PART ONE

RECENT ECONOMIC DEVELOPMENTS
AND THE SHORT-TERM OUTLOOK IN THE
ECE REGION
CHAPTER 1

THE ECE ECONOMIES IN AUTUMN 2003

1.1 The global context

Improved expectations for a global cyclical recovery – but with regional differences

There are widespread hopes for a strengthening of global economic activity in the second half of 2003 and its continuation in 2004. These hopes reflect to a large degree improved forward-looking business surveys as well as profit expectations in international equity markets, which have rallied after the end of the Iraq war. However, this optimism about the short-term outlook contrasts with a weaker assessment, in the same business and consumer surveys, of the current economic situation, and the volatility of many “real activity” indicators, which points to only a rather hesitant recovery.

There were marked regional variations in economic growth in the first half of 2003. Hopes for a global recovery continued to be pinned on a strengthening cyclical momentum in the United States, which would thus continue to be the engine of growth for the world economy. Indeed, economic activity picked up in the United States in the second quarter of 2003, albeit strongly influenced by special factors. There was also a surprisingly strong rebound of economic growth in Japan and growth was also strong in the Asian emerging markets. In contrast, economic activity in western Europe stagnated in the first two quarters of 2003, with a number of countries in recession. But in central and eastern Europe and the CIS, growth has remained buoyant despite the deteriorating external economic environment. In fact, growth was particularly dynamic in the Baltic States and the CIS.

Hopes for a strengthening of global economic activity are largely based on a considerable monetary policy stimulus in the industrialized countries, with interest rates falling to 40 year lows. Fiscal policy has also been supporting economic activity in the United States and the United Kingdom, but in the euro area it has been somewhat restrictive, despite the protracted cyclical downturn.

Global uncertainties have been reduced somewhat by the rapid ending of the Iraq war, but the outlook is still surrounded by significant downside risks (see section 1.5 below). Global economic activity continues to be restrained by the ongoing adjustment in the private sector to the collapse of international equity markets in the first half of 2000; by the consequences of previous overinvestment, which has led to significant margins of excess capacity, notably in the high-tech sector; and by the accumulation of high levels of debt in the corporate and household sectors. Progress in adjusting corporate balance sheets has been uneven, with western Europe lagging behind the United States. Household debt remains at high levels, especially in the United States.

Although earlier concerns about the risks of a global deflationary spiral appear to have abated, there are still concerns that adverse shocks could lead to deflation in Germany and the United States. A persistent source of uncertainty arises from the large and rising United States current account deficit.

Oil prices have fallen from their levels in the spring, but they still remained relatively high throughout most of the second and third quarters of 2003. The attempt by OPEC to counter the recent downward pressure on oil prices by reducing production targets could, if successful, weaken the global cyclical recovery, at least in the short run.

United States: economic performance improves – but doubts about recovery remain

Economic activity gathered momentum in the second quarter of 2003 (table 1.1.1) when real GDP rose by 0.8 per cent compared with 0.4 per cent in the first quarter of 2003. The acceleration was driven mainly by increases in personal consumption expenditures, supported by a decline in the household savings rate by 0.3 percentage points to 3.3 per cent, the lowest since the final quarter of 2001. The other main support of economic growth was a surge in defence spending, related to the war in Iraq. Business fixed investment (equipment and software as well as buildings) more than reversed the declines of the first quarter, reflecting easier financing conditions in equity

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1 In terms of seasonally adjusted annual rates (SAAR) reported by the United States Department of Commerce, this is equivalent to an acceleration in GDP growth from 1.4 per cent to 3.3 per cent.
markets and increased profits. Residential investment continued to be stimulated by low mortgage rates and rising house prices. But changes in inventories were a drag on economic activity in the second quarter (chart 1.1.1). As a result, total domestic demand expanded by 1 per cent between the first and second quarters, corresponding to a seasonally adjusted annual rate of somewhat more than 4 per cent.

The dynamism of domestic demand was also reflected in a large increase in imports. In contrast, the volume of exports fell for the third consecutive quarter, despite the depreciation of the dollar, reflecting the protracted cyclical weakness in major trading partners. Overall, the change in real net exports in the second quarter had a negative impact on GDP growth. The trade deficit (goods and services) rose to a seasonally adjusted annual rate of $502 billion. The current account deficit for the first half of 2003 corresponded to 5.2 per cent of GDP, compared with an annual average of 4.6 percent in 2002.

Despite stronger economic growth, the situation in the labour market has remained depressed. The unemployment rate was 6.1 per cent in September 2003, slightly down from its recent peak of 6.4 per cent in June 2003, a level not seen since the second quarter of 1994. Non-farm payroll employment continued to decline in August for the seventh consecutive month but edged up slightly in September (chart 1.1.2). Partly as a result of job cuts, labour productivity grew strongly by 1.8 per cent in the second quarter in the business sector, and more than offset the rise in hourly compensation, leading to a decline in unit labour costs.

Inflationary pressures have remained absent so far, reflecting falling unit labour costs and the weak pricing power of firms. The headline inflation rate averaged 2.4 per cent (year-on-year) during the first eight months of 2003, while the core rate (which excludes food and energy prices) fell significantly, to 1.2 per cent, over the same period.

### TABLE 1.1.1

| Changes in United States real GDP and main expenditure items, 2002QI-2003QII (Percentage change over previous quarter, seasonally adjusted) |
|---|---|---|---|---|---|
| | 2002 | | | | 2003 |
| | QI | QII | QIII | QIV | QI | QII |
| Private consumption | 0.8 | 0.4 | 1.0 | 0.4 | 0.5 | 0.9 |
| Government consumption | 1.0 | 0.9 | 0.7 | 1.4 | 0.2 | 2.1 |
| Gross fixed investment | 0.4 | -0.6 | 0.1 | 0.9 | -0.1 | 1.6 |
| Stockbuilding | 0.7 | 0.3 | 0.1 | 0.1 | -0.2 | -0.2 |
| Total domestic demand | 1.4 | 0.6 | 1.0 | 0.7 | 0.1 | 1.0 |
| Exports | 0.9 | 3.4 | 1.1 | -1.5 | -0.3 | -0.3 |
| Imports | 2.1 | 5.1 | 0.8 | 1.8 | -1.6 | 1.9 |
| Net exports | -0.2 | -0.3 | -0.4 | 0.2 | -0.3 | |
| GDP | 1.2 | 0.3 | 1.0 | 0.3 | 0.4 | 0.8 |

Source: Bureau of Economic Analysis, United States Department of Commerce.

Note: Growth contribution in percentage points.

### CHART 1.1.1

Quarterly changes in real GDP and major expenditure items in the United States, 2000QI-2003QII (Percentage change over previous quarter, seasonally adjusted at annualized rate)

### CHART 1.1.2

Monthly unemployment rate and non-farm employment in the United States, January 2000-September 2003 (Per cent, thousand persons)


Note: Unemployment is measured in per cent of the civilian labour force aged 16 and above; non-farm employment is payroll employment (establishment data).
The risk of deflation remains a major concern of monetary policy. In mid-September the Federal Open Market Committee (FOMC) left the target for the federal funds rate unchanged at 1 per cent. As a result, real short-term interest rates have so far been negative throughout 2003. However, long-term interest rates (yields on 10-year treasury bonds) have risen by 1 percentage point to an average of 4.4 per cent in September 2003, compared with their recent low in June, suggesting that deflationary expectations of bond investors may be on the wane and pointing to a shift in expectations of a tightening of monetary policy in 2004 (chart 1.1.3). Corporate bond yields followed the same tendency as yields on treasury bills.

Fiscal policy continues to be highly expansionary. For the first 11 months of fiscal 2003, the federal government deficit was double that in fiscal 2002. This reflected the combined impact of lower revenues and higher spending, and was related not only to the automatic stabilizers but also to the tax cuts enacted in 2001 and 2003, increased outlays on defence and homeland security, and legislation that temporarily increases the share of the federal government in social security spending. The general government budget deficit is projected to reach 6 per cent of GDP, a marked swing from a surplus of 1.2 per cent in 2000. The bulk of this change in the fiscal balance is structural in nature. The cyclically adjusted budget deficit will rise to some 5 per cent in 2003, compared to a surplus of 0.6 per cent of potential GDP in 2000. The medium-term fiscal outlook has thus worsened considerably and has led to calls for a strategy to redress the situation.

