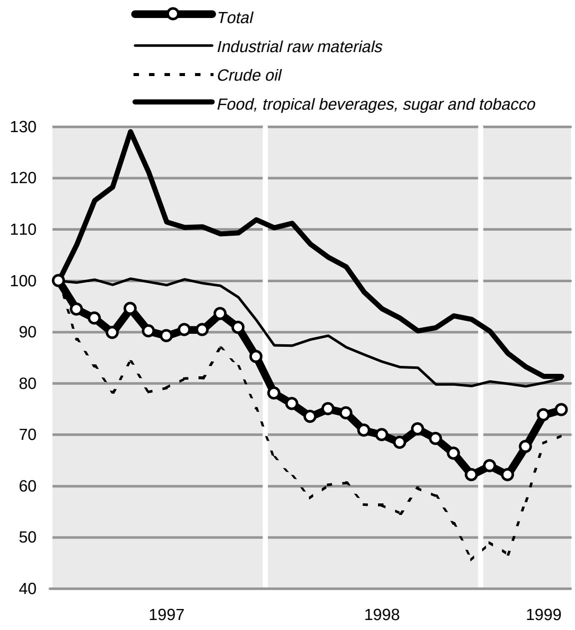
There was a generally sharp fall in *international commodity prices* in 1998 which reflected to a large degree the adverse effects of the Asian crisis on demand. Price developments for the main commodity groups, however, have diverged during the first five months of 1999. There was a marked recovery in petroleum prices which contrasts with the continued slide in the prices of food products. Industrial raw material prices have been fairly stable (at a low level) since the final quarter of 1998 (chart 2.1.1). Commodity prices, in general, will continue to be restrained by the existing large margins of excess capacity. Recent price developments have been influenced, in some cases, by output cuts (e.g. oil and copper) or expectations of a recovery in demand later in the year.

The global cuts in oil production (for a period of one year) agreed by OPEC in March 1999 reflect an attempt to arrest and reverse the fall in oil prices and to increase revenues. Non-OPEC countries, such as Mexico, Norway and Oman, have also announced that they will curtail oil production. Available data and industry estimates indicate that so far there has been a high degree of compliance with the agreed cutbacks.[65] Crude oil prices, on average, rose by 50 per cent between February and May 1999, but they were still below their level at the beginning of 1998. In early June, however, there was some downward pressure on prices. In view of the expected modest growth in world petroleum consumption (some 1¼ per cent) in 1999 it is clear that maintaining these higher oil prices will depend, at least in the short run, on effective control of supply. Non-oil commodity prices are expected to recover somewhat from their depressed levels on account of increasing demand in line with the strengthening of economic activity (notably in Asian emerging markets) in the second half of the year.

CHART 2.1.1

World commodity prices, January 1997-May 1999

(Indices, January 1997=100)



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

2.2 The western market economies

In *western Europe*, the cyclical slowdown in the second half of 1998 reflected in the main the weakening of industrial activity in response to falling export demand. This dampened activity levels in sectors producing tradeables and probably led firms to lower their investment plans. In fact, manufacturing output fell in the final quarter of 1998 by some 1¼ per cent, compared with the preceding quarter, and was only about 1 per cent above its level in the final quarter of 1997. Real GDP rose by only 0.3 per cent over the same period, in both the euro area, and in western Europe as a whole.

Preliminary estimates suggest, that real GDP in the euro area increased by 0.4 per cent in the first quarter of 1999 (table 2.2.1) and was only 1.8 per cent higher than in the first quarter of 1998 (chart 2.2.1). For western Europe as a whole, real GDP rose by slightly less, reflecting the stagnation of aggregate output in the United Kingdom. Partial data also point to relatively sluggish manufacturing activity. Exports of goods in

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[63] This would possibly lead to more favourable external financing conditions but would also require a high degree of real economic convergence with the United States economy. An important issue is whether the United States Federal Reserve would be willing to act as lender of last resort in the event of a domestic financial crisis in Argentina. The adoption of the dollar as legal tender is not equivalent to "dollarization", which is generally understood to describe a situation where a more or less large part of financial assets held by domestic residents are denominated in dollar or other foreign currencies.

[64] B. Eichengreen, *Does Mercosur Need a Single Currency?*, NBER Working Paper, No. 6821 (Cambridge, MA), December 1998.

[65] In the past, several agreements on oil output quotas were not respected. The pressures to adhere to the present one might be greater, however, in view of the considerable financial losses and related economic problems associated with the steep fall in oil prices in 1998. This is also reflected in strong political support for this latest agreement. International Energy Agency, *Monthly Oil Market Report* (Paris), April 1999.

TABLE 2.2.1

Real GDP in the seven major economies, 1997 QIII-1999 QI
(Percentage change over previous quarter)

	1997		1998				1999
	QIII	QIV	QI	QII	QIII	QIV	QI
France	0.8	1.1	0.8	0.8	0.3	0.7	0.3
Germany	0.4	0.5	1.0	–	0.5	-0.1	0.4
Italy	0.3	0.2	-0.2	0.8	0.5	-0.3	..
United Kingdom	0.8	0.8	0.4	0.3	0.3	0.1	–
4 countries above	0.6	0.6	0.6	0.5	0.4	0.1	..
Canada	1.4	0.8	0.7	0.3	0.6	1.2	1.0
United States	1.0	0.7	1.4	0.5	0.9	1.5	1.0
Japan	1.0	-0.9	-1.2	-0.7	-0.3	-0.8	1.9
Total above	0.9	0.4	0.6	0.2	0.5	0.6	..
Memorandum item:							
Euro area	0.6	0.7	0.6	0.6	0.4	0.3	0.4*

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

the first quarter of 1999 remained below their corresponding level of a year earlier, and import demand was also weak. Industrial confidence remains relatively depressed, although it has improved slightly in recent months. In contrast, consumer confidence, which is at relatively high levels, deteriorated slightly until May 1999. In principle, low real interest rates should encourage spending on interest-sensitive expenditure items and this should have supported private consumption and fixed investment in the first quarter of 1999. Private consumption is also being supported by the rise in aggregate incomes associated with further gains in employment and average earnings. Given the weak trade links with Yugoslavia and other south-east European countries, the Kosovo conflict has had, in general, little impact on recent economic developments, although there have been significant sectoral impacts in Greece, Italy and Turkey, especially on the tourism industry.

The recent upturn in international commodity prices (especially of oil), if maintained, will effectively remove a source of disinflation, which has contributed to reducing inflation to very low levels in early 1999. The sharp rise in international oil prices was quickly reflected in relatively large price increases for energy products at both the producer and consumer levels in March and April. The impact, however, was partly offset by still falling inflation for other goods and services. While the so-called “core inflation rate” (which excludes prices of food and energy products) continued to fall, the headline rate edged upward (chart 2.2.2). In fact, in the euro area, the all items consumer price index rose less than the core inflation rate between January 1998 and March 1999, but in April 1999 this gap was closed. The overall inflation rate, nevertheless, has remained very moderate at an average 1.2 per cent. This reflects not only intensive competitive pressures at the retail level but also the general absence of significant domestic cost pressures. The divergent cyclical developments and the associated relative strength of domestic demand, however, have contributed to the persistence of quite large inflation differentials among the member states of the euro area. Inflation rates significantly below 1 per cent in France and Germany in April contrasted with increases of 2 to 2.7 per cent in Ireland, Portugal and Spain. In Spain, the government recently adopted a package of measures (including lower utility prices, and deregulation of certain service sector activities) which is expected to put downward pressure on the rate of increase in prices.

Inflation has also remained moderate in countries outside the euro area. In Greece, for example, restrictive economic policies, designed to meet the convergence criteria for EMU membership, have led to a further large fall in the inflation rate to below 3 per cent in April. And in the United Kingdom, inflation (as measured by the retail price index excluding mortgage interest payments) fell to 2.1 per cent in May, significantly below the target of 2.5 per cent set by the government. In Turkey, a traditionally high-inflation country, consumer price inflation has fallen sharply from 102 per cent in January 1998 to some 64 per cent in April 1999. This reflects, *inter alia*, the pronounced weakening of domestic demand and control over administered price increases.

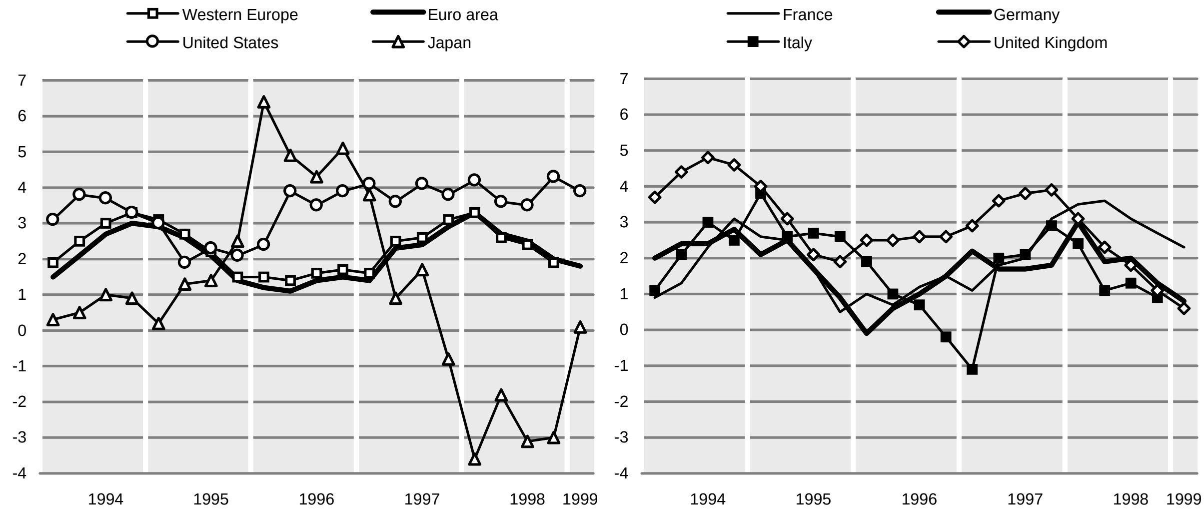
In the west European labour markets, there was a slight fall in the number of persons unemployed in 1998, with a fall in the standardized unemployment rate from 9.6 per cent to 9.1 per cent between January and December 1998. Available data suggest that this tendency has continued in early 1999. Thus, in the European Union, the unemployment rate was 9.6 per cent in April compared with 9.7 per cent in December 1998. In the euro area, the average unemployment rate fell by 0.2 percentage points to 10.4 per cent over the same period. The slowdown in economic activity has been depressing the demand for labour, especially in the export-oriented sectors of manufacturing industry, but this has been more or less offset to a large extent, by increased demand for labour in services and construction.

At the time of writing, national accounts data for the first quarter of 1999 are available only for a few countries. In *France*, real GDP rose by 3.2 per cent in 1998, the largest increase in this decade and a reflection of robust private consumption expenditures and an upturn in business fixed investment. Favourable patterns of sectoral specialization and market orientation in international trade have cushioned the adverse effects of the crises in emerging markets on export demand. But real GDP rose only by a modest 0.3 per cent in the first quarter of 1999, down from 0.7

CHART 2.2.1

Changes in real GDP, 1994 QI-1999 QI

(Percentage change over same quarter of preceding year)



Source: National statistics.

Note: Data are seasonally adjusted. Euro area excludes Ireland and Luxembourg. Western Europe: euro area plus Denmark, Norway, Sweden, Switzerland and the United Kingdom.

per cent in the preceding quarter. This slowdown largely reflects the weaker growth of private consumption. In addition, there was a more moderate rate of inventory accumulation, which had a negative impact on growth, although this was partly offset by an increase in fixed investment. The corporate sector increased expenditures on machinery and equipment, and households, encouraged by low mortgage rates, invested more in residential buildings, which stimulated the construction sector. Both exports and imports fell in the first quarter of 1999, the net effect being neutral for overall economic growth. Employment rose by 0.4 per cent compared with the final quarter of 1998, but the unemployment rate remained stable at 11.4 per cent in the first four months of 1999.

In *Germany*, the adverse trade effects of the crises in Asia, Russia and Latin America were increasingly felt in the second half of 1998. After falling by 0.1 per cent between the third and final quarters of 1998, economic activity picked up slightly in the first quarter of 1999, real GDP rising by 0.4 per cent. This reflected increased consumer and fixed investment expenditures which, however, were largely offset by a sharp slowdown in inventory accumulation (which subtracted nearly 2 percentage points from overall economic growth). Exports fell for the third consecutive quarter, and there was a slight fall in imports as a result of the weakness of aggregate domestic demand. As in France, the effect of changes in real net exports on domestic activity were neutral, following two consecutive quarters when their growth contribution was negative. Employment data for 1999 are currently not available due to changes in statistical survey methods. The unemployment rate was 9 per cent in March 1999, unchanged from February. The wage bargaining round in early 1999 led to much larger wage increases than in preceding years, but the increase in labour costs is probably broadly neutral in its effect on the price competitiveness of firms.

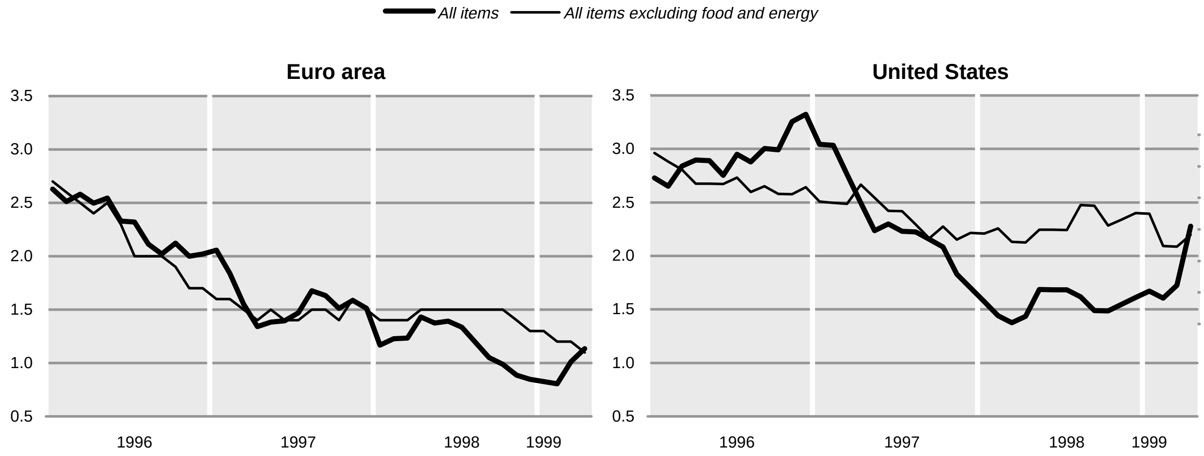
In *Italy*, national accounts data for the first quarter of 1999 were not available at the time of writing this *Survey*. Short-term indicators point to the continuing weakness of domestic and foreign demand. Exports have been affected by the weak growth of demand in major markets. Industrial output was very volatile during the first quarter of 1999, but there was only a slight increase over the preceding period, and it remained about 1.5 per cent below the corresponding level of 1998. Employment growth slowed down to 0.3 per cent in the first quarter of 1999 and consumer confidence continued to weaken throughout the first five months of 1999. Growth expectations for 1999 have been scaled back and current forecasts point, at best, to an increase in real GDP of 1.5 per cent.

In the *United Kingdom*, real GDP stagnated in the first quarter of 1999 when there was an increase over the previous quarter of only 0.1 per cent. It is now generally expected, however, that a recession will be avoided. The marked cyclical downturn reflects to a large degree the lagged effects of monetary tightening and tight fiscal policy, which were accentuated by the effects of the strong pound on net export growth. Domestic demand in the first quarter of 1999 was

CHART 2.2.2

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

(Percentage change over same month of preceding year)



Source: Eurostat and Bureau of Labor Statistics.

supported by rising private and government consumption expenditures. In contrast, gross fixed capital formation fell significantly following two consecutive quarters of strong growth, and changes in inventory accumulation also dampened economic activity. Exports continued to fall and import demand slowed down to near stagnation. Changes in real net exports made a negative contribution to growth for the sixth consecutive quarter. Differences in the development of different sectors remain marked. The manufacturing sector moved into recession in the first quarter of 1999, output falling for the second consecutive quarter, while construction activity remained sluggish. The services sector continues to grow but the pace of expansion has slowed down further, low aggregate growth in the first quarter is actually masking a fall in the real value added of business services and finance. Employment edged up by 0.2 per cent with labour shedding in manufacturing industry offset by rising employment in services. Labour market conditions are still tight, but business surveys suggest that skilled labour shortages are less acute and that recruitment plans are being reduced. The unemployment rate has remained relatively stable at slightly more than 6 per cent since mid-1998, which is close to a 20-year low.