Short-term economic indicators paint a mixed picture of the current state of the United States economy. Consumer confidence has recovered from its low during the Iraq war in March, but has actually declined slightly since the end of hostilities was announced in May, probably as a result of the persistently weak state of the labour market (chart 1.1.4). The Conference Board’s composite leading indicator edged up significantly between March and August 2003, but the underlying tendency of industrial production is still rather sluggish, despite the ISM Purchasing Managers’ Index moving back above the 50 per cent threshold which usually signals expanding manufacturing activity. The improvement of business activity in the non-manufacturing sector is more pronounced (chart 1.1.5). Margins of spare capacity in the manufacturing sector are still very large (chart 1.1.6). Demand for housing is still very strong. New residential sales continued to expand in August despite rising interest rates and although sales of existing single-family homes fell slightly in June they remained close to record levels. Housing starts reached a new all-time high in July but fell slightly in August 2003 (chart 1.1.7).

\[2\] Or rather, in the words of the FOMC, “the risk of inflation becoming undesirably low”. Federal Reserve Board, Press Release, 16 September 2003 [www.federalreserve.gov].

The Canadian economy slows down

In Canada, real GDP fell by 0.1 per cent in the second quarter of 2003 following relatively robust growth of 0.6 per cent in the previous quarter. The weakening reflected the combined impact of the considerable appreciation of the Canadian dollar against the United States dollar, the SARS disease and export restrictions on Canadian cattle and beef resulting from the discovery of mad cow disease. The economic slowdown and the sizeable currency appreciation led to consumer price inflation slowing markedly, to an annual 2 per cent in August, its lowest rate in over a year. Core inflation fell below the 2 per cent mid-point of the Bank of Canada’s target range. The labour market softened significantly, with the unemployment rate climbing to 8 per cent in August, and employment falling slightly.

The weakening economy, and the concomitant decline of inflation, together with the appreciation of the exchange rate, prompted the Bank of Canada to cut its overnight interest rate by 50 basis points in the third quarter. This fully reversed an equivalent increase of this key rate in the first four months of 2003, when there were still concerns about inflation being above the bank’s target range and expectations that the economy would continue to expand strongly, with attendant risks of overheating.

Japan on the road to recovery?

In Japan, there was a surprisingly strong acceleration in the rate of economic expansion in the second quarter of 2003, when real GDP rose by 1 per cent compared with an increase of 0.6 per cent in the preceding quarter. This has nourished hopes for a sustained economic recovery, but it is known from past experience that Japanese national accounts statistics can be subject to major revisions. In fact, there are indications that the growth figure for the second quarter may be significantly overstated.\(^4\) The available data point to a recovery in domestic demand, reflecting mainly a significant strengthening of private sector fixed capital formation, driven by improved corporate profits. Private consumption continues to be weak in the face of uncertain job prospects. Changes in real net exports supported economic activity in the second quarter, reflecting a rise in exports and falling imports. Deflationary tendencies, however, persist. There was a slowdown in the rate of decline of consumer prices during the first eight months of 2003, but this was partly due to special factors such as a rise in the tobacco tax and the higher costs of health care resulting from a reform of the insurance system. The recent rise in world oil prices has also played a role.

Monetary policy remains very expansionary. As a result of ample liquidity provided by the Bank of Japan, the overnight call rate has remained at virtually zero. The same holds for three-month short-term interest rates.

\(^4\)“Japan scales back growth figures”, Financial Times (London), 20/21 September 2003.
The central bank also began purchasing asset-backed securities in a move to support the credit channel of monetary transmission and to alleviate the credit crunch caused by the persistent weakness of balance sheets in the commercial banking sector. The authorities have also repeatedly and strongly intervened in the foreign exchange markets to prevent the yen from appreciating against the dollar (see chart 1.1.10 below).

**Varying growth rates in emerging markets**

Private capital flows to emerging markets and other developing countries in 2003 started to recover from a severe downturn in 2001-2002. The latter – the most acute retrenchment in private capital flows since the 1960s – had resulted in net outflows from developing countries during those two years.\(^5\) In 2003 private capital flows to the major emerging markets are forecast to rise to $129 billion. Although higher than the previous year’s $110 billion, this is still $50 billion lower than the previous 10 years’ average.\(^6\)

Most of the increase will go to Latin America and will be in the form of bonds and portfolio investment. Net inward FDI will fall marginally but will remain the largest component of the foreign capital inflow into emerging markets.

Growth in *developing Asia* was resilient during the first half of 2003, although it slowed down from the previous year due to the weaker global environment and the outbreak of the SARS (Severe Acute Respiratory Syndrome) epidemic. The negative impact of the epidemic was mostly concentrated in the second quarter. Another factor limiting growth in developing Asia in early 2003 was sluggish import demand in industrialized countries. Economic activity, nevertheless, was underpinned by robust domestic demand and by intraregional trade in east and south-east Asia. Household consumption has started playing a stronger role in supporting economic growth in countries such as China, Indonesia, Malaysia and Thailand, based on strong labour markets, rising consumer credit and low interest rates. Most countries in the region have been adopting expansionary macroeconomic policies. Exports have also contributed to growth, as intraregional trade strengthens. It is boosted by deeper regional integration of production networks and by the rising importance of China as an export market.

Economic activity in developing Asia is expected to strengthen during the second half of 2003 and the region should grow by nearly 6 per cent in 2003 as a whole (slightly below the 6.2 per cent rate of the previous year), led by the two largest economies, China

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\(^5\) World Bank, *Global Development Finance 2003* (Washington, D.C.), 2003 [www.worldbank.org]. These overall developments hide stark regional contrasts: private capital flows to east Asia rose strongly, moderately to central Europe, but fell sharply in Latin America and Turkey, the economies most dependent on foreign capital inflows.

and India, which are forecast to expand by some 7.5 per cent and nearly 6 per cent, respectively. It should thus remain the fastest growing region in the world.

Latin America remains strongly dependent on developments in the international economic environment, which has not been very supportive in 2003. The annual rate of economic growth of the region is forecast to be weak in 2003 (1.5 per cent), although this represents an improvement from the previous year’s contraction by 0.6 per cent. Domestic demand is weak in most countries, a reflection of the lingering effects of the previous two years’ crises on domestic labour markets and structural reforms in public finances in most countries, which in the short term limit the room for manoeuvre of fiscal policy. More competitive exchange rates have contributed to a strong growth in exports in 2003, particularly in South America. With imports compressed due to weak domestic demand, current account deficits have been falling. The improvement in external and fiscal accounts has led to falling international financing spreads for the region. The two largest economies – Mexico and Brazil – should grow by 1.5 per cent in 2003, only marginally better than the previous year’s performance. In the former country, growth forces have been restrained by a loss of competitiveness in the United States market on account of the appreciation of the peso against the dollar. In Brazil, restrictive macroeconomic policies have dampened economic growth. Argentina is forecast to have the strongest growth rate in the region (6 per cent), following four years of contraction, but it still has to renegotiate its debt to foreign private creditors.

Non-energy commodity prices continue rising

Non-energy commodity prices rose moderately during the first three quarters of 2003, following a strong recovery from their cyclical trough in late 2001 (chart 1.1.8). This aggregate, however, masks differences among the major product groups. Prices of industrial raw materials continued the recovery that had started in the last quarter of 2001, buoyed by expectations of a worldwide recovery leading to higher industrial production. They were also supported by the arrival in commodity markets of international investors seeking to diversify their portfolios and the depreciation of the dollar. In August 2003, the current dollar prices of metals and agricultural raw materials were 15 per cent higher than 12 months earlier. In contrast, food products in 2003 resumed their long-term decline after they had risen in the wake of temporary supply disruptions during the second half of 2002.

Oil prices remain high

Crude oil prices remained relatively high during the first three quarters of 2003. On average they were some 18 per cent higher than in the same period of 2002 and reached their highest level in three years. Between January and September 2003 oil prices were erratic (chart 1.1.9). The spot price of Brent crude fell abruptly from $35/barrel to $23/barrel in the two months up to the end of the war in Iraq, as OPEC promised to maintain oil supplies and as uncertainties concerning the conflict dissipated. In the following months prices rose again, reaching $30/barrel in late August. From the demand side, they were underpinned by the growth in world consumption, forecast at 1.4 per cent in 2003, the largest increase in four years. This rise stems mainly from the United States and Asia and is driven not only by the incipient economic recovery, but also by special factors such as temporary fuel-switching to oil from gas and from nuclear power (in the United States and Japan, respectively) and the need to replenish industrial country stocks from very low levels.

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9 “Commodities are a big, new theme”, Financial Times (London), 18 September 2003.
Rising demand allowed petroleum producers (both within and outside OPEC) to increase their output through the third quarter of 2003, while benefiting from higher prices. This increase offset supply shortfalls in Iraq, Nigeria and Venezuela. In the first case, persistent security problems and disruption caused by military action are likely to prevent exports from reaching pre-war levels in the near future. Nevertheless, the country’s output has risen steadily since mid-2003. Together with the partial removing of supply constraints elsewhere, this led to a rapid decline of the oil price in September, to a low of $25/barrel.