In the *Netherlands*, the business cycle passed its peak in 1998, with both domestic demand and export growth weakening in the second half of the year. Real GDP rose by only 0.6 per cent in the first quarter of 1999, down from 1.3 per cent in the preceding quarter, but industrial output fell by half a percentage point. The details of expenditure were not available at the time of writing.

In *Norway*, there was a relatively large increase in real GDP by 1.1 per cent in the first quarter of 1999 (over the preceding quarter). This reflected in the main a striking recovery in private consumption expenditure which contrasts with a large fall in fixed investment and a slight fall in exports.

In *Switzerland*, the rate of economic growth slowed to 0.7 per cent in the first quarter, down from 1.1 per cent in the preceding period. Strong growth in private consumption expenditure was offset by weakening investment and export demand.

Among the other smaller economies, industrial output statistics point to a wide variation in performance. There was a sharp contraction in Belgium in the first quarter and partial data also point to falling activity levels in Sweden. Production broadly stagnated in Spain, albeit at a high level of activity, but buoyant growth continued in Finland, Ireland and Portugal.

In the *United States*, the rate of economic expansion has remained strong over the first five months of 1999. Manufacturing has gained new momentum: between March and May, monthly output rose at a steady rate of 0.4 per cent, equivalent to an annual rate of nearly 5 per cent. Capacity utilization rates have edged upward slightly, but the margin of spare capacity is still considerable. The Purchasing Managers' Index, a gauge of business activity in the manufacturing sector, rose in May to its highest level since October 1997, an indication of the dominance of expansionary forces. Construction activity continues to grow at a brisk rate against a background of favourable mortgage rates and strong home sales. Consumer confidence is very strong, rising in each of the six months ending in May 1999, the longest continuous upturn in the 32 years for which this index has been compiled. Against this background, retail sales have expanded at a brisk pace.

Real GDP rose by 1 per cent in the first quarter compared with 1.5 per cent in the previous quarter. The slowdown was due to continuing strength in both personal consumption and fixed investment being offset by adverse changes in real net exports and stockbuilding. Household incomes continue to benefit from a combination of higher average earnings and rising employment, as well as from the wealth effects associated with rising asset prices. Aggregate personal savings turned negative in the first quarter of 1999 after falling to zero in the preceding quarter.

The labour markets have tightened further in 1999. Non-farm employment has increased steadily, by 0.6 per cent between January and May, although labour shedding in manufacturing industry has continued. The unemployment rate was at an historic low of 4.2 per cent in May. Pervasive skilled labour shortages in various sectors have resulted in upward pressures on wages which, however, appear to have been offset to a large degree by productivity gains.

Despite buoyant demand, consumer price inflation has remained moderate, reflecting intense competition at the retail sales level. Rising energy prices contributed significantly to a large increase in the monthly inflation rate to 0.7 per cent in April. This triggered fears of a more persistent rise in inflation, but in fact consumer prices were stable in May and were only 2.1 per cent higher than 12 months earlier.

The significant differential strength of demand at home and abroad has led to a further rise in the current account deficit to $68.6 billion or 2.8 per cent of GDP in the first quarter of 1999, up from 1.8 per cent of GDP in the same quarter of the preceding year. The main factor behind this further deterioration was the rise in the merchandise trade deficit. It is noteworthy that the surplus in services has fallen since the second half of 1997 and that the balance on the income account has been in deficit since the second quarter of 1998.

In *Canada*, the economy maintained the high momentum attained in the final months of 1998, mainly under the influence of rising exports to the United States (to which Canada ships more than three quarters of its exports). Against a background of rising incomes and employment, private consumption expenditure strengthened markedly in the first quarter of 1999 and fixed investment also increased. In sum, real GDP in the first quarter of 1999 was 1 per cent higher than in the preceding quarter.

(i) Monetary conditions

In the *euro area*, monetary conditions continued to ease in the second quarter of 1999, reflecting the combined impact of the lowering of official interest rates by the ECB on 8 April and the continued depreciation of the euro. Expectations of a cut in interest rates had built up in the first quarter of 1999 in view of the deteriorating economic situation and inflation falling below 1 per cent. In the event, the ECB reduced its repo rate by half a percentage point to 2.5 per cent, which was more than generally anticipated.[66] As a result, nominal short-term interest rates in the money market also declined: in mid-June, they stood at 2.6 per cent, their lowest level in this decade (chart 2.2.3).

The average real short-term interest rate[67] fell to about 1.5 per cent in April (the latest month for which inflation data are available), which is more than one percentage point below the corresponding rate in the United States. The existing variation in the inflation rates in the member states of the euro area translate, however, into quite significant differences in their real short-term rates. In April, they ranged from 2 per cent and more in Austria, France and Germany to 0.6 per cent and less in Italy, the Netherlands, Portugal (where rates were actually negative) and Spain. The real rates in the other countries (Belgium, Finland and Ireland) were close to 1.5 per cent.

The fall in nominal short-term interest rates was accompanied by a slight rise in long-term rates to 4.2 per cent in May and a further increase to 4.4 per cent in the first half of June, leading to a wider maturity spread and an increase in the slope of the yield curve (chart 2.2.3). The recent rise in long-term bond yields reflects to a large extent spillover effects from the United States market, rather than an increase in inflationary expectations for the euro area.

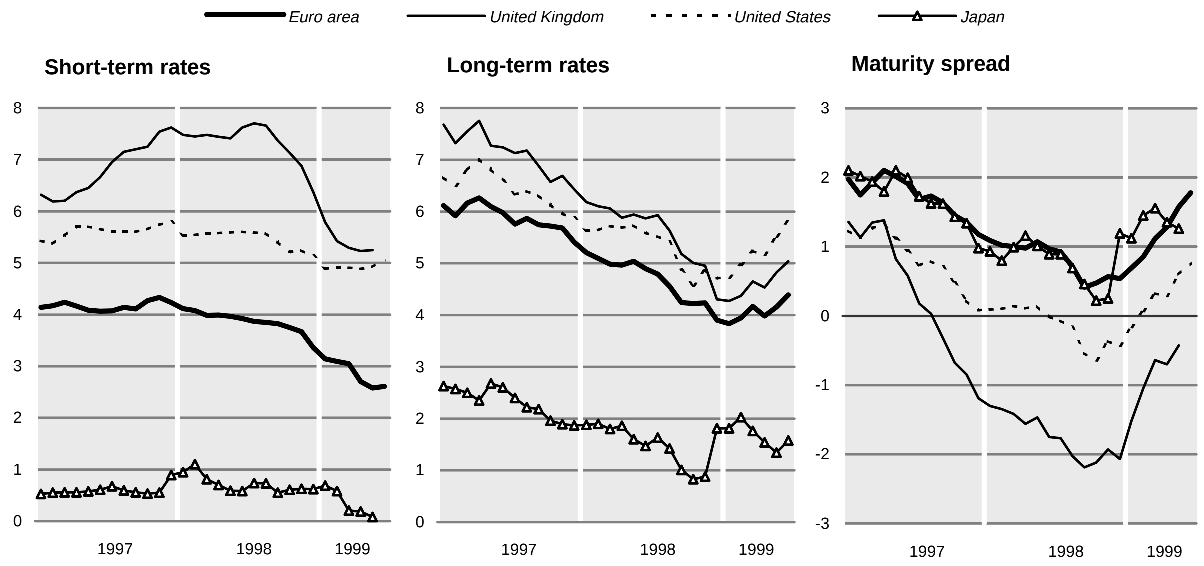
Outside the euro area, in the *United Kingdom*, the Bank of England's Monetary Policy Committee continued the process of monetary easing which began in the final quarter of 1998. The background to this was the increasing sluggishness of economic activity and, last autumn, perceptions of an increasing risk of recession, as well as inflation falling below the government's target of 2.5 per cent. Official interest rates have now fallen by 2.5 percentage points since June 1998, when monetary policy was last tightened to avoid overheating. It also seems likely that the latest lowering of official interest rates was also influenced by the continued strength of the pound, which at

[66] This was the first change in official interest rates made by the ECB and, as such, it will provide data for studying the transmission mechanism of monetary policy in the single currency area and the importance of regional differences in the transmission process.

[67] Based on national definitions of consumer price indices.

CHART 2.2.3

Nominal interest rates, January 1997-June 1999
(Average monthly rates, per cent per annum)



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

Note: Short-term rates: three-month money market rates. Long-term rates: yields on 10-year government bonds. Maturity spread: long-term interest rates less short-term interest rates. The interest rates for the euro area prior to 1999 are GDP weighted averages of national rates. The figures for June 1999 are average rates for the first half of the month.

unchanged interest rates could have implied a high probability of inflation falling short of the government's target of 2.5 per cent over the next year. The strength of the pound relative to the euro can to a large extent be attributed to the large differential between short-term interest rates in the United Kingdom and the euro area. In May, the gap was 2.7 percentage points in favour of pound denominated financial assets. At the longer end of the maturity spectrum (yields on 10-year government bonds) the difference was only 0.7 percentage points. It is understood that the convergence of short-term interest rates will be required at such time as the United Kingdom might want to join EMU. Depending on cyclical developments, however, this process could also be facilitated by a rise in interest rates in the euro area.

In the *United States*, the stance of monetary policy has been left unchanged so far in 1999, following the progressive lowering of the target for the federal funds rate between end September and mid-November of last year.[68] This move was mainly designed to stabilize the international financial markets, but it has also provided a significant monetary stimulus to the real economy. Given the continued buoyancy of the economy, tight labour markets and associated concerns about the risk of mounting inflationary pressures, the Federal Open Market Committee (FOMC) decided in May 1999 to allow for a possible upward bias in the Fed's interventions in the interbank market for overnight funds.[69] This has been generally interpreted to signal an increased probability of a tightening of monetary policy in the months ahead.

Against this background, short-term interest rates, which had been rather stable at around 4.9 per cent in the months before, rose slightly to 5.1 per cent in early June. There were somewhat larger increases in long-term bond yields, which had spillover effects on the European bond markets although long-term rates in the euro area rose less than in the United States (chart 2.2.3).

In the foreign exchange markets, the euro's depreciation against the dollar and pound sterling has continued (chart 2.2.4). In mid-June, the euro had depreciated by nearly 12 per cent against the dollar and 8.5 per cent against the pound since early January of this year.[70] A striking feature has been the high volatility of the yen-euro exchange rate, but without any discernible trend over the same period. It is useful to recall that there have been previous episodes during

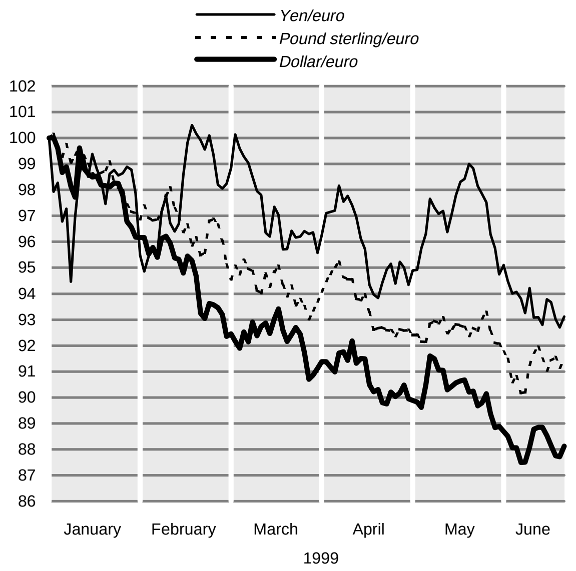
[68] There was also a lowering of the discount rate in mid-November 1998.

[69] This is the market where the federal funds rate is determined.

[70] The correlation coefficient between the daily exchange rates of the euro against the dollar and the euro against the pound is 0.98.

CHART 2.2.4

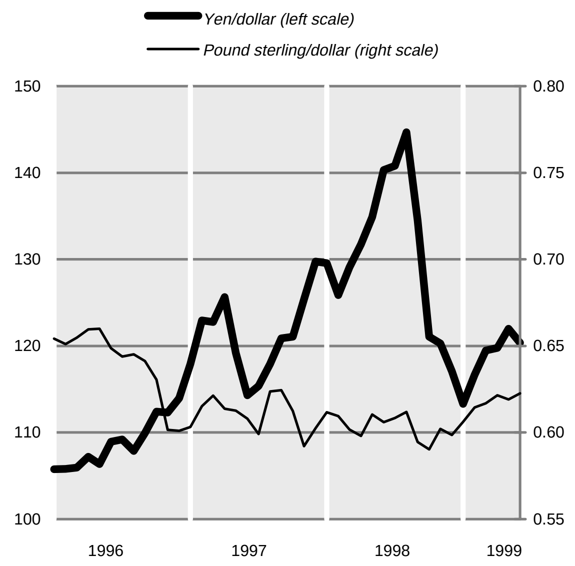
Euro reference rates, January 1999-June 1999
(Indices, 4 January 1999=100)



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

CHART 2.2.5

Bilateral exchange rates, January 1996-June 1999
(Monthly averages)



Source: United States Federal Reserve.
Note: The figures for June 1999 are the average rates of the first half of the month.

which the dollar appreciated strongly against the deutsche mark and other currencies in the old ERM, for example, over the period from late 1996 to mid-1997. The marked appreciation of the yen against the dollar witnessed in the second half of 1998 was partly reversed until May 1999. But there were renewed signs of yen appreciation in the first half of June, when market sentiment was probably shifting in favour of yen denominated assets on account of the strong GDP growth rates published for the first quarter (chart 2.2.5).

As is the case for the pound, the weakening of the euro against the dollar can to a large degree be attributed to the diverging business cycles and, related to that, the sizeable short-term interest rate differentials, which international investors expect to persist for some time to come. The end of the bombing of Yugoslavia has had apparently no significant impact on the euro exchange rate.

(ii) The short-term outlook

There has been no significant change in the short-term economic outlook for the western market economies of the ECE region since the previous *Survey*[71] was finalized in mid-March 1999. Real GDP in western Europe is still forecast to increase by some 2 per cent in 1999, which contrasts with a significantly stronger annual growth rate of more than 3 per cent expected for the United States (table 2.2.2).

These forecasts embody the assumption that forces for growth will strengthen in western Europe but weaken in the United States in the second half of this year. Such tendencies, however, are not yet discernible in the currently available short-term economic indicators for the first four or five months of 1999.

In Germany, the largest west European economy, business confidence (as measured by the IFO business climate index) rose again in May following a fall in April. But overall confidence has fallen to low levels since the Russian crisis of last year, and the May figure is only slightly higher than the recent trough in February.

There are, nevertheless, some factors which could lead to a pick-up in economic growth in western Europe later on in the year. In the euro area, the monetary impulses which are now in the pipeline will stimulate domestic demand, although the effects of lower short-term interest rates could be partly offset by a rise in long-term interest rates. In addition, the depreciation of the euro has improved price competitiveness and this should strengthen the growth of net exports. Fiscal policy, in the aggregate, will be neutral in its effect on economic activity in 1999. In the United Kingdom, the resolute easing of monetary policy and the slightly expansionary stance of fiscal policy can be expected to offset the restraining effects on exports of the strong pound.

[71] UN/ECE, *Economic Survey of Europe, 1999 No. 1*, pp. 35-37.

TABLE 2.2.2

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

	1996	1997	1998	1999 [a]
Western Europe	1.9	2.7	2.6	1.8
4 major countries	1.2	2.1	2.2	1.5
France [b]	1.1	2.0	3.2	2.3
Germany [b]	0.8	1.8	2.3	1.5
Italy	0.9	1.5	1.4	1.5
United Kingdom [b]	2.6	3.5	2.1	0.7
17 smaller countries	3.1	3.9	3.4	2.4
Austria	2.0	2.5	3.3	2.2
Belgium [b]	0.9	3.2	2.9	2.0
Cyprus	2.0	2.5	5.0	4.0
Denmark [b]	3.3	3.1	2.9	1.6
Finland [b]	4.1	5.5	4.7	3.0
Greece	2.4	3.2	3.5	3.0
Iceland	5.6	5.4	5.0	5.0
Ireland	7.4	9.8	8.5	6.5
Israel	4.7	2.7	2.0	1.7
Luxembourg	3.0	4.7	5.7	3.3
Malta	3.8	4.4	7.6	7.5
Netherlands	3.1	3.6	3.7	2.2
Norway [b]	5.5	3.4	2.1	1.0
Portugal	3.2	3.7	3.9	3.0
Spain	2.4	3.5	3.8	3.3
Sweden	1.3	1.8	2.9	2.0
Switzerland	0.3	1.7	2.1	1.3
Turkey	7.0	7.5	2.8	1.4
North America	3.3	3.9	3.8	3.4
Canada [b]	1.7	4.0	3.1	2.8
United States	3.4	3.9	3.9	3.5
Total above	2.6	3.3	3.2	2.6
Japan	5.0	1.4	-2.8	-1.4
Total above, *including Japan*	3.0	3.0	2.3	2.0
Memorandum items:				
European Union	1.6	2.5	2.6	1.9
Euro area	1.4	2.3	2.7	2.1

Source: National statistics and national economic reports.

Note: All aggregates exclude Israel. Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1991 GDP data converted from national currency units into dollars using purchasing power parities.

a Forecasts.

b Data corresponds to new SNA93 or ESA95 definitions.

Support for this scenario is also provided by the increasing evidence that the economic situation in the Asian emerging markets most directly affected by the financial crisis of 1997 has been improving recently. This is reflected in a significant upward revision of forecasts for GDP growth in the Republic of Korea in 1999. Stabilization and growth in Asia should, of course, stimulate western European exports to the region.

There remain, however, considerable downside risks which have been already identified.[72] These include the weakness of the Japanese economy, notably the fragility of its financial sector, the vulnerability of emerging markets to new financial shocks, the sustainability of the rise in the United States current account deficit and of the level of equity prices in many industrialized countries, notably the United States, which appear to be quite excessive on the basis of historical valuation criteria.[73] There is also lingering uncertainty about the state of the Chinese economy and the adverse regional effects of a possible devaluation of the renminbi, which could put into question the sustainability of the nascent recovery in other Asian economies.

In the United States, the continued strength of the economy and the absence of any significant inflationary pressures remain striking. Private household spending has been fuelled by expectations of further increases in already high asset prices, which is not sustainable. Moreover, the pool of available labour resources has now been virtually exhausted and, at this very mature stage of the business cycle, productivity gains will be increasingly less able to offset labour cost pressures, which must inevitably mount if the economy remains as strong as it is at present. Overall, the existence of significant domestic and external imbalances calls for a pre-emptive tightening of monetary policy to avoid a hard landing.

2.3 Central and eastern Europe and the CIS

During the early months of 1999, economic performance deteriorated in many of the ECE transition economies. The most visible evidence of this was the weakening of output and export performance which was noticeable throughout the whole region. The weakening of economic activity had a negative impact on the situation in the labour markets causing further increases in unemployment. While inflation rates continued to fall in most transition economies, in some CIS countries there were painful setbacks, fuelled in most cases by depreciating exchange rates. The international trade of the transition economies was in general weak and in some areas (in particular Russian imports and intra-CIS trade in general) there were especially large falls: the Russian crisis practically eliminated some of the trade flows in this region. The current account balances of most transition economies have also deteriorated suggesting that balance of payments constraints may become a serious bottleneck for some of the countries in the region.

The worsening of the economic situation in the transition economies – which in fact started in mid-1998 – was triggered by a series of external shocks, the latest being the Kosovo conflict. Their aggregate and

[72] Ibid.

[73] BIS, *69th Annual Report* (Basle), June 1999, pp. 83-88.

multiplier effects have resulted in an unexpectedly large and widespread negative impact on the ECE transition economies: thus, for example, the rate of growth of aggregate GDP in eastern Europe in 1998 was the lowest since 1993 (table 2.3.1 and appendix table B.1).[74] In addition to the diverse and wide-ranging repercussions of these shocks, there was also a deterioration in a number of various aspects of domestic economic performance. These developments highlight once again the general fragility of most of the transition economies and their vulnerability to external disturbances, an issue that has been repeatedly emphasized in previous issues of this *Survey*. They underline once again the need for a cautious and consistent policy approach in engineering and maintaining a balanced and sustained rate of growth during the transition.

(i) Output and demand

The general weakening of economic activity in the ECE transition economies which became noticeable in the closing months of 1998 continued in the first quarter of 1999, and was especially marked in certain regions and in certain sectors of economic activity. Although at the moment of writing this *Survey* quarterly GDP figures were not available for many of the countries, other preliminary statistics indicate a substantial deterioration in output performance. This was particularly the case in manufacturing: in the first quarter of 1999 industrial output was declining, year-on-year, in 17 of the 27 ECE transition economies (table 2.3.3). Aggregate industrial output declined in all the major subregions in the first quarter: eastern Europe, the Baltic states and the CIS. In eastern Europe the fall in total industrial output was the first since 1993 (appendix table B.4).

Basically the same external factors that caused the setback in the ECE transition economies in the second half of 1998 continued to further worsen their output performance in the opening months of 1999: weak global demand (caused by the global financial turmoil that followed the Asian crisis), the large fall in Russian imports in the aftermath of the August financial collapse and the weakening of import demand in western Europe. As argued in more detail in chapter 1, the outbreak of the Kosovo conflict and the escalation of war-related damage was another major external shock for many of the ECE transition economies, especially those in south-east Europe.

Among the *central European transition economies*, in the first quarter of 1999 growth remained relatively strong only in Hungary. Although the growth of industrial output (with manufacturing the main engine of recovery) decelerated somewhat (having grown at double-digit rates in 1997 and 1998 – table 2.3.3), it was still sufficient to preserve a healthy rate of recovery in the economy as a whole. The growth of domestic demand also slowed a little from the very high rates in 1998 (table 2.3.4) but it still provided an important support to economic activity. The major source of policy concern in Hungary was the state of public finances with the budget deficit somewhat larger than forecast, largely as a result of the effects of the Kosovo conflict.

Sluggish output, and in some cases recessionary trends, prevailed in the rest of the central European transition economies. Poland has been experiencing its worst economic performance since 1994: industrial output in the first quarter of 1999 fell below its level in the same period of 1998 (table 2.3.3) and was the second consecutive quarter of year-on-year falls in industrial production. Preliminary estimates suggest that quarterly GDP only grew marginally in the first quarter, and even if it picks up later in the year it is highly unlikely that Polish growth performance in 1999 will match the record of the last five years. In the Czech Republic, which has been in recession since the beginning of 1998, both GDP and industrial output fell sharply in the first quarter of 1999 (table 2.3.3). Although a turnaround is widely expected in the course of 1999,[75] recession will probably prevail for the year as a whole.

Since taking office (after the September 1998 parliamentary elections), the new Slovak government has been implementing a major fiscal adjustment aimed at restoring macroeconomic equilibrium (in the first place, by reducing the large current account deficit – table 2.3.2).[76] Overall, this has resulted in a dampening of economic growth: in the first quarter of 1999 quarterly GDP increased by a meagre 1.8 per cent year-on-year (table 2.3.3), following a 0.5 per cent increase in the fourth quarter of 1998.

[74] Starting with this issue of the *Survey*, the UN/ECE secretariat has introduced new weights for computing regional aggregates for the ECE transition economies on the basis of the results of the 1996 European Comparison Programme. In some cases this has resulted in minor deviations from previously reported numbers for some regional groupings.

[75] As a first positive sign, retail sales recovered by an impressive 9.3 per cent, year-on-year, in March, following 14 months of decline; this led to positive growth of the quarterly volume of retail sales during the first quarter of 1999 (table 2.3.4). However, it remains to be seen whether this change actually marks a reversal in domestic demand (in April, the year-on-year rate of growth of retail sales amounted to 1.8 per cent).

[76] The latest set of measures proposed by the government in May include, *inter alia*, increases in the import surcharge and in VAT as well as the introduction of some new taxes; at the same time they envisage cuts in public expenditure, in particular, on public administration and social benefits. Government regulated prices (of electricity, heating and telecommunication services) will also be raised. *SITA* (Slovenska Tlacova Agentura) as quoted in *Reuters Business Briefing*, 1 June 1999.

TABLE 2.3.1

Basic economic indicators for the ECE transition economies, 1996-1999

(Rates of change and shares, per cent)

	GDP (growth rates)					*Industrial output (growth rates)*			*Inflation (per cent change, Dec./Dec.)*			*Unemployment rate (end of period, per cent)*		
			1998											
	1996	*1997*	*Ex-ante official forecast*	*Actual outcome*	*1999 official forecast*[a]	*1996*	*1997*	*1998*	*1996*	*1997*	*1998*	*1996*	*1997*	*1998*
Eastern Europe	3.8	2.3	4.1	1.5	2.2	5.2	4.9	1.4	..	..	..	11.7	11.9	12.6
Albania	9.1	-7.0	10	8*	5-6	13.6	-5.6	10.0	17.4	42.0	7.8	12.3	14.9	17.6
Bosnia and Herzegovina[b]	..	..	..	..	18	87.6	35.7	23.8	3.2	12.2	2.2	..	39*	38.5
Bulgaria	-10.1	-6.9	3.0	3.5	2	3.1[c]	-9.6	-9.4	311.1	578.7	0.9	12.5	13.7	12.2
Croatia	6.0	6.5	7.5	2.7	1.5-2	3.1	6.8	3.7	3.5	4.0	5.6	15.9	17.6	18.6
Czech Republic	3.9	1.0	1.4-2.6	-2.7	-0.8	2.0	4.5	1.6	8.7	9.9	6.7	3.5	5.2	7.5
Hungary	1.3	4.6	4.0	5.1	4-5	3.4	11.1	12.6	20.0	18.4	10.4	10.5	10.4	9.1
Poland	6.0	6.9	5.6-5.8	4.8	4-4.5	8.3	11.5	4.7	18.7	13.2	8.5	13.2	10.3	10.4
Romania	3.9	-6.9	–	-7.3	-2	6.3	-7.2	-17.0	56.8	151.7	40.7	6.6	8.8	10.3
Slovakia	6.6	6.5	5.0	4.4	3	2.5	1.7	5.0	5.5	6.5	5.5	12.8	12.5	15.6
Slovenia	3.5	4.6	3.5-4	3.9	4	1.0	1.0	3.7	9.0	8.8	6.6	14.4	14.8	14.6
The former Yugoslav Republic of Macedonia	0.8	1.5	5.0	2.9	-8	3.2	1.6	4.5	0.3	4.5	-1.0	39.8	42.5	..
Yugoslavia[d]	5.9	7.4	10.0	2.6	..	7.5	9.5	3.6	59.9	10.3	45.7	26.1	25.6	27.2
Baltic states	4.1	8.4	6.3	4.4	3	4.8	8.4	4.2	..	..	..	6.4	6.3	7.3
Estonia	3.9	10.6	5.5-6	4.0	2.0-2.5	3.5	15.2	0.5	15.0	12.3	6.8	5.6	4.6	5.1
Latvia	3.3	8.6	5-6	3.6	2	5.5	13.8	2.0	13.2	7.0	2.8	7.2	6.7	9.2
Lithuania	4.7	7.3	7.0	5.1	4	5.0	3.3	7.0	13.1	8.5	2.4	6.2	6.7	6.9
CIS	-3.4	1.0	1.4	-2.8	0.1	-3.4	2.6	-3.1	..	..	..	6.6	7.6	9.0
Armenia	5.9	3.1	5-6	7.2	4	1.4	0.9	-2.5	5.6	21.8	-1.2	9.7	11.0	8.9
Azerbaijan	1.3	5.8	..	10.0	6	-6.7	0.3	2.2	6.8	0.3	-7.6	1.1	1.3	1.4
Belarus	2.8	11.4	7-8	8.3	4-6	3.5	18.8	11.0	39.1	63.4	181.6	4.0	2.8	2.3
Georgia	11.0	11.3	11-13	2.9	4	6.8	8.2	-2.7	13.6	7.3	10.8	3.2	8.0	4.2
Kazakhstan	0.5	1.7	3.5	-2.5	-1.5	0.3	4.0	-2.1	28.6	11.3	1.9	4.1	3.9	3.7
Kyrgyzstan	7.1	9.9	3.6	1.8	2.8	8.8	50.4	4.6	35.0	14.7	18.3	4.5	3.1	3.1
Republic of Moldova[e]	-7.8	1.6	3-3.5	-8.6	-5	-6.5	–	-11.0	15.1	11.1	18.2	1.5	1.7	1.9
Russian Federation	-3.5	0.8	0-0.5	-4.6	(-1-0)	-4.0	2.0	-5.2	21.8	11.0	84.5	10.0	11.2	13.3
Tajikistan	-16.7	1.7	..	5.3	3	-23.9	-2.0	8.1	40.6	159.9	2.7	2.4	2.8	2.9
Turkmenistan	6.7	-11.4	..	5.0	10	19.7	-32.3	0.2	445.8	21.5	19.8	..	..	..
Ukraine	-10.0	-3.2	0.5	-1.7	-1	-5.1	-0.3	-1.5	39.7	10.1	20.0	1.5	2.8	4.3
Uzbekistan	1.7	5.2	6.0	4.4	4.4	2.6	4.1	5.8	80.0	27.5	..	0.3	0.3	0.4
Total above	-0.8	1.6	2.5	-1.1	1.0	0.3	3.7	-1.0	..	..	..	..	..	..
Memorandum items:														
CETE-5	4.7	5.0	4.5	3.1	3.1	5.0	8.3	5.1	..	..	..	11.2	9.8	10.2
SETE-7	1.9	-3.9	3.1	-2.6	-0.6	5.5	-3.9	-9.3	..	..	..	12.5	14.3	15.4
Former GDR	3.2	1.7	..	2.0	..	3.3	5.8	7.5	..	..	..	15.9	19.4	17.4

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE secretariat (IMF and World Bank data for Albania).

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

[a] The 1999 regional aggregates exclude Bosnia and Herzegovina and Yugoslavia.

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

[c] Bulgarian industrial output indices were recently recalculated according to a new methodology and the old series reportedly have been revised back to 1991. Here and in appendix table B.4 industrial output now includes the gross output of all activities of industrial enterprises (and not just the gross output of "pure" industry, as previously published). The figure for industrial output growth in 1996 according to the new methodology (3.1 per cent) differs significantly from the figure for the rate of change of gross industrial output (-9.1 per cent) reported in the national accounts for the same year.

[d] Gross material product instead of GDP.

[e] Excluding Transdniestria.