The dollar's foreign exchange value continued its downward tendency against major currencies over the first nine months of 2003. The trade-weighted exchange rate index fell against a broad group of countries by 4.2 per cent in September 2003 compared with January 2003. Since its recent peak in February 2002, this index has declined by 8.4 per cent. The decline in the dollar’s nominal effective exchange rate index has been limited by continued strong interventions in the foreign exchange market by central banks in some Asian countries, especially China and Japan, which has led to a massive accumulation of foreign reserves in the region. A main motive in Japan has been to stem an appreciation of the yen against the dollar, which is seen to weaken export growth, a major engine for the expected recovery. China has maintained a fixed exchange rate at 8.26 renminbi per dollar since 1994 and the currency is widely believed to be significantly undervalued. A weaker dollar is key for the adjustment of global current account imbalances, meaning essentially the reduction of the huge United States’ current account deficit. The need for more exchange rate flexibility for promoting necessary global economic adjustments was emphasized in a statement of G-7 finance ministers and central bank governors in Dubai on 20 September 2003.  

Against this background, the exchange rate of the dollar against the yen was relatively stable during the 12 months to August 2003 (chart 1.1.10). In September 2003, stronger market focus on the need to finance the United States external deficit together with the G-7 Ministerial statement led to stronger selling pressure on the dollar. At the end of September the dollar was traded at 111.4 yen down from 117.4 yen in mid-September, corresponding to dollar depreciation by 5.1 per cent over two weeks. The average monthly exchange rate was 114.8 yen/dollar in September 2003, which compared with a recent monthly peak of 133.6 yen/dollar corresponds to dollar depreciation by 14.1 per cent (or a yen appreciation by 16.3 per cent).

The dollar depreciates against the euro and the yen

The dollar’s foreign exchange value continued its downward tendency against major currencies over the
the Japanese currency. On September 30, the euro traded again at $1.17, up by more than 8 per cent compared to early September. The average monthly exchange rate of the euro was $1.12 in September 2003; compared with the recent low of the euro at $.87 in February 2002, this amounts to an appreciation by nearly 29 per cent (chart 1.1.10). In September 2003, the euro traded at a monthly average of 128.9 yen, which still amounted to an appreciation by nearly 9 per cent compared with the same months of the preceding year.

In terms of the real effective exchange rate against a broad group of countries, the euro appreciated by 8 per cent in the 12 months to September 2003 (chart 1.1.11). From its trough in October 2000, it had risen by 23 per cent. The dollar had depreciated in real effective terms by nearly 6 per cent over the same period. Compared with its recent peak in February 2002, the real effective depreciation amounts to some 8 per cent. The average monthly real effective exchange rate of the yen fell by 1.5 per cent in the 12 months to September 2003.

International stock markets are moving up

After a stagnant first quarter attributed to war-related risks, prices in global stock markets started to rise in the second quarter of 2003, reflecting investors’ optimism about short-term prospects for the world economy. The upward tendency continued in the third quarter of 2003 on the back of positive economic news about the stronger than expected performance of the United States economy in the second quarter of 2003 and in anticipation of a continued accommodative stance of monetary policy. Compared to their January 2003 opening levels, the blue-chip Dow Jones Industrial Average in September 2003 (month-end data) traded about 8 per cent higher while the broader S&P 500 index rose almost 10 per cent. The high-tech oriented Nasdaq Composite rose by as much as 29 per cent over the same period. It now stands at its highest level in 16 months after a seventh straight monthly gain (chart 1.1.12).
In the euro area, the developments on the stock markets were considerably more damped over the same period. By end-September 2003, pan-European benchmarks (Euro Stoxx 50 and Stoxx 50) were trading around 5 per cent lower than their January 2003 opening levels, despite sharp losses in the second quarter. The German DAX Xetra was among Europe’s best performing national benchmarks rising some 5 per cent in the year to end September 2003. This was explained in part as a correction in view of the sharp losses experienced in 2002 but also was seen as the result of better than expected profitability.

In Japan, the Nikkei 225 made steep gains in the third quarter of 2003, amounting to over 17 per cent lower than their January 2003 opening levels, despite sharp losses in the second quarter. The German DAX Xetra was among Europe’s best performing national benchmarks rising some 5 per cent in the year to end September 2003. This was explained in part as a correction in view of the sharp losses experienced in 2002 but also was seen as the result of better than expected profitability.

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1.2 Western Europe

Economic activity in western Europe stagnated in the first two quarters of 2003 against the background of weak business and consumer confidence resulting from uncertainties concerning the world economic and political situation (uncertainties that prevailed despite the end of the war in Iraq), deteriorating labour markets, corporate sector difficulties and the appreciation of the euro.

**Protracted sluggishness of economic activity in the euro area**

In the euro area, real GDP declined by 0.1 per cent in the second quarter of 2003 following stagnation in the first (table 1.2.1). Real GDP fell in France, Germany, Italy and the Netherlands in the second quarter. In fact, the latter three countries have moved into recession, defined as a decline of real GDP in two consecutive quarters. The aggregate level of economic activity in the euro area in the second quarter was only 0.2 per cent higher than a year earlier (chart 1.2.1), the lowest year-on-year growth rate since the recession of 1993.

A weakening of domestic demand (to near stagnation) and contracting foreign demand combined to bring about the decline of economic activity in the euro area in the second quarter (table 1.2.1 and chart 1.2.2). Private household consumption rose only slightly against the background of softening labour markets, which dampened consumer confidence. Although consumer confidence improved somewhat after the first quarter, it remained at low levels (chart 1.2.3). While government consumption moderately supported economic activity, this was more than offset by fixed investment, which declined in both the first and second quarters, falling back to its level of early 1999. Business capital spending was pulled down by uncertainties regarding the world economy, the depressed state of industrial order books (chart 1.2.4),

**TABLE 1.2.1**

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<thead>
<tr>
<th></th>
<th>2002</th>
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<tr>
<td></td>
<td>QI</td>
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<tr>
<td>France</td>
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<td>Germany</td>
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<td>Italy</td>
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<tr>
<td>United States</td>
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</tr>
<tr>
<td>Japan</td>
<td>0.2</td>
<td>0.9</td>
</tr>
<tr>
<td>Total above</td>
<td>0.8</td>
<td>0.5</td>
</tr>
</tbody>
</table>

**Memorandum items:**

- **Euro area**
  - France: 0.3
  - Germany: 0.3
  - Italy: 0.3
  - United Kingdom: 0.3
  - Total industrialized countries: 0.7

Source: National statistics; Eurostat, New Cronos Database.

Note: End of month data.
declining capacity utilization in manufacturing and continuing corporate balance-sheet restructuring. While investment in stockbuilding provided a strong support to GDP during the first quarter, this disappeared in the second quarter (table 1.2.2) when the expected economic upturn did not materialize. The volume of exports continued to decline in the second quarter of 2003. This was the third consecutive quarterly decline, reflecting a loss in price competitiveness brought about by currency appreciation and the generally sluggish level of economic activity in the area’s major export markets. At the same time, the volume of imports was maintained in spite of weak domestic demand. As a result, the changes in real net exports continued to be a drag on overall economic activity.

Business and consumer surveys for the third quarter of 2003 point to only a moderate improvement in the second half of the year. Consumer confidence improved marginally from June to August, and business confidence strengthened in August and September (chart 1.2.3). The Reuters-NTC Purchasing Managers’ Index edged up in July and August, but remained below the 50 per cent threshold, which separates expansion from contraction. There are signs of a tentative – and stronger – recovery of business activity in the services sector (chart 1.2.5). Nevertheless, uncertainties remain. Stronger sentiment seems to hinge on growing demand outside the euro area, particularly in the United States. A continuing appreciation of the euro, however, would again be likely to dampen business sentiment. Another factor restraining fixed investment is the relatively high level of spare capacity in manufacturing. Thus, even if the situation improves, this is likely to happen only gradually.

In the second quarter of 2003, the cost competitiveness (in terms of unit labour costs) of euro area producers vis-à-vis those of other industrial countries had deteriorated by 14 per cent (year-on-year). European Commission, Price and Cost Competitiveness, Second Quarter 2003 [europa.eu.int/comm/economy_finance].
Against this background, inflation in the euro area has remained moderate in 2003. Core inflation (which excludes energy, food and tobacco prices) was well below 2 per cent in August (chart 1.2.6). The economic downturn has continued to take its toll, albeit modestly, on the euro area’s labour markets. There has been a steady erosion of the favourable trend from mid-1997 to late 2001, when the harmonized unemployment rate dropped from just under 11 per cent to a 10-year low of 8 per cent. By July 2003, the rate had edged up to 8.9 per cent (chart 1.2.7). Quarter-to-quarter employment change in the total economy remained at zero in the first quarter of 2003 as in the two previous quarters. Employment in the first quarter was also unchanged from its level of a year earlier. With a sluggish economic activity and rising unemployment, wage growth has moderated. Unit labour costs rose by 1.9 per cent over the same period in the first quarter over its year-ago level, compared with a recent peak of 3.2 per cent in the final quarter of 2001.