TABLE 2.3.2

International trade and external balances of the ECE transition economies, 1996-1998
(Rates of change and shares, per cent)

	Merchandise exports in dollars (growth rates)			Merchandise imports in dollars (growth rates)			Trade balances (per cent of GDP)			Current account (per cent of GDP)		
	1996	1997	1998	1996	1997	1998	1996	1997	1998	1996	1997	1998
Eastern Europe [a]	3.0	6.4	9.4	14.5	6.5	8.9	-9.5	-10.4	-9.9	-3.7	-4.2	-4.6
Albania	5.3	-33.5	46.2	40.5	-32.1	28.2	-26.0	-21.1	-20.2	-4.0	-12.0	-6.4
Bosnia and Herzegovina [b]	141.6	232.1	134.5	129.9	29.2	30.2	-41.3	-40.8	-38.4	-47.0	-44.0	-38.5*
Bulgaria	-8.5	1.0	-13.1	-10.0	-2.8	1.3	-1.9	0.1	-5.7	0.2	4.2	-2.1
Croatia	-2.6	-7.6	8.9	3.7	16.9	-7.9	-16.5	-24.5	-18.0	-4.3	-12.1	-7.3
Czech Republic	4.3	2.7	15.7	10.5	-1.3	4.6	-9.9	-9.2	-4.5	-7.4	-6.2	-1.9
Hungary	2.2	21.7	20.4	4.8	17.1	21.0	-5.4	-4.7	-5.7	-3.7	-2.1	-4.8
Poland [c]	6.8	5.4	2.6	27.9	13.9	10.9	-8.9	-11.6	-11.9	-0.9	-3.0	-4.3
Romania	2.2	4.3	-1.6	11.3	-1.4	4.8	-9.5	-8.2	-9.2	-7.3	-6.7	-7.9
Slovakia	2.8	0.2	10.7	26.6	-8.0	11.0	-12.2	-10.5	-11.3	-11.2	-6.9	-10.1
Slovenia	-0.1	0.7	8.1	-0.7	-0.6	7.8	-5.9	-5.5	-5.4	0.2	0.2	–
The former Yugoslav Republic of Macedonia	-4.7	2.8	11.0	-5.4	7.8	9.0	-10.8	-15.5	-17.0	-6.5	-7.5	-8.2
Yugoslavia	20.6	45.0	6.8	54.3	17.3	0.5	-14.2	-10.9	-7.6	-5.1	-6.7	-4.6*
Baltic states	17.6	23.0	3.3	26.3	26.7	7.3	-18.6	-21.9	-22.5	-8.2	-9.5	-11.0
Estonia	13.2	40.9	9.7	27.2	37.5	7.1	-26.4	-32.7	-29.7	-9.7	-12.1	-8.6
Latvia	10.7	15.9	8.4	27.6	17.4	17.1	-17.1	-18.6	-21.5	-5.4	-6.1	-11.1
Lithuania	24.0	15.1	-3.8	24.9	23.8	2.7	-15.3	-18.6	-19.5	-9.2	-10.2	-12.1
CIS	10.2	1.8	-14.3	5.9	18.7	-12.6	7.0	5.4	6.5	1.2	-0.4	-1.3
Armenia [b]	55.4	-12.2	3.0	67.1	4.5	13.8	-25.8	-28.1	-28.4	-26.8	-27.9	-24.5*
Azerbaijan	-3.1	18.1	-20.6	41.4	-28.6	49.0	-8.8	-1.0	-8.3	-29.2	-23.7	-33.2
Belarus	6.3	1.8	-1.1	25.6	21.2	4.5	-3.5	-7.1	-8.2	-3.8	-6.0	-7.1
Georgia	23.3	45.1	-12.7	78.7	44.1	13.3	-8.2	-10.0	-12.0	-6.6	-7.0	-10.2*
Kazakhstan	15.7	28.4	-9.0	12.3	51.9	11.8	6.9	7.0	4.4	-3.6	-4.1	-7.6*
Kyrgyzstan	-20.0	154.5	1.1	107.6	-21.9	43.4	-13.4	0.6	-6.6	-23.7	-7.8	-20.8*
Republic of Moldova	-9.7	6.0	-28.8	54.5	35.0	5.8	-9.9	-15.6	-25.0	-11.1	-13.9	-20.3
Russian Federation	8.7	-1.2	-15.7	-4.9	23.3	-16.7	8.8	6.7	9.2	2.8	0.9	0.9
Tajikistan	-11.6	7.7	-16.7	-13.9	-6.2	-1.1	14.6	22.2	9.8	-7.0	-6.5	-17.1*
Turkmenistan	-42.1	-45.5	-32.7	49.3	-42.5	-11.3	-17.3	-8.6	-9.8	2.0	-22.2	-19.0*
Ukraine	13.4	23.6	-5.1	17.1	12.7	-8.9	1.3	2.8	3.9	-2.7	-2.7	-2.0*
Uzbekistan	94.0	-4.4	-20.6	96.0	1.9	-28.9	0.9	-0.5	1.4	-7.1	-4.0	-1.4*
Total above [a]	6.7	4.9	-1.1	12.7	10.6	3.1	-0.1	-1.4	-2.5	-0.9	-2.0	-3.2
Memorandum items:												
CETE-5	4.0	6.8	11.5	15.6	6.7	11.0	-8.6	-9.5	-9.1	-3.3	-3.5	-4.1
SETE-7 [a]	-0.5	4.7	1.0	10.9	6.0	2.1	-11.2	-11.8	-10.5	-5.3	-6.9	-6.8

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

Note: Foreign trade growth is measured in current dollar values. Trade and current account balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. Trade values include the “new trade” among the successor states of former Czechoslovakia and the former SFR of Yugoslavia, but not intra-CIS trade. Current price GDP values are in some cases estimated from reported real growth rates and consumer price indices. On regional aggregates, see the note to table 2.3.1.

a Totals excluding Bosnia and Herzegovina and Yugoslavia.

b Current account excludes official transfers.

c Trade balance for 1998 is derived from exports and imports based on the new methodology.

Nevertheless, private domestic demand remained relatively strong (table 2.3.4), although it can be expected to decelerate in the course of the year. During the first quarter of the year economic activity was also weak in Slovenia. Quarterly industrial output declined in this period (table 2.3.3), mainly because of low orders in the manufacturing sector.[77] As noted in chapter 1, as a result of the Kosovo conflict the tourist sector is expecting a sharp decline in revenues which is likely to have a negative impact on overall economic performance.

The economic situation in the *south-east European transition economies* was seriously destabilized by the conflict in Yugoslavia. As already discussed in more detail in chapter 1, the economies of most of these countries were already in a precarious state even before the outbreak of the conflict. The huge losses suffered by all of the south-east European transition economies

[77] During the first four months of 1999, output was declining in 12 out of 14 manufacturing sectors. Institute of Macroeconomic Analysis and Development, *Slovenian Economic Mirror* (Ljubljana), May 1999.

TABLE 2.3.3

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

	GDP					*Industrial output*				
	1998				*1999*	*1998*				*1999*
	Jan.-Mar.	*Jan.-Jun.*	*Jan.-Sept.*	*Jan.-Dec.*	*Jan.-Mar.*	*Jan.-Mar.*	*Jan.-Jun.*	*Jan.-Sept.*	*Jan.-Dec.*	*Jan.-Mar.*
Eastern Europe	3.1	3.0	2.4	1.5	..	5.8	4.3	3.4	1.4	-4.0
Albania	..	..	..	8*	..	-11.7	1.8	11.6	10*	20.7
Bosnia and Herzegovina	..	..	..	..	..	14.2	21.1	25.4	23.8	11.7
Bulgaria	18.9	11.9	4.3	3.5	..	6.2	-0.7	-6.7	-9.4	-16.2
Croatia	3.5	3.7	3.9	2.7	..	6.4	5.8	6.8	3.7	-3.6
Czech Republic	-0.9	-1.7	-2.1	-2.7	-4.5	8.4	6.7	5.0	1.6	-9.1
Hungary	4.5	4.8	5.1	5.1	..	13.6	13.6	13.6	12.6	7.2
Poland	6.4	5.8	5.5	4.8	1.5	11.0	8.4	7.0	4.7	-2.6
Romania	-9.4	-5.2	-5.7	-7.3	..	-21.8	-19.0	-17.0	-17.0	-9.6
Slovakia	6.2	6.2	5.8	4.4	1.8	4.7	5.3	6.4	5.0	3.8
Slovenia	6.1	4.3	4.1	3.9	..	9.8	4.2	4.5	3.7	-3.0
The former Yugoslav Republic of Macedonia	..	..	..	2.9	..	8.3	9.6	7.9	4.5	-13.3
Yugoslavia	..	..	..	2.6	..	15.9	12.3	7.0	3.6	-15.0
Baltic states	8.7	8.4	6.3	4.4	..	11.3	9.6	7.6	4.2	-10.4
Estonia	9.8	7.9	5.8	4.0	-5.8	11.4	7.9	3.9	0.5	-11.5
Latvia	8.9	7.2	5.4	3.6	..	14.7	11.2	7.0	2.0	-12.5
Lithuania	8.1	9.3	7.0	5.1	..	9.8	9.8	9.5	7.0	-9.1
CIS	1.1	0.5	-1.4	-2.8	..	2.5	1.3	-1.9	-3.1	-1.4
Armenia	6.4	6.7	6.9	7.2	4.6	4.3	3.2	0.6	-2.5	-4.4
Azerbaijan	8.2	9.1	8.5	10.0	6.2	0.2	0.7	1.1	2.2	4.1
Belarus	13.0	12.5	10.0	8.3	1.3	14.6	13.5	10.8	11.0	4.1
Georgia	11.2	8.9	7.3	2.9	1.2	-3.2	0.8	-1.2	-2.7	-5.7
Kazakhstan	1.9	1.7	–	-2.5	-3.6	3.8	1.1	-1.2	-2.1	-4.1
Kyrgyzstan	11.5	5.0	1.4	1.8	0.3	52.1	23.5	9.7	4.6	-4.6
Republic of Moldova	-4.2	-4.7	-4.7	-8.6	..	3.4	2.3	-5.7	-11.0	-27.1
Russian Federation [a]	–	-0.9	-3.3	-4.6	-3.7	1.3	0.1	-3.9	-5.2	-2.0
Tajikistan	1.3	2.6	6.5	5.3	2.4	9.5	12.5	8.7	8.1	4.4
Turkmenistan	-8.0	3.0	4.4	5.0	13.0	-11.0	-5.0	2.0	0.2	15.0
Ukraine	-0.2	0.2	-0.5	-1.7	-4.8	1.7	0.7	-0.3	-1.5	-2.4
Uzbekistan	3.3	4.0	4.4	4.4	2.9	4.3	5.5	6.1	5.8	4.7
Total above	2.0	1.6	0.2	-1.1	..	4.1	2.8	0.6	-1.0	-2.8
Memorandum items:										
CETE-5	4.5	4.0	3.8	3.1	..	10.3	8.4	7.4	5.1	-2.1
SETE-7	-0.7	0.4	-1.1	-2.6	..	-7.1	-7.2	-7.9	-9.3	-10.5
Former GDR	3.6	1.7	1.7	2.0	..	..	..	..	7.5	..

Source: National statistics; CIS Statistical Committee and direct communications from national statistical offices to UN/ECE secretariat (IMF and World Bank data for Albania).

Note: Industrial output figures above are based on monthly statistical reporting. Because of differences in coverage, monthly cumulative figures for 1998 as a whole differ slightly from reported annual figures for some countries. For these countries reported annual figures have been used. On regional aggregates see the note to table 2.3.1.

[a] Reported quarterly GDP figures for Russia are volume indices of the gross output in industry, agriculture, construction, transport and retail trade which covers about 70 per cent of total output at basic prices.

as a result of the conflict have resulted in a critical setback for this group of countries which threatens to escalate into a major economic crisis for the whole region.

The economies of south-east Europe continue to encounter serious macroeconomic problems. Romania has been facing serious macroeconomic imbalances and has been in a state of a deep recession since 1997. Its most acute problem in 1999 is the servicing of its foreign debt, which will be impossible without substantial additional assistance from the international financial institutions. Indeed, during the first months of 1999 the Romanian authorities came up with an anti-crisis programme[78] and progress was made in negotiations with the IMF on a new standby credit. In turn, the World Bank approved in June a $325 million programme aimed at fostering the development of the private sector. However, during this period the leu came under heavy pressure and between December

[78] The new programme envisages a strengthening of financial and fiscal discipline, the rehabilitation of the banking system, and stepping up the pace of privatization and restructuring of industrial enterprises. *Romanian Business Journal*, No. 15 (Bucharest), 16-22 April 1999.

TABLE 2.3.4

Retail trade in the ECE transition economies, 1997-1999
(Percentage change over same period of previous year)

	1997	1998 Jan.-Mar.	1998 Jan.-Jun.	1998 Jan.-Sept.	1998 Jan.-Dec.	1999 Jan.-Mar.
Bulgaria	-39.3	6.3	8.8	5.9	5.1	-4.6
Croatia	14.9	2.4	3.2	1.7	-0.6	-7.1
Czech Republic	-2.0	-4.3	-5.8	-6.0	-6.6	1.7
Hungary	-2.1	7.3	8.7	9.8	10.6	3.8
Poland	6.8	13.2	14.3	14.3	12.9	10.8
Romania	-12.1	-3.0	6.2	5.6	4.1	4.6
Slovakia	4.6	7.3	9.6	9.1	8.2	6.6
Slovenia	5.4	3.2	–	1.4	1.9	-6.0
The former Yugoslav Republic of Macedonia	4.3	5.2	3.3	3.5	3.2	21.1
Yugoslavia	9.0	22.0	18.8	9.3	2.7	..
Estonia	8.0	1.0	–	-2.1	-4.6	5.5
Latvia	18.6	21.5	25.4	24.8	21.8	19.9
Lithuania	12.9	23.6	20.4	16.9	11.1	-3.2
Armenia	5.2	2.1	8.3	5.2	6.1	12.7
Azerbaijan	14.9	12.0	13.0	9.7	9.1	14.8
Belarus	17.9	44.0	41.0	39.0	21.0	-3.9
Georgia	27.5	20.1	15.1	13.2	11.7	-8.4
Kazakhstan	29.3	31.0	23.0	20.0	18.0	7.2
Kyrgyzstan	8.8	12.4	9.3	8.6	8.4	1.6
Republic of Moldova [a]	-3.5	-13.0	-10.0	-8.0	-13.0	-25.0
Russian Federation	2.3	-0.6	-1.1	-0.7	-4.4	-15.8
Tajikistan	9.0	-35.6	-26.3	-9.3	8.2	49.4
Turkmenistan	13.7	9.0	..	..	..	23.0
Ukraine	0.2	0.4	0.4	-3.1	-4.5	-8.5
Uzbekistan	12.6	17.1	12.1	13.1	14.0	12.9

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

Note: Retail trade covers mainly goods in eastern Europe, the Baltic states and the Russian Federation (since 1998); goods and catering in other CIS countries. The coverage in 1997 and 1998, based on current reporting, may differ from the coverage in the annual statistics.

a Registered enterprises.

1998 and June 1999 it had lost almost half of its value vis-à-vis the dollar. This is likely to result in a renewed upsurge of inflation while private domestic demand (which was recovering in the first quarter of 1999 – table 2.3.4) is likely to be curbed yet again.

The preliminary and scanty data for output and demand in the first quarter of 1999 (tables 2.3.3 and 2.3.4) basically reflect the economic situation prior to the outbreak of the Kosovo conflict. As regards industrial output in the first quarter of the year, these data indicate a continuing sharp fall in Bulgaria and Romania and a reversal of the dynamics of industrial production in Croatia and The former Yugoslav Republic of Macedonia from positive to negative (which was rather dramatic in the latter case). In Albania and in Bosnia and Herzegovina, quarterly industrial output was reportedly growing in the first quarter of the year, but in both countries the weight of this sector in the economy is relatively small.

The *Baltic states* were among the worst affected by the Russian crisis. Indeed, the actual deterioration in output in the aftermath of the crisis has exceeded even the most pessimistic expectations. Economic activity began to weaken already in the second half of 1998 (in Estonia and Latvia industrial output was falling already in the third quarter of 1998) and became even more pronounced in the first quarter of 1999. In Estonia the preliminary estimates indicate that quarterly GDP fell by almost 6 per cent year-on-year (table 2.3.3), and recessionary trends were also observable in Latvia and Lithuania. In all three countries quarterly industrial output declined very steeply – in Estonia and Latvia at double-digit rates (table 2.3.3).

At present the *Russian economy* is in a rather precarious state after the major financial collapse that occurred in 1998. The crisis culminated in August, when the persistent loss of investor confidence led to a massive outflow of capital from Russia, to the collapse of the exchange rate regime, and default on domestic public debt.[79] After the Bank of Russia allowed the rouble to float in August 1998, its exchange rate fell sharply from some 6.2 roubles per dollar to 16.1 by the end of September. Although the rate of depreciation slowed thereafter, the nominal exchange rate was nearly 21 roubles per dollar at the end of 1998 and around 24.5 roubles per dollar in mid-June 1999.

Since the August financial collapse, Russian economic performance has been mixed. In the second half of the year, and especially in the fourth quarter, domestic demand started to weaken significantly as real incomes fell sharply as a result of the upsurge in inflation which followed the collapse of the currency. At the same time, some local producers apparently benefited from the devaluation: exporters gained in competitiveness while some domestic sales picked up thanks to devaluation-induced import substitution.[80] The increase in the price of oil (a major Russian export product) since the beginning of 1999 has also had a favourable effect on Russian economic performance. The combination of these factors produced a deceleration in the rate of decline of industrial output already in the fourth quarter of 1998. In the first quarter of 1999 this decline was arrested and in March-April modest year-on-year growth of monthly industrial output resumed (although the rate of growth of quarterly industrial output remained negative – table 2.3.3). Nevertheless, overall economic activity remained weak with GDP declining by 3.7 per cent in the first quarter of 1999 (table 2.3.3).

[79] For details see UN/ECE, *Economic Survey of Europe, 1998 No. 3*, pp. 31-41.

[80] However, as discussed later, import substitution was selective due to the generally low supply responsiveness of local producers and the subsequent adjustments in domestic prices.

Private domestic demand in Russia remained extremely subdued in the first months of 1999: the quarterly volume of retail trade in the first quarter fell by almost 16 per cent (table 2.3.4). The main factor behind this development was the considerable erosion of real incomes after the August financial crash.[81] With no signs of reversal, the crisis is likely to have a long-lasting negative impact on the level of real incomes in Russia.

The Russian crisis caused a considerable deterioration in the economic performance of most of the *CIS countries.* On average, economic activity in the CIS continued to weaken in the first quarter of 1999: in all countries except Turkmenistan, rates of GDP growth in the first quarter were lower than the annual rates in 1998 (table 2.3.3). In addition to Russia, aggregate output also declined in the first quarter in Kazakhstan, Ukraine and most probably in the Republic of Moldova as well. Poor export performance, and in particular, an abrupt fall in the intra-CIS exports of many CIS countries (of which Russia accounts for a significant share) appears to have been one of the main factors behind this negative outcome (table 2.3.8). Apart from the direct impact of depressed Russian import demand, output and exports in many CIS countries were hit by the continuing weakness of some commodity prices which in turn lowered their export revenues.

Although earlier forecasts did suggest a continuing recession in Ukraine, the actual downturn in the first months of 1999 (quarterly GDP declined year-on-year by 4.8 per cent – table 2.3.3) was unexpectedly strong. Ukraine's exports were strongly affected both by the negative external factors mentioned above and its chronic failure to diversify its export markets. The tight monetary policy maintained by Ukraine's central bank since mid-1998 in support of the hryvna (which despite the September devaluation continued to be under pressure) was another factor depressing domestic economic activity.[82] For a while there was a serious risk that Ukraine would default on its foreign debt which would have had catastrophic consequences for the country's economic prospects, which currently are not very bright anyway. However, the May decision by the IMF to increase Ukraine's current three-year Extended Fund Facility by some $366 million has provided vital balance of payments support and will alleviate the current payments problem.

Kazakhstan, another large CIS economy, has also been in serious economic difficulty in early 1999. The tenge (as well as other CIS currencies) had been under strong pressure ever since the collapse of the rouble in August 1998. While in the aftermath of the rouble devaluation other countries chose to allow their currencies to depreciate in parallel (in order to maintain their competitive position vis-à-vis Russia), the Kazakh authorities tried to prevent a major devaluation. The central bank was therefore forced to intervene repeatedly on the foreign exchange market in support of the tenge but, faced with a significant loss of reserves, the bank was forced to abandon its interventions in April and the tenge was allowed to float freely. Within two months, the national currency lost some 50 per cent of its value vis-à-vis the dollar.[83] The size of this depreciation indicates the extent to which the tenge was overvalued in the months preceding the collapse of the exchange rate and the negative effect it was likely to have been having on economic activity. Indeed both GDP and industrial output had fallen significantly in the first quarter of 1999 (by 3.6 and 4.1 per cent, respectively – table 2.3.3).

In the first months of 1999 there was a noticeable recovery of economic activity in Turkmenistan (both in terms of GDP and of industrial output – table 2.3.3).[84] The main factors that contributed to this development were the resumption of gas deliveries to Ukraine and other CIS countries and the increased extraction and export of oil.[85] However, the high rates of growth in early 1999 largely reflect the return to previous output levels and are most likely to be a one-time phenomenon.

The economic situation in most of the other CIS countries remains difficult despite positive rates of GDP growth in some cases. The weakening of economic activity in this region is highlighted by the poor performance of industry in the first quarter of 1999: industrial production was growing in only five of the 12 CIS states (table 2.3.3). Many of them (Armenia, Azerbaijan, Georgia, Kyrgyzstan and the Republic of Moldova, among others) face serious balance of payments problems and rely heavily on external official assistance; meeting IMF conditionality will be crucial for maintaining an uninterrupted flow of finance and preventing the emergence of payments crises.

(ii) Inflation

Rates of inflation continued to fall in most transition economies in early 1999 (table 2.3.5).[86] As in

[81] According to Goskomstat estimates, average real wages (due) in April 1999 were 39 per cent lower than their level in April 1998. Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii* (Moscow), January-April 1999, p. 261.

[82] In the second quarter the central bank started to reduce gradually its refinancing rate, but real interest rates nevertheless remained highly positive.

[83] Before allowing the tenge to float on 5 April, it traded at 88.3 to the dollar; towards end May the exchange rate had fallen to 131 to the dollar. *RFE/RL*, "Newsline", Part I, 28 May 1999.

[84] At the beginning of 1999, after a break of almost two years, Turkmenistan resumed publication of official statistics on current economic performance.

[85] For details see subsection (iv) below.

[86] The official statistical data in this report refer to January-April 1999; however, other information, mainly from national and international press, cover the period to mid-June.

TABLE 2.3.5

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

	Annual average, all items		*December over previous December*		*April over previous December*		*April over previous April*	
	1997	*1998*	*1997*	*1998*	*1998*	*1999*	*1998*	*1999*
Albania	33.1	20.3	42.0	7.8	8.3	–	28.0	-0.4
Bosnia and Herzegovina	11.8	4.9	12.2	2.2	3.6	0.5	8.5	-0.9
Bulgaria	1 082.6	22.2	578.7	0.9	3.7	-0.3	28.4	-3.0
Croatia [a]	3.7	5.9	4.0	5.6	3.3	1.4	6.1	3.6
Czech Republic	8.4	10.6	9.9	6.7	5.0	0.9	13.0	2.5
Hungary	18.4	14.2	18.4	10.4	7.2	6.2	15.9	9.4
Poland	15.1	11.7	13.2	8.5	6.2	4.1	13.5	6.3
Romania	154.9	59.3	151.7	40.7	19.9	18.2	59.9	38.8
Slovakia	6.2	6.7	6.5	5.5	3.2	4.7	7.2	7.0
Slovenia	8.4	7.9	8.8	6.6	4.0	2.0	9.1	4.6
The former Yugoslav Republic of Macedonia [a]	3.6	1.0	4.5	-1.0	-0.7	-2.9	2.9	-3.2
Yugoslavia	23.2	30.4	10.3	45.7	13.8	..	20.4	..
Estonia	11.1	10.6	12.3	6.8	5.3	2.2	12.5	3.7
Latvia	8.5	4.7	7.0	2.8	2.5	1.3	6.1	1.6
Lithuania	8.8	5.1	8.5	2.4	2.4	0.8	7.0	0.8
Armenia	13.8	8.7	21.8	-1.2	6.1	3.8	20.5	-3.4
Azerbaijan	3.6	-0.8	0.3	-7.6	2.8	-0.7	-1.3	-10.8
Belarus	63.9	73.2	63.4	181.6	14.9	59.6	45.7	291.3
Georgia	6.9	3.6	7.3	10.8	2.3	11.2	5.6	20.4
Kazakhstan	17.4	7.3	11.3	1.9	4.2	5.1	9.9	2.8
Kyrgyzstan	25.5	12.1	14.7	18.3	5.7	13.8	10.4	27.4
Republic of Moldova	11.8	7.7	11.1	18.2	2.3	9.8	8.0	26.8
Russian Federation	14.7	27.8	11.0	84.5	3.4	19.6	8.0	113.3
Tajikistan	85.4	43.1	159.9	2.7	5.7	14.4	103.4	11.2
Turkmenistan	83.7	16.8	21.5	19.8	11.6	13.1	18.7	21.5
Ukraine	15.9	10.6	10.1	20.0	3.0	5.9	8.7	23.4
Uzbekistan	73.2	..	27.5	..	..	..	..	..

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

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

1998, the deceleration was widespread and rapid. In early 1999, however, the slowdown was mainly the result of a further weakening of domestic pressures while in 1998 external factors also played a role and probably the more important one. Given the intensified competition for export markets, the general weakness in import unit values for manufactured goods in dollar terms probably continued also in early 1999; however, international commodity prices (also in dollars) in April 1999 were nearly one fifth above their levels in December 1998, reflecting mainly the sharp recovery in crude oil prices.[87] Given the appreciation of the dollar vis-à-vis most currencies, including those of the transition economies, during the same period, the favourable downward effect of import prices on the overall inflation rate was in general less significant in early 1999 than in 1998. However, in many of these economies, this was largely offset by the further weakening of domestic demand, although the extent and reasons for it varied considerably among the various economies.

Among the *east European countries*, consumer price inflation in early 1999 accelerated only in Slovakia,[88] mainly because of numerous adjustments in utility prices which took effect at the start of the year as part of the new government's economic programme.[89] In fact, despite the koruna's sizeable depreciation after being left to float in October 1998, industrial producer prices remained more or less stable during January-April 1999 as export demand fell and the measures taken after the November elections to tighten domestic demand started to bite.[90] However, given the foreseen

[87] Crude oil prices, in dollars, rose by nearly 50 per cent during the January-April 1999 period after falling by some 40 per cent over the 12 months to December 1998. Hamburg Institute for Economic Research (HWWA), direct communication. Also see section 2.1 above.

[88] Inflation has probably accelerated also in Yugoslavia, but no data for 1999 were available at the time of writing this *Survey*.

[89] In January the CPI jumped by 3 percentage points reflecting an average 20 per cent increase in heating, drinking water, sewage and electricity prices.

[90] Although retail sales remained relatively strong in the first quarter (table 2.3.4), for the rest of the year private consumption is expected to weaken due to sharply rising unemployment and declining real wages.

increases in the floor rate of VAT (from 6 per cent to 10 per cent on 1 July), the reintroduction of an import surcharge (7 per cent on 1 June), further various large utility prices and rent increases (70 per cent on 1 July), the consumer price index is expected to climb further during the rest of 1999. The government expects the annual average inflation rate to reach 10 per cent in 1999, more than 3 percentage points above the 1998 rate.

In the Czech Republic, where the total output continues to decline and unemployment to soar, consumer price increases remained remarkably low, at a 0.2 per cent average monthly rate during the first four months of 1999, despite increases in regulated and fuel prices. In Hungary, inflation continued to fall faster than expected, amid signs of some slowdown in the rate of economic growth. The official target of 9 per cent (annual average) is likely to be achieved unless the rate of change in unit labour costs accelerates in the remaining months of 1999. In Poland too, the inflation rate fell further despite the usual New Year excise tax increases, higher petrol prices for consumers after February, and the weakness of the zloty at the beginning of the year. There are still some more administrative price increases to come in 1999[91] and the indirect effects of higher fuel prices are still to work their way through to the rest of the economy. Nevertheless, the official inflation target of 8 per cent is considered to be in reach, particularly if food prices remain weak and the recent pick-up in industrial productivity continues during the rest of the year. Consumer price inflation also fell significantly during early 1999 in Slovenia and Croatia mainly due to much weaker household expenditure.[92]

In Bulgaria, consumer prices were actually falling in the first months of 1999 reflecting the seriously depressed state of domestic demand. Weak consumer demand also led to near price stability in Albania and Bosnia and Herzegovina. In Romania, inflation decelerated but remained high in early 1999, partly reflecting the pressure on the leu and increases in public service prices and excise taxes. At the same time, real wages are declining and unemployment is rising sharply, but it remains to be seen whether during the rest of 1999 these factors counterbalance the effect of the ongoing depreciation of the currency. Disinflation continued for the sixth consecutive year in the Baltic states, mainly under the influence of the fixed exchange rate systems, although in Lithuania the collapse of private consumption was another factor behind the near zero inflation rate.

In contrast to eastern Europe and the Baltic states, inflation rates accelerated in most of the CIS countries after the Russian rouble crisis and the consequent large depreciations of other currencies in the region during the second half of 1998. However, given the collapse of real wages, rising joblessness and, consequently, a seriously depressed domestic demand, inflation rates have slowed down over the first four months of 1999 in some of these countries. In Russia, the monthly inflation rate fell from 8.5 per cent in January to 2.2 per cent in May, and the relative changes in most of the other CIS economies were similar. Inflation in early 1999 was very high in Belarus; following the depreciation of the tenge, it may also be expected that inflation will accelerate in the course of the year in Kazakhstan as well.

(iii) Unemployment

As a result of the general economic slowdown and the Russian crisis, unemployment started to increase in most transition economies in the second half of 1998. In some of them, where the external demand shock was amplified by deepening internal problems, there was an unexpectedly sharp upsurge in the rate of joblessness in the fourth quarter of the year. This unfavourable trend continued in the first months of 1999 and in March eight countries (Croatia, the Czech Republic, Latvia, Lithuania, Romania, Russia, Slovakia and Yugoslavia) reported their highest unemployment rates since the transition started in 1989. The total number of people registered as unemployed in the transition economies as a whole, reached 20 million people at the end of March (some 7.6 million in eastern Europe and the Baltic states and 12.4 million in the CIS countries), the highest level since records began in the early 1990s. In eastern Europe and the CIS the number of unemployed grew by some 14 and 22 per cent, respectively, in the 12 months to March 1998. The largest increase (25 per cent) during this period was in the Baltic states, reflecting in the main their greater trade and financial exposure to the Russian market which led to a greater and more extended deterioration in their output performance since mid-1998.

In eastern Europe, the already high rates of unemployment increased further in the first months of 1999 and in March averaged 14 per cent (only slightly below its previous peak in March 1994), with most countries falling within a range of between some 10 per cent (Hungary) and 19 per cent (Croatia) (table 2.3.6). In the 12 months to March 1998, unemployment rates declined slightly only in Bulgaria[93]

[91] In 1999, there were fewer administrative price increases than usual at the beginning of the year.

[92] Retail trade fell by 6 per cent year-on-year in Slovenia and 8.5 per cent in Croatia in the first quarter of 1999 (table 2.3.4).

[93] The unemployment rate in Bulgaria declined steadily during 1998, from a peak of 14.3 per cent in February, reflecting mainly a smaller than expected number of layoffs in the state sector (as the closure of the largest loss-making enterprises – envisaged by the programme agreed upon with the IMF – was delayed) and a larger number of job offers from small and medium businesses in the private sector. However, since October, unemployment started to rise again and April 1999 was the seventh consecutive month of increasing unemployment rate.

TABLE 2.3.6

Registered unemployment in the ECE transition economies, 1998-1999

(Per cent of labour force)

	1998		1999	
	March	December	March	April
Eastern Europe	12.3	12.6	14.0*	..
Albania	15.9	17.6	17.8	..
Bosnia and Herzegovina [a]	39.0	38.5	39.2	..
Bulgaria	13.7	12.2	13.2	13.3
Croatia	18.1	18.6	19.1	19.2
Czech Republic	5.5	7.5	8.4	8.2
Hungary	10.3	9.1	10.4	10.0
Poland	10.4	10.4	12.1	11.8
Romania	9.6	10.3	12.0	11.8
Slovakia	13.4	15.6	16.7	16.4
Slovenia	14.7	14.6	14.1	..
The former Yugoslav Republic of Macedonia	..	..	..	..
Yugoslavia [b]	26.5	27.2	28.8[c]	..
Baltic states	6.9	7.3	8.7	..
Estonia [d]	5.2	5.1	6.8*	..
Latvia	7.1	9.2	10.1	10.2
Lithuania	7.5	6.9	8.5	8.1
CIS	8.0	9.0	9.5	..
Armenia	9.6	8.9	10.4	..
Azerbaijan	1.4	1.4	1.4	..
Belarus	2.6	2.3	2.3	..
Georgia	5.4	4.2	4.3	..
Kazakhstan	4.0	3.7	3.6	..
Kyrgyzstan	3.7	3.1	3.1	..
Republic of Moldova	2.3	1.9	2.4	..
Russian Federation [e]	11.7	13.3	14.1	14.2
Tajikistan	2.9	2.9	3.1	..
Turkmenistan	..	..	..	..
Ukraine	3.3	4.3	4.0	..
Uzbekistan	0.4	0.4	0.6	..
Memorandum items:				
CETE-5	10.0	10.2	11.7	..
SETE-7	14.6	15.4	16.1	..
Russian Federation [f]	2.6	2.7	2.7	2.5

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

[a] The data reported by the statistical office of the Federation do not cover the area of Republika Srpska.

[b] Unemployment rates may be biased upwards as the reported employment data for the sector of agriculture cover only the public sector.

[c] February.

[d] Job seekers.

[e] Based on monthly Russian Federation Goskomstat estimates according to the ILO definition, i.e. including all persons not having employment but actively seeking and available for work. The figures have been seriously revised in line with the results of Goskomstat's February 1999 labour force survey.

[f] Registered unemployment.

and Slovenia,[94] whereas in Hungary strong output growth continued to generate a relatively strong demand for labour despite the continued fast pace of enterprise restructuring and, consequently, the rate of unemployment remained broadly unchanged. In the other countries of the region, the rate of unemployment increased markedly, in most cases by two to three percentage points, reflecting already weak economic situations which have been further aggravated by the ongoing Russian crisis, the Kosovo conflict, and intensified restructuring in some of them.