Among the three major euro area economies, economic activity in Germany is forecast to stagnate in 2003 following three consecutive years in which its performance was the weakest of all the member countries of the euro area. The appreciation of the euro and the unfavourable international environment led to a sharp drop in exports in the second quarter. Moreover, falling business confidence, weak order books and rising spare capacity in manufacturing industry dampened fixed investment in equipment, although construction investment recovered from its steep fall in the first quarter. Private household consumption stagnated, reflecting the lagged effects of higher social security contributions, worsening labour market conditions and faltering consumer confidence. To this was added the restraining economic effects of balance sheet adjustment problems in the corporate and banking sectors. The room for a fiscal stimulus is circumscribed by pressures to correct the general government budget deficit, which exceeds the 3 per cent limit set in the Maastricht Treaty (see below). Inflation has been hovering around 1 per cent in 2003 so far, which is among the lowest observed in the member states of the euro area. Accordingly, real short-term interest rates are about 1 percentage point above the euro area average, suggesting that the stance of monetary policy is too tight for Germany. Nevertheless, the Ifo index of business expectations for the coming six months (one of the two components of the Ifo business climate index) rose steadily between May and September 2003. But the assessment of the current situation has been very volatile over the same period; it fell again in September 2003, pointing to the fragile state of the economy.
In France, real GDP fell in the second quarter of 2003 by 0.3 per cent, the weakest performance among the large industrialized economies (table 1.2.1). This brought the country’s real GDP back to its level of a year earlier. This development resulted in equal proportion from a contraction of private consumption and negative stockbuilding. Fixed investment also fell during the second quarter, as had been the case throughout 2002. In the context of a sluggish international environment, foreign demand failed to compensate for the weakness of domestic demand. Changes in real net exports subtracted from GDP between mid-2002 and mid-2003. Conditions in the labour market have worsened: the unemployment rate rose to 9.4 per cent in July compared to 8.8 per cent a year earlier. Available third quarter data indicate declining or stagnant private consumption, while the outlook for fixed investment in 2003 was revised downwards by businesses at mid-year.

In Italy the current recession is the second in less than two years. With consumer and business sentiment still subdued, domestic demand rose only moderately. Fixed investment declined sharply during the first half of 2003 (due to cuts in spending on machinery and equipment) after rising strongly during the preceding semester, in response to temporary fiscal incentives. Changes in real net exports continued to be a drag on overall economic activity. The business sector continues to lose market share in its main export markets due to deteriorating price and cost competitiveness, as well as the specialization of the export sector. Despite sluggish growth, the country’s labour market has remained resilient in recent years. The unemployment rate in July was 8.7 per cent, lower than during the second quarter. Preliminary data for the third quarter indicate a slowing down of private consumption growth. Nevertheless, domestic demand is likely to receive some support during the second half from announced reductions in personal income and corporate taxes.

Among the smaller economies of the euro area, economic performance has continued to diverge significantly. In the Netherlands, economic activity fell in the three consecutive quarters to mid-2003, the second contraction in two years. The economy was hit by the loss of international cost and price competitiveness and the unfavourable international environment, which contributed to a sharp fall in domestic demand. In Portugal, the economy was still negatively affected by the consequences of the fiscal austerity programme adopted in 2002: this contributed to a year-on-year fall of 2.3 per cent in real GDP in the second quarter of 2003. In Austria, the negative effects of the international environment were countered by a fiscal stimulus, which provided moderate support to the economy. In Finland, there was a turnaround during the second quarter thanks to the contribution of net exports, where the country’s relative specialization in ICT goods was especially important. Greece and Spain maintained their growth patterns of recent years, expanding well above the euro area average and based on strong domestic demand.
In Greece, economic activity continues to be stimulated by the construction boom related to preparations for the Olympic Games in 2004.

**Monetary policy has remained on hold since June 2003**

In response to the deteriorating economic performance and forecasts that inflation would fall below 2 per cent in 2004, the ECB lowered its main refinancing rate by half a percentage point to 2 per cent in June. Taking German official interest rates as the benchmark, this is the lowest rate since the Second World War. Already in March 2003, the central bank had cut its refinancing rate by a quarter of a percentage point to 2.5 per cent. These moves helped to offset to a large extent the tightening of monetary conditions caused by the real effective appreciation of the euro. Despite forecasts of reduced growth for 2003 and 2004, the Governing Council of the ECB decided to leave interest rates unchanged at its latest meeting in September 2003.

Average monthly nominal short-term interest rates fell to 2.1 per cent in August, down from 2.8 per cent in January 2003 (chart 1.1.3). Real short-term interest rates were about a quarter of a percentage point in July 2003, down from 1.5 per cent one year earlier.

Nominal long-term interest rates (yields on 10-year government bonds) followed the trend observed for the corresponding United States treasury bills. After reaching a monthly low of 3.7 per cent in June, they edged up to 4.2 per cent in September. While in June there was still an average yield differential of 40 basis points in favour of euro-denominated bonds, this changed to a differential of 6 basis points in favour of dollar-denominated bonds in September (chart 1.1.3). This reversal can be associated with a more optimistic assessment of the relative growth prospects of the United States and also with the considerable deterioration of the United States federal government deficit.

**Significant deterioration of public finances**

There has been a significant deterioration of public finances in the euro area. This is largely due to the working of the automatic stabilizers in a cyclical downturn that has proved much more protracted than expected. As a result, there has been a shortfall of tax revenues, while expenditures on unemployment benefits have been higher than planned. As in 2002, France and Germany will have excessive deficits in 2003, which are expected to correspond to around 4 per cent of GDP. Current forecasts for 2004 are also for budget deficits close to 4 per cent in Germany and somewhat less, but still significantly above the 3 per cent threshold, in France. This would be the third consecutive year in which the rules of the Stability and Growth Pact are violated. Portugal, moreover, which had an excessive deficit in 2001, will also slip back into the critical zone in 2003. In most of the other
countries, the cyclical downturn will also lead to a deterioration of their fiscal positions. In the event, the actual budget deficit in the euro area as a whole is now expected to correspond to some 3 per cent of GDP in 2003, up from 2.3 per cent in 2002. The aggregate level of gross government debt in the euro area will rise to above 70 per cent of GDP.

Despite the severe cyclical weakness, the structural fiscal deficit for the euro area is forecast to decline to 1.7 per cent of potential GDP, down from 2 per cent in 2002. This points to the somewhat restrictive stance of fiscal policy in the euro area as a whole. Consolidation efforts are most pronounced in Germany and Italy, which are striving to meet their commitment to reduce the structural deficit by at least 0.5 per cent of GDP as demanded by the European Commission and the European Council. This effort appears to be less pronounced in France.

The German government, accordingly, has introduced higher tax rates (on tobacco, energy and, for a transitional period, corporate income), increases in social security contributions and expenditure cuts. To stimulate economic activity, the government plans to bring forward the third stage of its income tax reform package from 2005 to 2004. This would reduce tax revenues by some €16 billion (or 0.7 per cent of GDP), which ceteris paribus would mean an increase in the structural budget deficit. It is estimated, however, that this will provide only a mild stimulus to economic growth equivalent to 0.3 percentage points of GDP. The potential growth effects, moreover, will be further dampened if, as planned, the government does not fully finance the tax cuts by borrowing but instead offsets part of the revenue shortfall with a combination of cuts in subsidies and other expenditures as well as increases in other taxes.

In France, the budget for fiscal year 2003 was slightly expansionary in view of tax cuts being introduced against the background of a progressive cyclical downturn. In September 2003, the government announced further income tax cuts in its draft budget for 2004, which projects a budget deficit close to 3.5 per cent of GDP.

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13 IMF, op. cit.
14 Ibid.
15 Model simulations suggest that the net effect of fiscal policy may well be contractionary also in 2004. DW, Wochenbericht 27-28 (Berlin), 3 July 2003. While it may be argued that reductions in subsidies and tax exemptions can reduce distortions in the economy and thereby stimulate economic growth in the medium term (via the reallocation of resources to more efficient uses), the bulk of the evidence suggests that such measures do not have an expansionary impact on economic activity in the short run. R. Hemming, M. Kell and S. Mahfouz, The Effectiveness of Fiscal Policy in Stimulating Economic Activity – A Review of the Literature, IMF Working Paper WP/02/208 (Washington, D.C.), December 2002.

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Economic developments in other western European countries

In the United Kingdom, the rate of economic growth picked up in the second quarter of 2003, following a pronounced slowdown in the two proceeding quarters. Real GDP rose by 0.3 per cent between the first and second quarters of 2003, bringing it to 1.8 per cent above its level in the second quarter of 2002. The strengthening of economic growth was supported by a further improvement in manufacturing activity.

Household expenditure accelerated markedly in the second quarter of 2003, reflected mostly in accelerating retail sales. The rapid growth in house prices has been a key support for consumer spending over the last few years but surveys now confirm that the rate of increase has moderated substantially so a further boost to expenditure from this area looks less likely. Business investment continued to decline in the second quarter with an especially pronounced weakening in the manufacturing sector. After a strong first quarter, government expenditure declined in the second quarter due to weaker spending on defence.