The outlook for the labour markets in eastern Europe in 1999 remains rather bleak. Among the central European transition economies a further small decline in unemployment can probably be expected only in Hungary (where the economy will probably continue to grow strongly in 1999) and, perhaps, in Slovenia. In the Czech Republic, the main causes of rising unemployment – economic recession and intensified restructuring in industry – are likely to continue in 1999, and unemployment is expected to exceed 10 per cent by the end of the year.[95] In Poland, despite the signs of a revival of economic activity since March, the budget forecast of an unemployment rate of 9.4 per cent by the end of 1999 may still be optimistic given the current rate of 11.8 per cent and the continuing programme of enterprise restructuring. Indeed, according to a recent forecast by the Ministry of Economics, unemployment could still be at 11.5 per cent at the end of 1999.[96] An increase is also likely during 1999 in Slovakia, where the March unemployment rate of 16.7 per cent, an all-time high, was already above the 16 per cent target set by the government for the end of the year, and the economy is expected to be going through a much delayed macroeconomic adjustment in the months to come. The prospects for the south-east European countries now look very poor given the considerable deterioration of the economic situation in most of them since the second half of 1998 and the likely consequences of the Kosovo conflict.

As a result of the continued weakening of economic activity, mainly due to the effect of the Russian crisis, unemployment has grown considerably in the *Baltic states*. In Estonia, the unemployment rate in March 1999 was some 7 per cent, while in Lithuania it reached a record 8.5 per cent. The largest increase was in Latvia, where the rate climbed to more than 10 per cent in March and continued to increase in April in contrast to the usual seasonal fall. Since the Russian crisis will probably result in a long-lasting downward shift in

[94] Slovenia, being a relatively sheltered transition economy, was not much affected by the Russian crisis. Among all the east European and Baltic countries, exports in the first quarter of 1999 compared to the same period in 1998 increased only in Hungary and did not fall in Slovenia.

[95] In the first quarter of 1999, compared with the same period in 1998, industrial output fell by more than 9 per cent. Although the output decline has been slowing recently, and retail sales are recovering, restructuring at the enterprise level is expected to continue and probably more vigorously. The 0.2 percentage point decline in the unemployment rate in April may not therefore be indicative of a reversal of the negative trend in the short run and can probably be explained by seasonal factors, such as inventory rebuilding after the Easter period.

[96] *Rzeczpospolita* (Warsaw), 6 April 1999.

Russian import demand, even if there is no further deterioration in output, the rates of unemployment in the Baltic states are unlikely to return to their pre-crisis levels (around 5-7 per cent) in the short run.[97]

In the *CIS countries*, official unemployment rates were still very low in March 1999, varying between 0.6 per cent (Uzbekistan) and 4.3 per cent (Georgia), the main exception being Armenia (more than 10 per cent). These low rates of registered unemployment, despite the steep decline in output,[98] reflect on the one hand the excess employment still prevailing in many, particularly large, enterprises, and on the other, the omission from the *registered* unemployment statistics of a large part of the jobless who are willing to work but, for various reasons, do not register. In Russia, for example, the registered rate is virtually meaningless. Indeed, during the 12 months to April 1999, open unemployment computed on the basis of the ILO definition increased from 11.7 to 14.2 per cent, exceeding the east European average, while the registered unemployment rate, which accounted for less than 20 per cent of the ILO measure, even declined slightly (box 2.3.1). Given the state of most of the other CIS economies, it would not be unreasonable to assume that in the first quarter of 1999 their actual unemployment rates increased further and have probably reached levels similar to or even worse than those in Russia.

(iv) Trade

(a) Eastern Europe and the Baltic states

In the first three months of 1999, there was a fall in the value of exports from eastern Europe and the Baltic economies (table 2.3.7). The virtual paralysis of the CIS market, the weakening of intraregional demand, the increasingly more competitive conditions in western import demand and the effect of lower international prices were the main factors behind the fall of some 4 per cent in the dollar value of their exports.

Although the value of total exports had grown by 9 per in 1998 as a whole,[99] in the course of the year the rate of increase was decelerating in many countries in the region and in the later months their value was in fact starting to fall in several of them. The three Baltic states, Bulgaria and Poland[100] suffered badly from the collapse of the Russian market, whereas in the other east European economies, especially in those that had made more progress in the reform process, the negative effects from Russia were limited, at least to begin with, as their trade flows were by then mainly oriented towards the west.

However, the continuing paralysis of the CIS market in the early months of 1999 has hampered the region's exports as business confidence in this market has diminished and few new trade contracts, including those on a state-to-state basis, have been concluded. The indirect effects, especially for trade among the east European and Baltic countries, were also considerable with many individual countries attempting to strengthen protectionist measures and support the substitution of locally produced goods for imports. As a result, in January-March 1999, exports to Russia and to the rest of the CIS plunged by 50-70 per cent (as compared with the same period of 1998), while trade among the east European and Baltic states shrank by 10-15 per cent in value. The mutual trade of the Baltic states also fell, by some 14 per cent, and trade within CEFTA was greatly affected by a marked slump in trade between the Czech Republic and Slovakia, which was down by 20-25 per cent in the first three months of the year.[101] Hungary's exports to CEFTA member countries also declined by 5 per cent, although Slovenia's increased by 6 per cent. However, Slovenia's exports to Croatia – its third most important export partner in 1998 – were down by 9 per cent in value.[102]

[97] When discussing unemployment in these countries it should be kept in mind that the official figures for persons registered as unemployed may underestimate the actual number unemployed. Unemployment rates derived in 1998 from labour force surveys based on the ILO definition of unemployment stood at 9.6 per cent in Estonia (June), 13.8 per cent in Latvia (November) and 12.6 per cent in Lithuania (November), whereas the registered rates were 4.3, 8.8 and 6.5 per cent, respectively.

[98] For example in the extreme case of the Republic of Moldova, industrial production fell by 27 per cent (year-on-year) in the first quarter of 1999 while the registered unemployment rate in March 1999 was only 2.4 per cent, broadly the same as in March 1998.

[99] In volume terms, exports increased even more markedly, by 11-13 per cent, placing the east European and Baltic regions first among the world's regions in respect of trade growth. East European and Baltic export prices fell 2-4 per cent in 1998, partly reflecting a higher valuation of the dollar as compared with 1997, but also weak world demand, especially in commodity markets. Prices of internationally traded manufactured goods also declined in 1998, although by less than those of primary commodities. This was in fact a common feature of global trade; according to the WTO, the average prices of global merchandise exports declined by 5.5 per cent in 1998. WTO, "World trade growth slower in 1998 after unusually strong growth in 1997", *Press Release*, Press/128, 16 April 1999.

[100] A certain ambiguity about Polish export performance in 1998 has arisen recently. In the introduction to the Polish Central Statistical Office's bulletin (GUS, *External Trade, January-December 1998* (Warsaw), 1999), it is reported that the dollar value of exports increased by 9.6 per cent in 1998, while in fact it only grew by 2.6 per cent (see the above mentioned bulletin, p. 2, row b, in a panel of indices of value in United States dollars). The higher growth rate is based in fact on the comparison of two methodologically different data sets: as of 1 January 1998 a modification of the rules for customs declarations was introduced that allowed a much wider and probably more accurate statistical coverage of export transactions. Exports valued according to the new reporting rules amounted to $28,229 million, whereas based on the previous system, they came to only $26,422 million. In the absence of revised 1997 data, this difference in fact constitutes a serious break in the reported Polish foreign trade series.

[101] This collapse of trade between the Czech Republic and Slovakia was mainly due to a severe contraction of aggregate demand in the latter country, while a weakening of the Czech koruna probably affected price-sensitive imports from Slovakia.

[102] One of the major reasons for this was the fact that Slovenia's exports of electricity to Croatia have been cut since the end of July 1998; but also the kuna's depreciation (by 5.2 per cent in nominal terms) made Slovene goods less competitive on Croatia's market. Institute of Macroeconomic Analysis and Development, *Slovenian Economic Mirror* (Ljubljana), May 1999.

BOX 2.3.1

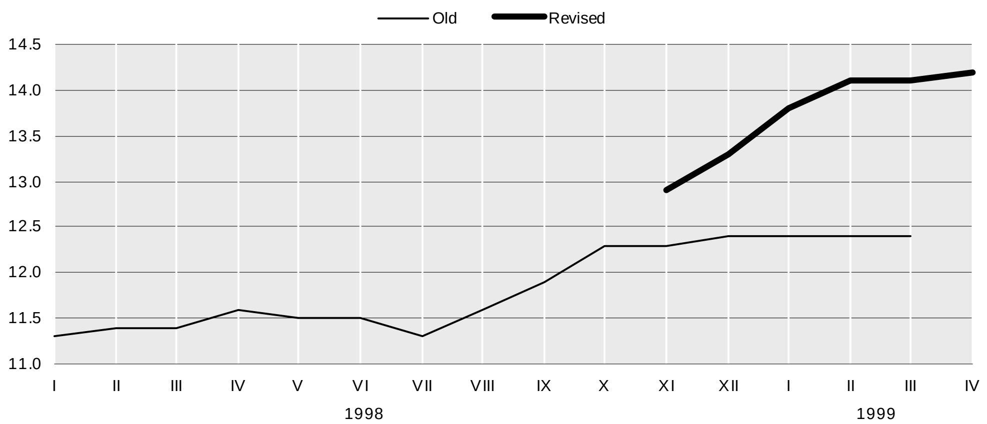
Goskomstat revision of Russian unemployment

In May 1999, the Russian State Statistical Committee (Goskomstat) published further revisions to the series for Russian monthly unemployment – known as "unemployment according to the ILO methodology".[1] The need for another revision to the series arose from the initial results of Goskomstat's February 1999 labour force survey (the previous survey having been conducted in October 1998). The table and the chart below show the old Goskomstat series and the new figures for the period covered by the latest revision, November 1998 to March 1999. As can be seen clearly in the chart, the movement of the two series diverges strikingly after October 1998, with a steadily increasing gap between the old and revised figures. The magnitude of the change is shown by the revision for February 1999, from 12.4 per cent of the labour force to 14.1 per cent.

Russian unemployment: old and revised data for 1998-1999
(Per cent of labour force)

	January	*February*	*March*	*April*	*May*	*June*	*July*	*August*	*September*	*October*	*November*	*December*
1998												
Old data	11.3	11.4	11.4	11.6	11.5	11.5	11.3	11.6	11.9	12.3	12.3	12.4
Revised data											12.9	13.3
1999												
Old data	12.4	12.4	12.4									
Revised data	13.8	14.1	14.1	14.2								
Memorandum item:												
Registered unemployment rate												
1998	2.8	2.8	2.7	2.6	2.5	2.5	2.4	2.4	2.4	2.5	2.6	2.7
1999	2.7	2.7	2.7	2.5								

Russian unemployment, 1998-1999
(Per cent of labour force)



Source: Russian Federation Goskomstat and direct communications to UN/ECE secretariat.

As pointed out earlier,[2] the rise in unemployment suggested by the old series was unexpectedly small given the deep economic recession that followed the financial collapse in August 1998. According to the old series, the unemployment rate in March 1999 was only 0.7 percentage points higher than a year earlier, and 1.1 percentage points above the pre-crisis month of July 1998. The increases of 2.4 and 2.8 percentage points, respectively, in the revised figures, seem to be more realistic given the evolution of the Russian economy.

It should be borne in mind that the Russian monthly "ILO" unemployment data are in fact estimates of what the measure of unemployment would have been had a survey been conducted at that point in time.[3] This means that the unemployment figures starting from March are also estimates, the reliability of which will be known only after the results of the actual labour force survey conducted in May are available.

[1] Direct communication to UN/ECE secretariat. For a more detailed discussion of the content and some of the specific features of the Russian monthly "ILO" series see UN/ECE, *Economic Survey of Europe, 1998 No. 3,* pp. 68-69. The discussion there refers to the revisions published by Goskomstat in June 1998.

[2] UN/ECE, *Economic Survey of Europe, 1999 No. 1,* p. 132.

[3] In 1999, Goskomstat started conducting quarterly labour force surveys in February, May, August and November.

TABLE 2.3.7

Trade performance and trade balances of the ECE transition economies, 1998-1999
(Growth rates in per cent, values in billion dollars)

	Export growth		Import growth		Trade balances		
	1998	1999 QI	1998	1999 QI	1998	1998 QI	1999 QI
Eastern Europe	9.4	-3.2	8.9	-3.3	-40.1	-8.0	-7.6
Albania	46.2	..	28.2	..	-0.6	..	..
Bosnia and Herzegovina [a]	134.5	-1.3	30.2	-22.3	-1.6	-0.2	-0.2
Bulgaria	-13.1	-24.1	1.3	-11.1	-0.7	-0.2	-0.2
Croatia	8.9	-11.1	-7.9	-13.7	-3.8	-0.8	-0.7
Czech Republic	15.7	-1.2	4.6	0.5	-2.5	-0.4	-0.6
Hungary	20.4	8.4	21.0	9.4	-2.7	-0.6	-0.7
Poland [b]	2.6	-8.2	10.9	-6.5	-18.8	-4.3	-4.1
Romania	-1.6	-9.0	4.8	-8.1	-3.5	-0.6	-0.6
Slovakia	10.7	-4.5	11.0	-9.6	-2.3	-0.5	-0.3
Slovenia	8.1	0.3	7.8	-2.7	-1.0	-0.3	-0.3
The former Yugoslav Republic of Macedonia	11.0	..	9.0	..	-0.6	..	..
Yugoslavia	6.8	..	0.5	..	-2.0	..	..
Baltic states	3.3	-16.6	7.3	-19.1	-5.0	-1.1	-0.8
Estonia	9.7	-11.4	7.1	-18.5	-1.5	-0.4	-0.2
Latvia	8.4	-7.2	17.1	-9.8	-1.4	-0.3	-0.2
Lithuania	-3.8	-25.3	2.7	-24.2	-2.1	-0.5	-0.4
CIS [c]	-15.3	-16.3	-14.0	-39.1	23.0	2.6	7.5
Armenia	-3.9	-9.0	0.4	-10.2	-0.7	-0.1	-0.1
Azerbaijan	-22.4	3.8	35.6	13.7	-0.5	-0.1	-0.1
Belarus	-3.9	-23.5	-2.1	-37.5	-1.5	-0.5	-0.1
Georgia	-20.8	-6.9	12.1	-44.0	-0.9	-0.2	-0.1
Kazakhstan	-17.8	-29.0	-1.4	-7.5	1.1	0.5	0.2
Kyrgyzstan	-14.9	-9.7	18.6	-23.3	-0.3	-0.1	–
Republic of Moldova	-27.7	-43.8	-12.6	-54.8	-0.4	-0.1	–
Russian Federation	-16.3	-15.4	-17.7	-48.2	28.5	4.1	8.1
Tajikistan	-19.3	0.7	2.8	-10.3	-0.2	-0.1	–
Turkmenistan	-20.9	184.5	-20.1	2.3	-0.4	-0.1	0.1
Ukraine	-11.2	-21.7	-14.3	-27.1	-2.0	-0.8	-0.4
Uzbekistan	-19.6	-10.1	-27.3	-16.4	0.2	0.1	0.1
Total above	-3.4	-9.9	0.3	-17.8	-21.1	-6.5	-0.9
Memorandum items:							
CETE-5	11.5	-1.3	11.0	-1.7	-27.3	-6.1	-5.9
SETE-7	1.0	-13.5	2.1	-11.1	-12.8	-1.8	-1.7

Source: National statistics. For CIS countries: CIS Statistical Committee, direct communication to the UN/ECE secretariat. UN/ECE secretariat estimates for Turkmenistan. *Uzbekistan Economic Trends*, direct communication to the UN/ECE secretariat.

Note: For country groupings see the note to table 2.3.1. Aggregate growth rates and trade balances for eastern Europe and SETE-7 in first quarter 1998 and 1999 do not include Albania, The former Yugoslav Republic of Macedonia and Yugoslavia.

a January-February instead of January-March.

b Trade balance for 1998 is derived from exports and imports based on the new methodology.

c Total CIS trade with CIS and non-CIS countries.

East European and Baltic exports continued to grow only in trade with the developed market economies, but the rise of some 7 per cent was less than half the rate in 1998. Within this aggregate there were larger increases (10 to 15 per cent) in Czech, Slovak and Hungarian exports to the EU, but below average changes (6 and 2 per cent) for Slovenia and Poland partly reflected greater competition from cheaper Asian goods.