Despite the slowdown in output growth, aggregate employment and unemployment have changed little during the past year. The unemployment rate was 5.1 per cent during the three-month period to July 2003, slightly lower than a year earlier. Inflation (RPIX) was 2.9 per cent in August 2003, above the government’s inflation target of 2.5 per cent. When measured on the basis of the HICP, however, inflation was much lower at only 1.4 per cent.

Against the background of lingering uncertainties about short-term global economic prospects, the Monetary Policy Committee (MPC) cut the base rate by a quarter of a percentage point to 3.5 per cent in July 2003; the rate had already been reduced by the same amount in February. At its meeting in early September, the MPC decided to leave the base rate unchanged. The stance of fiscal policy remains very expansionary, with the structural fiscal deficit estimated to increase by nearly 1 percentage point to 2.1 per cent of potential GDP, a marked swing from a surplus of somewhat less than 1 per cent in 2001. This reflects an increase in government spending on public infrastructure, education and health but also a large shortfall of profit taxes paid by financial corporations.

There was relatively robust growth in Sweden during the first half of 2003, thanks largely to real net exports, as the country benefited from the incipient recovery in international ICT trade. As in the other
Nordic countries, net exports also contributed positively to growth in Denmark during the second quarter, but in this case they were more than offset by the sharp fall in domestic demand, particularly of fixed investment.

Outside the European Union, both Norway and Switzerland were in recession in the second quarter of 2003. Switzerland has so far pursued a loose monetary policy in 2003, cutting interest rates and aiming at weakening the exchange rate vis-à-vis the dollar and the euro. The economy of Turkey was boosted by falls in inflation and interest rates; these strengthened business confidence and led to industrial production growing at rates above 10 per cent (year-over-year) in mid-2003. The key tourism sector recovered rapidly from the downturn associated with the war in neighbouring Iraq in the first quarter.

1.3 Eastern Europe

Growth still mostly driven by domestic demand

During the first half of 2003 growth gained further momentum in most east European economies and the region’s aggregate GDP increased by 3.4 per cent, which was above the rates of growth in 2002 (table 1.3.1). Eastern Europe preserved its positive growth differential vis-à-vis western Europe, a distinctive feature of European economic performance in recent years. However, while growth in the region as a whole accelerated in the first half of the year, the pace of economic activity was uneven across countries and subregions. In addition, throughout eastern Europe agriculture was hit by the extraordinarily hot and dry summer, which produced the worst harvests in decades in many countries, with a negative impact on aggregate output growth.

According to national accounts data, growth in eastern Europe continued to be predominantly driven by domestic demand (table 1.3.2). Although east European exports remained buoyant, imports generally grew even faster and, consequently, only in two countries (Poland and Slovakia) did net exports make a positive contribution to GDP growth. Both private consumption and, in some cases, the acceleration of fixed investment contributed to aggregate output growth in the region. The data also suggest that the underlying real income gains are based on productivity increases as well as on faster than expected rates of disinflation. At the same time, consumption-led growth has been associated in some countries with large and rising fiscal and current account deficits.

Central Europe: growth constrained by weak external demand and fiscal imbalances

Due to the intensity of their trade links with the EU, the central European economies were relatively more affected than other east European countries by the protracted economic slowdown in the western part of the continent. Since 2001, growth in central Europe, which was the most vibrant economic subregion in eastern Europe in the second half of the 1990s, has lost much of its dynamism and the situation hardly changed in the first half of 2003 (table 1.3.1 and chart 1.3.1). The economic slowdown in this period was marked by considerable fiscal imbalances in most of these economies (with the possible exception of Slovenia).17 The conventional cyclical deterioration of fiscal positions was only partly responsible for those large deficits: they are to a large extent the outcome of expansionary fiscal policies.

17 In the case of the Czech Republic and Hungary the consolidated general government deficit in 2002 reached almost 10 per cent according to preliminary estimates based on ESA 95 – compatible methodology; in Slovakia it was close to 8 per cent and in Poland around 6 per cent. UNECE, Economic Survey of Europe, 2003 No. 1, p. 49.
Since the start of the slowdown, governments in some central European countries (the Czech Republic, Hungary, Slovakia) have tried to counterbalance the effect of the adverse external shock with a fiscal stimulus to boost their economies. This stance was coupled with populist moves associated with general elections (such as generous increases in public sector wages or the postponement of planned cost-cutting measures). In the case of Poland, the widening fiscal gap was the outcome of inconsistent policies followed for a number of years.\(^{18}\) The main problem with expansionary policy measures of the type introduced in these economies is the strong hysteresis effect (this concerns especially wage increases): once put into effect, they are difficult to reverse; on the contrary, they create expectations of further moves in the same direction. At the same time, the prolonged slowdown in external demand has made it difficult for governments to tighten their fiscal policy stance.

Given the magnitude of these deficits, the fiscal policies associated with them are clearly unsustainable. The problem that policy makers in central Europe are now facing is that in view of their approaching elections (such as generous increases in public sector wages or the postponement of planned cost-cutting measures). In the case of Poland, the widening fiscal gap was the outcome of inconsistent policies followed for a number of years.\(^{18}\) The main problem with expansionary policy measures of the type introduced in these economies is the strong hysteresis effect (this concerns especially wage increases): once put into effect, they are difficult to reverse; on the contrary, they create expectations of further moves in the same direction. At the same time, the prolonged slowdown in external demand has made it difficult for governments to tighten their fiscal policy stance.

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<th>Major demand components of GDP in selected east European economies, 2002-2003</th>
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<td><strong>Table 1.3.2</strong> Major demand components of GDP in selected east European economies, 2002-2003 (Percentage change over the same period of the preceding year)</td>
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Source: National statistics and direct communications from national statistical offices to UNECE secretariat.

- a Expenditures incurred by households and non-profit institutions serving households.
- b Expenditures incurred by the general government on both individual consumption of goods and services and collective consumption of services.
- c Total consumption expenditure plus gross capital formation.
- d Percentage point contribution to GDP growth.

Fiscal consolidation is now an issue of major concern to policy makers in central Europe and in the first three quarters of 2003 some of them took important steps in this direction.\(^{20}\) However, these are just the initial steps and progress in reducing the deficits is likely to be slow and difficult. The envisaged policies often include unpopular austerity measures, which are likely to meet (and are already meeting) resistance from the public. Moreover, the persistent weakness of external demand is not conducive to the necessary fiscal adjustment.

**Recovery is finally gaining momentum in Poland…**

After two years of near-stagnation, the largest economy in eastern Europe finally seems to be on the

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\(^{19}\) For details see UNECE, *Economic Survey of Europe, 2003 No. 1*, pp. 13-15 and 33-34.

\(^{20}\) Thus, the Czech government approved in July a three-year public finance reform programme (which targets both the revenue and the expenditure sides of the fiscal balance) with the goal of trimming the budget deficit to 4 per cent of GDP by 2006. The Hungarian government initiated a series of austerity measures aimed at halving the fiscal deficit to 4.5 per cent in 2003 and reducing it to 3.5 per cent in 2004; in addition, the new tax bill (due to enter into effect in 2004) contains important changes in tax regulations, which are expected to boost tax revenue. However, the new fiscal targets are widely seen as too ambitious and probably unrealistic. In September, Poland’s government approved a medium-term fiscal strategy, which continues the public finance reforms (ongoing since 2001). While the 2004 budget assumes a temporary increase of the public sector deficit, the medium-term programme envisages its reduction to 3 per cent of GDP by 2007. A major, though somewhat controversial tax reform – especially in its bias towards flat-rate taxes and shifting the tax burden from direct to indirect taxes – was also initiated in Slovakia; the government there has confirmed its pledge to meet the Maastricht fiscal deficit reference level (3 per cent of GDP) by 2006, but this may also be overly ambitious.
The road to a full-blown recovery. After growing by 2.2 per cent year-on-year in the first quarter, Poland’s GDP increased by 3.8 per cent in the second. A strong, export-led rebound in the manufacturing sector (especially in the second quarter of the year) was the main supply-side factor behind the economic upturn. Final consumer demand has also been picking up, as evidenced by the accelerating growth in the volume of retail sales during the last year and a half (table 1.3.3), and this was another favourable factor for domestic economic activity. Real fixed investment continued to decline at a diminishing rate in the first two quarters and it now appears to be on the way to recovery. A further easing of the stance of monetary policy by the National Bank of Poland, which made six consecutive cuts in its key interest rates between January and June, contributed to the gradual revival of economic activity. The Polish public finances are in sizeable deficit, and since 2002 the government has been making adjustments, including the introduction of a cap on central government spending. Both the financing of the deficit and the growing public debt have been sources of concern. At the same time, given the general weakness of the economy, policy makers have been hesitant to pursue a more rapid rate of fiscal consolidation. However, the dilemma of whether to pursue growth or rehabilitate the public finances remains: the austerity measures needed to reduce the fiscal imbalance will tend to have an adverse effect on domestic economic activity and hence may endanger the nascent recovery. According to the latest policy programme (reflected also in the draft budget for 2004), the government has postponed for one more year the harshest of its planned measures, hoping that in the meantime the recovery will strengthen, and so provide cyclical support to the fiscal balance and a more conducive environment for restructuring government spending.

…but economic activity is lacklustre in the Czech Republic, Hungary and Slovenia

With the exception of Slovakia, economic activity remained rather subdued in the rest of central Europe in the first half of 2003. In the Czech Republic, Hungary and Slovenia, the rate of GDP growth ranged between 2.2 per cent and 2.5 per cent, year-on-year, and these rates were only achieved because domestic demand was still strong, net exports making a negative contribution to growth (table 1.3.2). In the Czech Republic and Hungary, the dynamics of final domestic demand were dominated by the enduring strength of private consumption (fuelled in both cases by rising real wages and household credit), while in Slovenia, fixed investment, boosted by a large-scale public investment programme, also contributed to growth.

In the first months of 2003, fiscal problems in Hungary were compounded by financial volatility instigated by short-term capital flows. The exchange
rate regime was the main casualty of this volatility; interestingly, within a period of just six months (January to June), there were attacks on both the higher and the lower bounds of the forint’s fluctuation band. The Hungarian monetary authorities were unusually active in this period but the outcomes were sometimes equivocal: in January the central bank successfully resisted a speculative attack on the forint (when market participants were betting on its depreciation), but the effect of its interventions in June (including an official devaluation) were much more debatable. 21 In the Czech Republic, economic policy has been broadly supportive of growth in 2003, with fiscal policy becoming increasingly expansionary and monetary policy relaxing in response to inflation remaining well below the target range and to weakening upward pressures on the exchange rate of the koruna. However, the threat of unsustainable twin deficits, evoked by another large increase in the general government deficit and the rapid widening of the current account deficit, presents the Czech authorities with difficult policy choices.

21  At the beginning of June the National Bank of Hungary devalued the central parity of the forint against the euro by 2½ per cent, partly succumbing to pressure from the government, in a move to boost competitiveness and help job creation. However, the financial markets interpreted this move as a sign of underlying weakness of the currency and soon the forint was under downward pressure, forcing the central bank to raise interest rates by 300 basis points.

In contrast to its neighbours, Slovakia’s economy continued to grow at a relatively fast pace, with GDP increasing by 3.9 per cent, year-on-year, in the first half of 2003. The sources of growth also differed considerably in Slovakia: in the first half of the year aggregate economic activity was entirely driven by accelerating exports (only real net exports contributed positively to GDP growth), while domestic demand as a whole was virtually stagnant (table 1.3.2). The robust export growth reflects the new capacity installed in the industrial sector (associated with inward FDI) and strong cost competitiveness resulting from comparatively low wage levels and rapid productivity growth. Despite this positive outcome, the Slovak economy remains vulnerable to shocks due to its high level of dependence on the automotive sector. The envisaged fiscal reforms also entail certain macroeconomic risks, which may have adverse short-run effects on output.

The Baltic states remain the growth champions of eastern Europe

With an average year-on-year rate of GDP growth of 7 per cent in the first half of 2003, the Baltic region remained the fastest growing part of eastern Europe for the fourth consecutive year (table 1.3.1 and chart 1.3.1). GDP growth accelerated in both in Latvia and Lithuania (to 7.5 per cent and 7.9 per cent year-on-year in the first half of 2003), while it slowed down in Estonia reflecting weak performance in some key sectors such as transport and communications. In all three countries (and especially in Estonia and Latvia) final domestic demand (both private consumption and fixed investment) remained strong and gave a boost to domestic economic activity. The growth of merchandise exports slowed down in all three countries (chart 1.3.2) and, according to the quarterly national accounts data, net exports did not make a positive contribution to growth (table 1.3.2).

Mixed performance in south-east Europe

In the first half of the year, GDP growth remained relatively strong in the majority of south-east European economies despite the weak external environment and the adverse effects of the drought (which was especially pronounced in this region due to the relatively large share of the agricultural sector). The continuing recovery in Bulgaria, Croatia and Romania was mainly supported by buoyant domestic demand: rising real incomes, and a strong tourist season in Bulgaria and Croatia boosted private consumption, while robust fixed investment (mostly private in Bulgaria and Romania and, in the case of Croatia, dominated by public infrastructure projects) also contributed to aggregate output growth. Although export performance was also strong in these
economies, it was outpaced by an even more rapid growth of imports; as a result, the effect of net trade on GDP growth was generally negative in the first half of the year.

Other parts of south-east Europe fared worse in this period and the effects of poor harvests were compounded with other difficulties. In Serbia and Montenegro, following the opening up of the economy, the ongoing price liberalization and the launching of an ambitious programme of restructuring and privatization of the enterprise sector, economic performance has been weak during the last couple of years. (Some observers see parallels between the current state of the economy of Serbia and Montenegro and the initial transformational recession that other east European economies underwent more than a decade ago.) In the first half of 2003 both agricultural and industrial output were down (the latter by 2.4 per cent year-on-year), while aggregate output was probably stagnant. Economic activity in The former Yugoslav Republic of Macedonia and in Bosnia and Herzegovina remained subdued, in the former partly due to a forced fiscal retrenchment following overspending during the recent conflict.

**Further progress in disinflation**

Consumer price inflation in eastern Europe continued its downward trend through August 2003, for the third consecutive year (table 1.3.4). With few exceptions, monthly rates of change fell to historic lows and in many countries there were even price falls. The main exception was Slovakia where some regulated prices (mainly utilities) and excise duties were increased sharply.\(^{22}\) Imported inflation continued to fall thanks to the dampening effect of the large depreciation of the dollar and intense competition in weak international markets for manufactured goods.\(^{23}\) The rate of increase of domestic food prices also slowed down further and they retained their inflationary pressure only in Croatia, Romania and Slovenia. In contrast, service prices, albeit rising more slowly than in 2002, remained the major inflationary force, and rose much more rapidly than the total index.\(^{24}\)

In contrast to the previous two years, the rates of core inflation (CPI excluding food and energy prices) also fell in this period in most of the east European economies for which such data exist. This reflected subdued domestic cost pressures as a result of continued wage disinflation (with the main exceptions of the Czech Republic, Estonia and Hungary) combined with rising industrial labour productivity (table 1.3.4). In fact, industrial unit labour costs remained stagnant or declined in most of these economies with the exception of Romania and Slovenia where the growth of labour productivity was relatively weak and unable to offset the growth in wages.

Despite the moderate wage growth, the low inflation environment has supported a continued rise in real consumer wages (nominal wages deflated by the CPI).\(^{25}\) Thus, real household disposable incomes probably increased in the first half of 2003, particularly in those countries where household credit expanded rapidly (such as the Czech Republic and Hungary) and those where the labour market situation also improved.

Nevertheless, in the absence of external shocks, and given the present state of the labour markets in general, falling import prices and the widespread decline of industrial producer prices, inflation rates (as measured by the CPI) for the year as a whole can be expected to continue to fall in most of the region’s economies, and in many of them to remain below the revised (downwards) official targets.

**Some signs of improvement in east European labour markets but the situation differs across countries**

In the first half of 2003 there were increasing signs of improvement in east European labour markets as several countries reported notable reductions in unemployment rates. Nevertheless, unemployment in the region remains high and its persistence constitutes a serious challenge for economic policy. Thus, although the number of the registered unemployed in eastern Europe declined by some 400,000 in the 12 months to June 2003, the total still exceeded 8 million people, and the average registered unemployment rate was close to 15 per cent of the labour force. The situation, however, differs considerably across subregions and countries.

In central Europe, the average registered unemployment rate was broadly unchanged (at some 15 per cent) in the 12 months to June 2003, but this masks a divergent labour market dynamics in

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\(^{22}\) Year-on-year, August inflation in Slovakia was 9.2 per cent. However, excluding administered prices and indirect tax effects, the increase was only 2.7 per cent.

\(^{23}\) In August 2003, world market prices in dollars for non-energy and energy resources were 8.9 and 11.3 per cent, respectively, higher than a year earlier. In euro terms (in which most of the region’s trade is denominated and to which many east European currencies are pegged) these prices fell by 4.4 and 2.3 per cent, respectively. For more details, see sect. 1.1 and charts 1.1.8. and 1.1.9.

\(^{24}\) Apart from the absence (or low level) of pressure from international competition, the more rapid rise of service prices may reflect the differential dynamics of labor productivity in the tradeable and non-tradeable sectors (the so-called Balassa-Samuelson effect) in catching-up economies.