Export volumes grew slightly more or declined less than values as export prices (in dollars) for many countries in the region continued to fall in the early months of 1999. Import prices, however, fell even more due mainly to weak world demand, particularly for primary commodities, although manufactured goods prices were also somewhat cheaper.[103]

[103] For instance, Polish and Slovene export dollar unit values declined on average by 4.5-5.2 per cent in January-March 1999 year-on-year. Czech average export unit values remained broadly flat, although those for manufactured goods (SITC 6 and 8) declined by 2-3.5 per cent. In Hungary, export unit values (in dollar terms) declined on average by 3.6 per cent and those for manufactured goods (SITC 5,6,8,9) by 2 per cent. For imports, dollar unit values shrank by a few percentage points more on average, with considerably larger declines for raw materials and fuels. Thus, for most of the east European and Baltic countries there was a further improvement in their terms of trade.

The total value of imports into the east European and Baltic countries fell by some 5 per cent in the first quarter of 1999, partly a result of the cooling down of aggregate demand in the area and lower global commodity prices. Increases in the cost of import credit and weaker domestic currencies in some countries, as well as recent administrative measures to increase protection against imports, have also played a role.[104]

For the first time since the transition started, imports into the three Baltic countries declined considerably in the first quarter (table 2.3.7 and appendix table B.11). There were also large falls in import values (10-14 per cent) in Bulgaria, Croatia and Slovakia, mainly because of severely constrained domestic demand but also domestic currency depreciation in the latter two. In most of the other countries imports also fell, although less notably; the main exception was Hungary where they grew rather strongly, by 9 per cent with above average increases coming from CEFTA and the EU. In all the other east European and Baltic countries only imports from the developed market economies continued to increase.

The improvements in the merchandise trade balances of most countries in the region in the first months of 1999 were predominantly caused by lower imports. However, in Hungary, the Czech Republic (where imports remained flat) and Bulgaria, trade deficits increased by some $60-$120 million in the first quarter of 1999 (table 2.3.7). In the same period, the aggregate east European and Baltic countries' deficit was $8.4 billion compared with $9.1 billion a year earlier. There was a particularly large fall in the region's merchandise trade deficit with the developed market economies (from $6.1 billion to $4.5 billion), but with the CIS the deficit increased substantially (from $0.7 billion to $1.6 billion) as the collapse of imports from the CIS was notably less severe than of exports to it.

As far as changes in the commodity pattern of trade are concerned, the impact of globally weaker demand for primary commodities and most intermediate goods (reflected in a further fall in their prices on international markets) seems to have been less important for the east European and Baltic trade than the collapse of the CIS market, in particular for exports of agricultural products, and a range of industrial and consumer goods. According to the data available at the moment of writing this *Survey*, the dollar value of the region's exports of food, beverages and tobacco (SITC 0 and 1) sank by 25-40 per cent (year-on-year) in the first quarter of 1999, leading to large falls in its share of total exports. In Estonia, for instance, the share of these products in total exports fell from 17 per cent a year earlier to 14 per cent in January-March 1999, in Hungary, from 11 to 7 per cent, and in the Czech Republic from 5 to 3 per cent.

In the Baltic states and in some south-east European countries exports of industrial goods also suffered considerably from the loss of the CIS market. In Lithuania, for instance, the value of exports of machinery and transport equipment (SITC 7) to the CIS fell by $75.5 million and by one third to all markets when compared with January-March 1998; in Bulgaria, too, exports from this sector fell by more than 30 per cent. In contrast, in the central European transition economies, this sector is widely engaged in the vertically integrated production processes of multinational companies and does not appear to have been affected by the Russian crisis, remaining in fact the major source of export earnings in most of them.

A recovery of east European and Baltic countries' trade is not very likely in the short run as external demand, especially in the west, seems to be flat, and within the region demand is weakening. The Kosovo conflict has added another major disturbance to foreign trade flows, as discussed in chapter 1, not only for the south-east European countries but for all the European transition economies. Following closely on the collapse of the CIS market, this new shock is likely to reinforce and prolong the negative effects on trade which were already observable before its outbreak.

(b) CIS countries

In the first quarter of 1999, the dollar value of *total merchandise exports* from the CIS countries fell by 16 per cent and *imports* by 39 per cent (table 2.3.7). All CIS countries' total exports declined, except from Azerbaijan and Tajikistan where they increased slightly, and Turkmenistan where they tripled due to a short-lived resumption of natural gas sales to Ukraine. Total imports also fell across the board, except in Azerbaijan and Turkmenistan. The CIS area's *merchandise trade* surplus showed a significant improvement over the first quarter of 1998, increasing from $2.6 billion to $7.5 billion, due to a very large surplus in Russia. The first quarter trade performance did not significantly differ from that in 1998 as a whole. The value of exports continued to be affected by lower commodity prices while imports fell even more than in 1998, reflecting the financial crisis in Russia, weaker national currencies, and falling GDP in Russia, Kazakhstan and Ukraine, the three largest economies of the CIS region.

As most CIS countries are largely dependent on commodity exports, the prices of crude oil, metal, gold and cotton are usually major determinants of their trade performance. In the first quarter of 1999, prices for these commodities were considerably lower than in the

[104] For some details on the attempts of individual east European and Baltic countries to increase import duties, impose quotas and other non-tariff barriers to trade in the beginning of 1999 see UN/ECE, *Economic Survey of Europe, 1999 No. 1*, sect. 3.6(ii), pp. 150-152.

corresponding period of 1998.[105] CIS ferrous metal shipments, in addition to weak global demand, continued to face anti-dumping actions across the world.[106] These lower prices could not be offset by increased volumes and so there were large falls in the export earnings of all CIS primary commodity exporters.

After the financial collapse of August 1998, Russia – the economic engine of the CIS region – is slowly recovering. As anticipated, the rouble devaluation has not had a substantial impact on Russia's *exports*, which are generally priced in dollars and constrained by transportation capacity. Exports to the non-CIS area have also been discouraged by the imposition of export duties on virtually all primary commodities. While they are ostensibly aimed at reducing the fiscal deficit and slowing capital flight, the duties also make the Russian trade regime more complex – thus, potentially, making economically undesirable rent-seeking activities more attractive.[107] The low level of Russian imports continued throughout the first quarter due to a much lower real value of the rouble and lower industrial output. The much-awaited import substitution has yet to emerge on a large scale.[108] While anecdotal evidence points to some relatively dynamic areas of import substitution, notably in a few consumer durable and non-durable goods sectors, many observers question the assertion that the weak industrial recovery from the trough of September 1998 is the result of import-substituting activities.[109] Moreover, as real wages have declined, domestic producers may be gaining market share while the total size of the Russian consumer market is shrinking. Nonetheless, the increase in domestic production might possibly become a foundation for lasting economic growth in Russia but it is still too soon to be confident about this.

The Russian financial crisis, in addition to inflicting heavy economic costs on Russia, continues to have a negative effect on the other CIS countries. In the first quarter of 1999, Russia's imports from CIS countries were down by 50 per cent, a reduction that has certainly contributed to the first quarter GDP contraction (year-on-year) in the largest CIS economies of Ukraine and Kazakhstan and flat GDP growth in Belarus. Improved export performance in many CIS countries crucially depends on the prospects for economic recovery in Russia, but in its present state Russian domestic demand is neither greatly responsive to cheaper domestic substitutes nor is it demanding imports from the CIS. In addition to the immediate reduction in the demand for CIS goods, the devaluation of the Russian rouble has forced CIS countries to devalue their own national currencies. Other than in Armenia and Azerbaijan, nominal dollar exchange rates have depreciated between August 1998 and March 1999, by between 10 per cent in Kazakhstan to 80 per cent in the official rate in Belarus.[110] Real exchange rates, in dollar and CPI terms, have also declined as in most cases the fall in nominal rates has outpaced the rate of inflation. In Armenia and Azerbaijan, the currencies have remained relatively strong in both nominal and real terms. In Armenia, the nominal rate has been relatively steady largely due to the approval of domestic economic policies by the international lending institutions. In Azerbaijan, a falling inflation rate and the continued interest of foreign investors in the country's oil and gas fields have contributed to the strength of the national currency. Considering the relatively strong domestic currencies of both countries, the large reductions in their exports to CIS markets may also partly reflect a loss of competitiveness.

In the trade policy area, CIS countries have continued to work on the framework governing their mutual trade relations in spite of (or perhaps because of) drastically curtailed intra-CIS trade.[111] Recent discussions on the creation of a CIS free trade zone did not produce an agreement as the member countries remained divided over the collection of value added taxes on goods crossing their borders.[112] The disagreements caused by conflicting economic

[105] While virtually all commodity prices began to recover in April 1999, in the first quarter of 1999 (year-on-year) crude oil, gasoline and heating oil prices were between 17 and 23 per cent lower. Prices of base metals such as copper, aluminium and nickel were down 15-18 per cent. Cotton prices were 19 per cent lower and the already low gold price was 3 per cent lower.

[106] New investigations, duties or minimum prices in the Philippines, Canada, Argentina and Venezuela in April and May have expanded the list of anti-dumping measures undertaken against Kazakh, Russian and Ukrainian steel products.

[107] The Russian government has further increased the number of goods subject to export duties (e.g. hardwood, seafood, alcohol, scrap metal, fertilizers and paper) and in some cases raised their rates (base metals).

[108] Many domestic producers raised prices after August 1998, effectively neutralizing any positive devaluation effects.

[109] See for example, "Rouble's crash helps to restock the Lada", *Financial Times*, 7 June 1999 and PlanEcon, "Russia – still far from growth", *Monthly Report*, 27 April 1999.

[110] The pressures for depreciation continued in the second quarter, particularly in Kazakhstan, which belatedly abandoned its intervention policy in April 1999, and Kyrgyzstan.

[111] The CIS Treaty on the Creation of a Free Trade Zone of 15 April 1994 envisages transitional free trade arrangements among CIS countries leading to the establishment of a customs union characterized by a unified customs and foreign economic policy toward third countries.

[112] Presently, CIS countries use different tax principles for intra-CIS and non-CIS destined trade. Under the "destination principle" – applied to trade with non-CIS countries – CIS exports are zero rated and imports are taxed. Under the "origin principle" – used by some CIS countries in intraregional trade – VAT is payable by domestic producers regardless whether the good is exported or not. Considering this duality, some CIS countries are gradually moving to the internationally accepted "destination principle" for their intra-CIS transactions. For example, in April 1999, Belarus signed bilateral agreements with Kazakhstan and the Republic of Moldova to switch from origin-based taxation to the destination principle.

objectives among the CIS countries were also evident in the regional trade tensions that have continued in central Asia.[113]

In the first quarter of 1999, the dollar value of Russia's and other CIS countries' *exports to non-CIS* countries fell by 8 per cent (table 2.3.8). The traditional commodity exporters such as Kazakhstan, Kyrgyzstan, Russia, Tajikistan, Ukraine and Uzbekistan registered export declines of between 3 and 15 per cent which largely reflected lower commodity prices. Their responses to lower commodity prices varied. Russia's exports of crude oil, natural gas, aluminium, coal and copper, in volume, increased between 1 and 17 per cent, while those of ferrous metal, iron ore and nickel declined.[114] Kyrgyzstan's non-CIS exports are dominated by gold from the Kumtor gold mine, which has continued to meet its production targets. In Tajikistan, falling export prices of two key exports, aluminium (down 6 per cent) and cotton (down 20 per cent), contributed to a flat export performance despite a 50 per cent increase in the volume of aluminium exported. In Uzbekistan, the recent poor cotton harvest was behind the 7 per cent fall in non-CIS exports. The remaining CIS countries (Armenia, Azerbaijan, Belarus, Georgia, the Republic of Moldova and Turkmenistan) registered considerably higher first quarter non-CIS exports. The increases ranged from 5 per cent in the Republic of Moldova to 82 per cent in Azerbaijan and were due to a variety of factors. Armenian exports to non-CIS countries were up one third, probably on the strength of jewellery and precious stone sales to western Europe and scrap metal to Iran. Azerbaijan's non-CIS exports increased by over 80 per cent, largely as a result of the new export pipeline and increased crude oil production. Turkmenistan's exports increased as a result of a doubling of crude oil extraction and a subsequent increase in exports of refined oil products.

The aggregate of CIS *imports from non-CIS* countries fell by 41 per cent. The decreases were between 3 per cent in Kyrgyzstan and 61 per cent in the Republic of Moldova with Russia's imports down by almost 50 per cent. The key factors explaining this fall are declining real exchange rates, falling industrial output and declines in retail trade in most CIS economies. Anecdotal evidence also suggests that CIS consumers have begun to substitute food, alcohol, tobacco and other locally produced non-durables for better quality, but relatively more expensive non-CIS imports. Finally, countries such as Belarus, the Republic of Moldova, Ukraine and Uzbekistan, have been forced to deal with balance of payments problems by reducing imports. The three countries that went against the general trend by increasing their non-CIS purchases were Azerbaijan, Tajikistan and Turkmenistan. Azerbaijan's non-CIS imports (mostly machinery and oil extraction equipment) are still rising, albeit at a slower rate due to spending cutbacks on oil exploration, the withdrawal of some oil companies from the country and the general slowdown in the development of new wells by foreign oil companies.

In the first quarter of 1999, the value of *intra-CIS trade* decreased by some 36 per cent (table 2.3.8). Exports and imports declined across the board, with the exception of a small increase in Tajikistan's exports and a fivefold increase in Turkmenistan's exports. The latter's exports were boosted by natural gas sales to Ukraine, after a two year period of being unable to access the Russian gas pipeline network, resulting in a tripling of natural gas output.[115] The dramatic overall decline in the mutual trade of the CIS is a result of the Russian financial crisis and, in some cases, supply-side difficulties. The Russian financial crisis and the subsequent contraction of import demand for consumption as well as industrial goods has affected all the CIS countries. Russian retail trade was 16 per cent lower than a year earlier while the country's machinery and equipment imports from the CIS region were halved in the first quarter of 1999. Armenia, Georgia and the Republic of Moldova were hit hardest by Russia's lower demand for food, beverages and tobacco products. In Armenia and Georgia, exports of brandy, mineral water and wine were down dramatically. Similarly, the Republic of Moldova's CIS exports fell by 62 per cent with much of this decline due to Russia's economic crisis. The country relies heavily on CIS exports of food, beverages and tobacco, which fell by almost two thirds. In the areas of machinery and intermediate inputs, Armenia, Belarus, the Republic of Moldova and Ukraine fared worst. As a result, the industrial output in Armenia was 4.4 per cent lower while in the Republic of Moldova it fell by 27 per cent. For Belarus, its CIS exports fell by over 40 per cent, reflecting the crisis in Russia, restrictions on trade in Belarussian roubles and higher transportation costs. Unable to sell its output, Belarus has increased barter trade to over 36 per cent of its total

[113] In April, Kazakhstan prohibited Kyrgyz and Uzbek cargo trains from crossing its territory until these countries pay their transit debt. Uzbekistan cut off Kyrgyzstan's natural gas supplies when the country failed to make in-kind payments on time. In return, Kyrgyzstan cut off water supplies to Kazakhstan after the country did not supply it with coal. Finally, Uzbekistan imposed duties of $300 per vehicle on Kazakhstan's cargo vehicles entering its territory and it also revised a list of imported commodities and their tax rates from Kazakhstan and Kyrgyzstan, which are subject to excise taxes ranging from 10 to 100 per cent.

[114] Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii* (Moscow), January-April 1999, p. 143.

[115] Ukraine suspended Turkmenistan's natural gas exports in May because of the country's admitted inability to pay mounting gas debt arrears.