\(^{25}\) Slovakia was an exception as real gross wages actually fell by nearly 1 per cent in the first half of the year.
individual countries (table 1.3.5). In Slovakia, export-led growth has contributed to a steady decline in unemployment in the last three years: in July 2003, the unemployment rate stood at 14.5 per cent, more than 3 percentage points lower than a year earlier and a five-year low.

In the same 12 months to June, the unemployment rate declined, albeit slightly, also in Slovenia, and it was broadly unchanged in Hungary. In Slovenia, however, it occurred against a background of declining employment suggesting departures from the labour force rather than the creation of new jobs. In contrast, unemployment is on the rise in the Czech Republic for a second consecutive year and in February the rate peaked at a record high of over 10 per cent. After some seasonal easing in the spring, joblessness started to rise again reaching a rate of 10 per cent in August, 0.6 percentage points higher than a year earlier. In Poland, where the high level of unemployment is probably the most urgent policy issue at present, some first signs of stabilization appeared around mid-year: August was the fifth consecutive month of falling unemployment and the 17.6 per cent unemployment rate was only 0.1 percentage points above the rate of a year earlier.

Polish unemployment – as in many other east European countries – is largely structural and it is not realistic to expect a significant fall in the near future, even if output growth continues to pick up.27

The assessment of unemployment on the basis of the regularly conducted labour force surveys (LFS), which are generally regarded as producing more accurate and internationally comparable data, sharpens the differences among these countries even more. Thus, in the second quarter of 2003, the LFS rate of unemployment was between some 6 to 8 per cent in the Czech Republic, Hungary and Slovenia, but stood at 17 per cent in Slovakia and was above 19 per cent in Poland (table 1.3.5).

In the Baltic states, the continuation of strong economic growth contributed to some easing of labour market problems during the first months of the year. In June, the average registered unemployment rate in the region was 8.6 per cent, nearly 1 percentage point lower than a year earlier. Unemployment continued to fall in all three countries, but the steepest decline was in Lithuania where the robust economic recovery has

27 According to national forecasts, the unemployment rate is expected to reach 18.1 per cent at the end of 2003 and then fall to 17.6 per cent by the end of 2004. PAP News Agency, 4 September 2003, as quoted by Dow Jones Reuters Business Interactive (Factiva).
been associated with net job creation, particularly in industry and construction.

There were also clear signs of improvement in the labour markets of most of the south-east European countries. At 16.1 per cent, the average unemployment rate in June was nearly 2 percentage points lower than a year earlier. During the preceding 12 months, the rates fell noticeably (by some 3 percentage points or more) in Bulgaria, Croatia and Romania; it continued to fall in Albania as well. These improvements were generally the result of a relatively strong economic recovery and, in some cases, of active labour market policies (such as incentives for investment in regions with high unemployment and public works programmes). But in some countries labour markets remain very weak with unemployment rates reaching some 30 per cent or more in Bosnia and Herzegovina, Serbia and Montenegro and The former Yugoslav Republic of Macedonia. High unemployment in these three countries is not expected to fall in the short run as privatization and structural reforms are likely to result in further increases in the number of people out of work.

**Exports grow but gradually lose their momentum**

In January–June 2003, the volume of east European exports and imports continued to expand, at year-on-year rates of around 7 per cent, notably faster than the recent growth of EU trade and world trade in general. In current dollar terms, the region’s trade grew by nearly 30 per cent (table 1.3.6), a reflection of the substantial depreciation of the dollar; in current euros – in which about two thirds of the region’s trade is conducted – the increases were much more moderate, about 4-5 per cent.

The pace of export volume growth slowed noticeably in the second quarter of the year in several countries of the region (chart 1.3.2). Nevertheless, as the supply capacity and competitiveness of many east European countries has been enhanced considerably in recent years by FDI coming on stream, the region’s
Computing resources seem to have become quite resilient to faltering demand in western Europe in the past two years and also rather successful in increasing exports to the more dynamic markets of other developed and developing economies (table 1.3.7). Moreover, some east European countries (such as the Czech Republic, Poland and Slovakia, among others) have perceptibly increased their share of EU markets since 2001.28 This is largely due to their integration into international production networks, particularly in the automotive and engineering industries, which in turn is supported by their geographical proximity to western markets and still competitive labour costs.

Hungary, however, has been an exception to this pattern since the middle of 2002. The volume growth of Hungarian exports has slowed down markedly since then and in fact stagnated in the second quarter of 2003, partly because several transnational companies relocated part of their production of office and data processing equipment to Asia in 2002 and early 2003. The move was in part due to the considerable rise in Hungarian unit labour costs in the past two years. The strong appreciation of the forint in real effective terms since the end of 2000 also started to affect the country’s export price competitiveness, particularly in the more competitive western markets, forcing the exporting sector to accept a serious squeeze on profit margins.29 There was also a sharp slowdown in Lithuania’s export volume growth (chart 1.3.2) and an actual fall in exports to the EU in the first half of 2003, but this was confined mainly to refined petroleum exports, which were redirected to other developed markets.30

28 According to Eurostat data, EU imports (in current euros) from the Czech Republic, Poland and Slovakia rose by 9, 8 and 30 per cent, respectively, in January-June 2003, year-on-year, following average annual increases of 13, 10 and 18 per cent, respectively, in 2001-2002, while the overall extra-EU imports remained flat (in 2003) or even declined (in 2001-2002); as a result, these three countries accounted for above 7 per cent of extra-EU merchandise purchases, a gain of more than 2 percentage points in share since 2000. Eurostat, Euroindicators, News Release, No. 110/2003, 18 September 2003 and Eurostat, Comext, Intra- and Extra-EU Trade, CD-ROM No. 8, 2003.

29 The Hungarian forint had appreciated at an average annual rate of above 14 per cent in real effective terms, deflated by unit labour costs, in 2001-2002; it remained broadly unchanged year-on-year in the first half of 2003.

30 In current euros, Lithuanian exports of refined petroleum to the EU fell year-on-year, nearly 20-fold in January-May 2003, from €28.5 million to €14.4 million. However, these exports seem to have been largely redirected to other countries: thus, according to Lithuanian statistics, exports to Switzerland increased from a mere €9 million in January-May 2002 to €28.7 million in the first five months of 2003.
CHART 1.3.2
Merchandise trade flows and balances in selected east European economies and Russia, 2001Q1-2003QII
(Percentage change in export and import volumes over same quarter of the previous year, trade balance values in million dollars)

Source: UNECE secretariat calculations, based on national statistics.

Note: Export and import volume changes as reported by countries or estimated from changes in average export and import prices (unit values) and trade values. Merchandised trade balance values at the end of the quarter cumulated over 12 months.
The strong growth of import demand in Russia and Ukraine, the two largest CIS economies, was the main factor behind the general rise of east European exports to the CIS (table 1.3.7), while the strength of eastern Europe’s intraregional trade was sustained by the buoyant growth of domestic demand in the region.  

**Import demand remains high**

In the first half of 2003, the growth of east European imports was supported by the generally robust growth of domestic demand, but it was also partly driven by the exporting sectors’ requirements for inputs and capital goods and, in some cases, by the strong appreciation of domestic currencies. In aggregate, imports grew slightly less than exports, both in volume and value, and also slowed down during the second quarter of the year. However, the growth of imports varied from country to country and the aggregate outcome was influenced mainly by the slowdown of import volume growth in Poland. Developments were somewhat similar in Lithuania, Slovakia and some of the south-east European countries, while Czech import volumes tended to move more in parallel with exports (chart 1.3.2 and table 1.3.6).  

In other countries (such as Bulgaria, Estonia, Hungary and Romania), imports markedly outpaced exports (especially in more recent months), in most cases driven by buoyant consumption. The recent import surge in smaller economies such as Latvia and Slovenia, however, was often due to one-off purchases of expensive equipment (such as civil aircraft and helicopters in the case of Slovenia).

In those economies with rapidly growing imports there was a considerable widening of their merchandise trade deficits compared with the first half of 2002, both in value terms and in relation to GDP, while in the other east European countries there was generally a narrowing of their deficit-to-GDP ratios; in dollar value terms, only in the Czech Republic and Slovakia were deficits slightly smaller than a year earlier.

With the exceptions of Hungary and Poland, the terms of trade improved slightly or remained unchanged across the region, partly as a result of the lower dollar prices of imported energy in the second quarter of 2003, but also due to somewhat lower prices for imports of intermediate goods originating from outside western Europe (the weak dollar effect). On the export side, however, the increased competitive pressures in international markets for manufactured goods generally inhibited a rise in export prices. The pick-up of world market prices of agricultural products and some industrial raw materials in the second quarter of 2003 had a positive effect on the terms of trade of several south-east European countries, which are net-exporters of these goods (inter alia, Bulgaria and Romania).

**Current account deficits tend to widen**

The general widening of merchandise trade deficits shaped the dynamics of current-account positions in the first half of the year in most east European economies; changes in the balance on services were on the whole rather small while changes in net investment income and transfers, often in opposite directions, were important in only a few countries. The aggregate east European current account deficit amounted to $16.3 billion in January-June 2003, a deterioration by some $3.1 billion compared with the same period of 2002.  