TABLE 2.3.8

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

	Export growth		Import growth		Trade balances		
	1998	*1999QI*	*1998*	*1999QI*	*1998*	*1998QI*	*1999QI*
Armenia							
Non-CIS	3.3	31.2	13.7	-7.2	-532	-115	-96
CIS	-14.4	-49.5	-26.0	-17.4	-140	-30	-34
Azerbaijan							
Non-CIS	-7.2	82.4	51.7	28.8	-299	-59	-50
CIS	-38.6	-52.2	15.3	-7.0	-173	-10	-40
Belarus							
Non-CIS	-0.7	34.0	4.6	-29.3	-1 094	-359	-4
CIS	-5.1	-40.1	-5.3	-41.7	-399	-142	-62
Georgia							
Non-CIS	-17.4	23.9	12.7	-53.4	-592	-146	-56
CIS	-23.5	-28.6	11.3	-25.4	-274	-62	-47
Kazakhstan							
Non-CIS	-7.9	-15.1	13.8	-3.4	999	324	222
CIS	-29.6	-45.3	-14.2	-11.5	99	194	-54
Kyrgyzstan							
Non-CIS	-0.5	-10.8	46.5	-3.2	-118	2	-4
CIS	-27.8	-8.1	1.1	-37.7	-210	-54	-19
Republic of Moldova							
Non-CIS	-23.6	5.1	2.9	-61.3	-381	-114	-13
CIS	-29.5	-61.9	-27.2	-46.6	-11	-4	-22
Tajikistan							
Non-CIS	-16.7	-2.8	-1.3	16.7	129	38	26
CIS	-23.8	7.0	5.0	-20.4	-299	-98	-64
Turkmenistan							
Non-CIS	47.2	43.3	-9.5	35.4	-39	-23	-25
CIS	-66.3	446.2	-28.2	-21.3	-348	-108	127
Ukraine							
Non-CIS	-2.4	-11.4	-6.5	-38.1	1 657	501	853
CIS	-24.8	-41.0	-20.1	-20.1	-3 695	-1 319	-1 279
Uzbekistan							
Non-CIS	-9.3	-6.4	-27.1	-19.5	237	29	98
CIS	-39.2	-19.0	-27.8	-8.5	3	17	-9
Total above							
Non-CIS	-4.3	-4.1	-2.5	-25.6	-33	77	952
CIS	-22.3	-34.0	-14.6	-25.8	-5 446	-1 615	-1 502
Russian Federation							
Non-CIS	-15.8	-8.7	-16.7	-47.4	26 146	3 339	7 158
CIS	-18.4	-37.9	-20.5	-50.5	2 314	747	892
CIS total							
Non-CIS	-13.3	-7.7	-12.2	-41.3	26 113	3 416	8 110
CIS	-20.4	-36.0	-16.9	-35.4	-3 133	-868	-610

Source: CIS Statistical Committee, direct communication to the UN/ECE secretariat. UN/ECE secretariat estimates for Turkmenistan. *Uzbekistan Economic Trends*, direct communication to the UN/ECE secretariat.

foreign trade.[116] Kazakhstan's CIS exports fell by 45 per cent in the first quarter, its relatively strong national currency being an additional factor depressing the country's exports. After effectively devaluing the currency in April (it fell by 22 per cent in March), the government expects the new exchange rate policy to raise the competitiveness of Kazakh products in Russia and in other CIS markets. Similarly, Azerbaijan's CIS exports were affected by the relative appreciation of the domestic currency.

(v) Current account and financial developments

(a) Current account developments

Two economic shocks – faltering import growth in western Europe and the devaluation of the Russian rouble in August 1998 – have contributed to larger current account imbalances in many transition economies. This deterioration, which became apparent already in mid-1998, resulted in a current account deficit in eastern Europe of nearly $18 billion in 1998 or some 4.6 per cent of GDP (table 2.3.9). In the Baltic states, the growth of the already large deficits appears to have been reversed in Estonia and possibly checked in Lithuania, but in Latvia the imbalance has continued to mount. In general, the deficits would have been still larger but for falling commodities prices and unsettled capital markets. The fall of world commodity prices moved Russia's current account into deficit in the first half of 1998, but there was a surplus for the whole year ($2.4 billion)[117] due to the collapse of imports following the rouble devaluation. In Belarus, the Republic of Moldova, Romania, The former Yugoslav Republic of Macedonia and Ukraine, large exchange rate depreciations and reduced possibilities for foreign borrowing helped to curb the growth of current account imbalances although, with the exception of Ukraine, they increased nonetheless.

In early 1999, the transition economies have been facing increasing pressure on their balance of payments. Projections of west European economic growth had been steadily lowered and, although the currencies of several transition economies had depreciated, there were other signs of declining export competitiveness.[118] Moreover, borrowing prospects were uncertain, particularly for the higher credit risk countries, as a result of the continuing volatility in international financial markets. This situation underlines the growing importance of foreign direct investment (FDI), net inflows of which covered some 70 per cent of the current account deficits of eastern Europe and the Baltic states in 1998. However the continuation of these large inflows was also uncertain given excess global capacity in key industrial sectors, worsening prospects for economic activity, especially in the transition economies, and in the latter the possibility of further postponements of privatizations due to unfavourable market conditions.[119] This outlook for larger current account deficits, large debt servicing obligations (in several instances), and doubts about the size of foreign

[116] Belarus Ministry of Statistics and Analysis as quoted in BBC Monitoring, *Summary of World Broadcasts*, 3 June 1999.

[117] The current account moved into surplus in the third quarter of 1998, rising to over $6 billion in the fourth quarter.

[118] UN/ECE, *Economic Survey of Europe, 1999 No. 1*, pp. 174-175.

[119] Factors potentially affecting FDI flows in the wake of the Asian crisis have been discussed in recent issues of the *Survey*.

TABLE 2.3.9

Current account balances in selected ECE transition economies, 1997-1999
(Million dollars and percentage of GDP)

	Million dollars								Percentage of GDP	
			January-February		January-March		January-April			
	1997	1998	1998	1999	1998	1999	1998	1999	1997	1998
Eastern Europe [a]	-14 703	-17 557	..	..	..	..	..	..	-4.2	-4.6
Albania	-271	-187	..	..	..	..	..	..	-12.0	-6.4
Bosnia and Herzegovina [b]	-1 468	-1 580*	..	..	..	-411	..	..	-44.0	-38.5
Bulgaria	427	-252	-51	-234	-89	-234	..	..	4.2	-2.1
Croatia	-2 434	-1 554	..	..	-670	-490	..	..	-12.1	-7.3
Czech Republic	-3 211	-1 046	..	..	-349	-315	..	..	-6.2	-1.9
Hungary	-981	-2 298	-226	-239	-381	-598	-444	-763	-2.1	-4.8
Poland	-4 312	-6 858	-1 243	-1 382	-1 998	-2 226	-2 453	-3 144	-3.0	-4.3
Romania	-2 338	-3 010	-33	-192	-224	-277	..	..	-6.7	-7.9
Slovakia	-1 343	-2 059	-332	-147	..	..	..	..	-6.9	-10.1
Slovenia	37	-4	-47	44	-78	-15	-96	-140	0.2	–
The former Yugoslav Republic of Macedonia	-276	-289	-76	-35	-86	-49	..	..	-7.5	-8.2
Yugoslavia [c]	-1 317	-1 200*	..	..	..	..	..	..	-6.7	-4.6
Baltic states	-1 889	-2 458	..	..	..	..	..	..	-9.5	-11.0
Estonia	-563	-447	..	..	..	..	..	..	-12.1	-8.6
Latvia	-345	-713	..	..	..	..	..	..	-6.1	-11.1
Lithuania	-981	-1 298	..	..	..	..	..	..	-10.2	-12.1
European CIS	1 648	348	..	..	..	..	..	..	0.3	-0.1
Belarus	-799	-945	..	..	-369	21	..	..	-6.0	-7.1
Republic of Moldova	-267	-333	..	..	-104	-14	..	..	-13.9	-20.3
Russian Federation	4 049	2 446	..	..	..	..	..	..	0.9	0.9
Ukraine	-1 335	-821	..	..	..	..	..	..	-2.7	-2.0
Total above [a]	-14 944	-19 667	..	..	..	..	..	..	-1.7	-2.7

Source: National balance of payments statistics and UN/ECE secretariat. IMF for Ukraine 1998.

a Excludes Bosnia and Herzegovina and Yugoslavia.

b Excludes official transfers.

c Adjusted for imports of goods for processing and finishing (see chapter 1).

capital inflows has raised questions as to whether the financial positions of several countries can be sustained.[120]

Incomplete data do in fact show some widening of current account deficits in the first few months of 1999 (table 2.3.9) which, at least in Hungary and Poland, seem to have been larger than officially expected (although neither country faces financing difficulties). The worsening of the imbalances was often due to a contraction of exports of goods and services, reflecting the weakness of foreign markets as well as internal factors. Smaller imbalances were reported by Croatia and Slovakia, both of which have tightened macroeconomic policies to reduce their high current account deficits in 1999. A depreciation of real exchange rates appears to have been a factor in this outcome, as also seems to have been the case in the Czech Republic and Slovenia (although neither has had a large deficit). In Belarus and the Republic of Moldova, tighter financing constraints appear to explain the shift of the current account into surplus and the smaller current account deficit, respectively, in the first quarter of 1999.

These developments largely occurred before the recovery of international fuel prices in the second quarter of 1999 and the conflict in Kosovo. As far as the latter is concerned, the current account balances of all transition economies have been adversely affected to different degrees by the disruption of merchandise exports, the higher costs of transport, and losses of revenue from transport services and transit (see chapter 1). Tourism is reported to have been hit hard in south-east Europe and also in Slovenia (which reported a large increase in the overall current account deficit in April) and Hungary. Widespread cancellations of reservations imply that the full impact will only become apparent during the peak tourist season (the second and third quarters of the year). However, in several countries, currency depreciations in the early part of the year and weaker than expected economic activity may help to reduce current account deficits, as would any strengthening of west European economic growth in the second half of 1999. In Russia, customs statistics

[120] UN/ECE, *Economic Survey of Europe, 1999 No. 1*, pp. 172-179.

suggest that the current account surplus continued to increase in the first months of 1999, a development which may be strengthened by the rise in international fuel prices.

(b) Financial flows

Since the end of 1997, it has been more difficult for emerging market borrowers to raise funds in the international financial markets. Many transition economies continue to face higher premia, and they have scaled back their borrowing,[121] which in any case has been largely confined to periods of relatively stable market conditions (as during March-May 1998). However, access virtually ceased following the Russian debt moratorium in August 1998 and again after the devaluation of the Brazilian real in January 1999. Initially, the conflict in Yugoslavia also disrupted debt issuance by the transition economies, but conditions have eased for some of the better credit risks (generally those countries possessing investment grade ratings). In the first half of 1999, these countries issued bonds worth $3.4 billion (less than the already depressed amounts in the same period of 1998).[122] Hungary alone accounted for $1.8 billion, fully covering its 1999 borrowing requirement. Other sovereign borrowers included Croatia (in February), Slovenia (March) and Latvia, Lithuania and Slovakia (June).[123] Except for Hungary's $750 million of dollar bonds, all these issues were denominated in euros, the global popularity of which has recently almost matched that of the dollar. If the current stability of the markets continues, the prospects for filling the financing gaps in the area would be greatly improved.

Despite concerns about the possible impact of global financial turmoil on FDI,[124] inflows to the European transition economies rose from $17.4 billion in 1997 to $18.7 billion in 1998 (although there was a large decline in Russia due to the worsening of the investment climate).[125] Fragmentary data for the first quarter of 1999, mostly from eastern Europe, generally show increases, often very large ones, relative to the same period in 1998. These suggest that long-term considerations involving foreign investment have prevailed over the numerous concerns (some also of a longer-term nature) which emerged after the financial shocks of late 1997. In some transition economies privatizations involving strategic foreign investors have gone ahead because of commitments to improve economic performance, to finance balance of payments (and fiscal) deficits and/or to meet the conditionality of IMF programmes. In other cases, the bulk of FDI has been associated with greenfield projects and additions to existing capacity. The conflict in Yugoslavia initially appears to have frightened investors interested in eastern Europe, but many projects are going ahead. In the Czech Republic a majority share of Ceskoslovenska Obchodni Banka (CSOB) was sold to a strategic foreign investor in June for $1.1 billion. In Slovakia, the much postponed privatization of Slovak Telecom is to be completed before the end of 1999.[126] Within south-east Europe, the situation appears to be more mixed. In Croatia preparations continue for the sale of Croatian Telecom and a large insurance company, and the Romanian authorities remain confident that their ambitious privatization programme can be kept on track. However, in other cases, privatization plans have definitely been delayed.

(vi) Short-term outlook

On balance, the short-term outlook for the ECE transition economies has deteriorated since the beginning of the year. The outbreak of the Kosovo conflict – which was an unexpected negative shock for many transition economies – has undermined the economic prospects for a number of countries, especially those in south-east Europe. The worse than expected performance in some CIS countries in the early months of 1999 suggests that the outcome for the year as a whole in some parts of this region may also turn out to be worse than initially expected.

Since the publication of the previous issue of this *Survey*, the governments in a number of transition economies (Albania, Bulgaria, Hungary, Poland, The former Yugoslav Republic of Macedonia, all three Baltic states, Azerbaijan, Belarus, Georgia, Kazakhstan and the Republic of Moldova) have lowered their 1999 forecasts for economic growth. In view of the strong negative economic impact of the conflict in Yugoslavia as well as the prolonged impact of the depression in

[121] In 1998 the transition economies raised nearly $19 billion in bonds and medium-term loans, compared with nearly $30 billion in 1997. UN/ECE, *Economic Survey of Europe, 1998 No. 3*, table 4.3.4.

[122] In the first half of 1998, the transition economies raised funds of some $14 billion. Of this, Russia and Ukraine issued bonds worth nearly $6 billion, but they were no longer creditworthy in 1999 and syndicated loans appear to have virtually disappeared.

[123] The cities of Prague and Sofia also issued bonds in June and May, respectively.

[124] Reflecting this pessimism, the IIF estimated that FDI flows into emerging market economies fell by almost 5 per cent in 1998. Institute of International Finance, Inc., *Capital Flows to Emerging Market Economies* (Washington, D.C.), 27 January 1999. However, in the 25 April 1999 update of the same publication, the estimate of the 1998 flow has been raised to show an increase of 4 per cent.

[125] Flows of FDI to Russia fell from $6 billion in 1997 to $2 billion in 1998. See appendix table B.16.

[126] In Slovakia privatization has been slow, but recently the government approved a strategic plan to attract FDI, which includes the sale of shares in the gas and electric utilities. *International Herald Tribune*, 7 June 1999. The government is shortly to consider a plan to sell a minority share of Slovak Telecom to a strategic investor.

Russian import demand, even these revised official growth forecasts for 1999 (as reflected in table 2.3.1) may turn out to be too optimistic for some of the transition economies. In this regard, the only notable exception among the ECE transition economies is Russia, where the short-term prospects have improved from what was previously expected at the start of the year.

According to the official forecasts available at the time of writing this *Survey*, the authorities in three of 12 east European countries expected *falling* GDP in 1999.[127] As there were no obvious signs of a reversal in the current negative outlook at mid-year, it may well be that the number of countries with negative growth will actually increase in the second half. Besides, even the countries forecasting positive growth generally expect lower rates than those achieved in 1998.

The short-term outlook for the east European transition economies highlights once again the increasing divergence among these countries: while growth is expected to continue in most of the central European transition economies (albeit probably at lower rates than in the last few years), it is probable that the south-east European region will see another year of economic decline. On balance, the central European countries appear to be capable of absorbing the negative impact of the deterioration in the external environment with relatively little damage. Conversely, it seems certain that the shock of the Kosovo conflict will lead to the south-east European transition economies falling still further behind.

The short-term economic outlook for the Baltic states is not favourable either. The unexpectedly poor performance in the first quarter suggests that even the revised forecasts have probably not taken into full account all the negative external shocks that these economies have been subjected to recently. Unless a reversal in the current trends materializes in the near future, it may well turn out that some of these countries will end the year in recession or stagnation.

While much uncertainty remains as regards the future of the Russian economy, the short-term prospects have improved somewhat since the beginning of 1999. The problems of the Russian economy are deep-seated and require the implementation of a comprehensive reform programme. At the same time, the very high level of foreign debt is a serious burden for the Russian economy and, as openly admitted by high-level Russian officials, Russia will not be able in the foreseeable future to service its foreign debt without additional foreign assistance. This is why the support of the international financial institutions is crucial. However, relations with the IMF suffered a major blow after the August collapse and remained effectively frozen for several months. Only in late April did Russia and the IMF come close to a framework agreement under which the IMF would lend Russia $4.5 billion over 18 months. However, the approval of this agreement by the IMF board is conditional on a number of measures that the Russian government still has to implement.

Still, in view of the recent improvement in economic performance, the latest official forecasts by the Russian government are more optimistic than they were several months ago. While at the beginning of the year the official government agencies were expecting for 1999 a decline in GDP ranging from between 2 per cent and 10 per cent, by May the expectation was for no more than a 1 per cent decline in GDP.[128] As regards the short-term outlook in the rest of the CIS, it has deteriorated in most cases and it may very well turn out that a number of these countries will end the year in recession.

[127] This number excludes Yugoslavia itself for which no official revisions of macroeconomic forecasts were available; however, it is all too obvious that a large fall in Yugoslav GDP can be expected in 1999.

[128] Statement by acting Finance Minister M. Zadornov, *Reuters*, 25 May 1999.