In relation to GDP, the current-account position weakened slightly for the region as a whole, but the ratio varied widely among countries (table 1.3.6). While the merchandise trade deficit widened, the total east European surplus from trade in services shrank, to $2.3 billion (from $2.4 billion in January-June 2002), mainly due to a surge in the deficit generated by services other than travel and transport. The latter two sectors still generated net inflows, although net inflows from transport were smaller than a year earlier owing to increasing outflows on transport commensurate with larger trade deficits. Tourism revenues, however, picked up in the second quarter in a number of countries. An increase in net outflows on the investment income account ($6.7 billion in aggregate, due mainly to the growth of external debt and profit repatriation) was nearly offset by a rise in the net inflow of current transfers – mainly workers’ remittances and funds associated with EU accession.

Only in Poland and Slovakia was there a marked reduction in their current account deficits. In Slovakia this was almost entirely due to the reduction in the merchandise trade deficit, while in Poland it was attributable to a surge of unclassified net inflows (a $190 million improvement in Poland’s merchandise trade deficit (balance of payment methodology) was more than offset by a marked rise in outflows on services).

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31 The growth potential of intraregional trade seems again to be a focus of research and policy debates as the majority of these countries are getting ready to join the EU. A recent study published by the French Ministry of Economy, Finance and Industry foresees that the intraregional trade of CEECs could triple over the next 10 years, accounting for around 15 per cent of their total trade in 2010. Revue Elargissement Spécial Intraregional Trade, Dossier No. 30, September 2003.

32 Imports into Poland seem to have been picking up since May 2003, supported by the recent strengthening of household consumption and investment. Large increases in imports were also reported in July-August in Slovakia.

33 In April-June 2003, the average world market dollar price for crude oil was just 4 per cent higher year-on-year following a 46 per cent increase in the first quarter.

34 In current euros, the deterioration of the aggregate current account deficit was much less pronounced.
The sharp deterioration of the current account balance in Hungary was largely due to the near tripling of its merchandise trade gap in current dollars (balance of payment methodology) compared with the amount of reinvested earnings of foreign-invested firms, which may be equivalent to 2-3 per cent of GDP.

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

**Note:** For country groups see table 1.3.1.

- Growth rates are calculated on values expressed in dollars.

- The current account deficit continues to be reported by the National Bank of Hungary on a net cash basis, diminishing the deficit by
first half of 2002, but it was also influenced by the appearance of a deficit on the services account. Net revenues from tourism declined, while net outflows on the income account and for other services increased considerably compared with the same period of last year. The main concern for the Hungarian authorities seems to be the financing of the current account: at present they are having to rely increasingly on new borrowing from abroad to cover the surging current account deficit.

Total net inflows of FDI to eastern Europe – which for most of the transition period have been the leading source of external financing in the region – diminished considerably in January-June 2003, mainly as a result of large net outflows from Hungary, but also due to smaller inflows to several other countries (the Czech Republic, Lithuania, Poland and Slovenia). Despite that, however, current account deficits were relatively easily financed. In particular, portfolio investment and short-term capital inflows have been picking up recently. The issuance of international bonds by east European entities (Hungary, Poland and Romania, among others) benefited from falling risk premia and low interest rates.

1.4 The CIS

A strong economic upturn

After a slowdown in 2002, there was a renewed surge in economic activity throughout the CIS in the first half of 2003 with aggregate GDP growing by 7.4 per cent year-on-year (table 1.4.1). There was strong growth in all subregions, and in most CIS economies the pace of expansion picked up. The simultaneous upturn in much of the CIS and, especially in its largest economies, Kazakhstan, Russia and Ukraine, benefited the region as a whole as – thanks to the strengthening of intra-CIS trade – growth in neighbouring economies was mutually reinforcing.

Growth in the first half of the year was predominantly driven by the rapid expansion of domestic demand, especially private consumption. The widespread acceleration of output growth in the industrial sectors (chart 1.4.1) provided solid support to GDP growth in most of the CIS economies. In addition, recent developments in world energy and commodity prices also favoured the commodity exporting countries. On the downside, grain harvests in some CIS economies were hit by drought (Ukraine was probably the worst affected) but the effect varied from country to country.

The economic revival in the CIS region (which has been underway for several consecutive years) has been accompanied by marked progress in their economic transformation, especially in recent years. The acceleration of systemic reforms in a number of countries (particularly in Kazakhstan, Russia and Ukraine) has brought about many positive changes in their economic environment. The recent consolidation of public finances in many CIS economies has contributed to greater macroeconomic stability. One important sign of the improving business climate is the recent surge of inward FDI to some of the CIS countries.36

In September 2003, the four largest CIS economies – Belarus, Kazakhstan, Russia and Ukraine, signed an agreement stipulating their intention to

36 Thus, in the first half of 2003, the inflow of FDI to Russia rose to $12.7 billion, an increase of some 50 per cent over the same period of 2002.
create a single economic space. Building on an earlier proposal to create a free trade zone within the CIS (which is still being debated), the four countries intend to pursue not only free trade in goods and services but also free movement of capital and labour. The agreement to create a single economic space is the latest of many CIS proposals made since the breakup of the Soviet Union, aiming at closer economic integration among the successor states. The effectiveness of the latest initiative remains to be seen, however, as previous ones so far have not been very successful.

In recent years, Russia’s economy has been one of the important engines of growth for the CIS region as a whole. While this engine lost some steam in 2002, rapid economic growth resumed in the early months of 2003, led by a broad-based surge in industrial production. In the first half of the year, Russia’s GDP increased by 7 per cent over the same period of 2002 (an increase that surpassed earlier expectations by a large margin), while gross industrial output rose by 6.8 per cent. Growth was predominantly driven by the continuing expansion of domestic demand (table 1.4.2) but fuel exporters also benefited from increases in world market prices. While private consumption remained the main driving force of domestic demand in the first half of the year (with real retail sales rising by almost 9 per cent year-on-year – table 1.4.3), fixed investment also increased sharply, real outlays being some 12 per cent higher than a year earlier. Notably, domestic producers managed to benefit from rising domestic demand and most manufacturing branches reported solid growth in the early months of the year. Although some parts of the country were affected by droughts, the impact of adverse weather conditions on Russia’s agricultural output was not very significant.

Russia’s economy is much stronger now than it was several years ago: public finances are in order (and during the last several years the budget has been in surplus); Russia’s financial markets are not the target of speculative capital flows; the banking system has been strengthened; and monetary circulation is back to normal (payments arrears have fallen substantially). Equally important, the authorities accelerated the pace of systemic and structural reforms after the 1998 crisis and this has helped to revitalize the Russian economy. An important confirmation of these positive developments is the recent upgrading of Russia’s sovereign credit rating by Moody’s Investors Service to investment grade.

In Ukraine, reservations about the participation of the country in the envisaged customs union, common currency arrangement and supranational decision-making bodies have already been expressed by opponents to the proposal.

37 In Ukraine, reservations about the participation of the country in the envisaged customs union, common currency arrangement and supranational decision-making bodies have already been expressed by opponents to the proposal.
TABLE 1.4.2
Major demand components of GDP in selected CIS economies, 2002-2003
(Percentage change over the same period of the preceding year)

<table>
<thead>
<tr>
<th>Private consumption expenditure a</th>
<th>Government consumption expenditure b</th>
<th>Gross fixed capital formation</th>
<th>Total domestic expenditure c</th>
<th>Net exports d</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>6.1</td>
<td>10.8</td>
<td>8.7</td>
<td>-5.2</td>
</tr>
<tr>
<td>Belarus</td>
<td>12.4</td>
<td>9.9</td>
<td>8.0</td>
<td>0.8</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>12.2</td>
<td>3.6</td>
<td>14.9</td>
<td>-2.4</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>5.7</td>
<td>5.3</td>
<td>8.3</td>
<td>-14.4</td>
</tr>
<tr>
<td>Republic of Moldova</td>
<td>13.9</td>
<td>4.5</td>
<td>12.0</td>
<td>16.8</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>8.3</td>
<td>8.7</td>
<td>7.6</td>
<td>1.8</td>
</tr>
<tr>
<td>Ukraine</td>
<td>5.6</td>
<td>4.2</td>
<td>13.4</td>
<td>7.2</td>
</tr>
</tbody>
</table>

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

- a Expenditures incurred by households and non-profit institutions serving households.
- b Expenditures incurred by the general government on both individual consumption of goods and services and collective consumption of services.
- c Total consumption expenditure plus gross capital formation.
- d Percentage point contribution to GDP growth.

Economic growth in Ukraine has also accelerated in the first half of 2003 and was considerably above the expectations, with GDP rising by 8.6 per cent year-on-year. An export-led upturn in key manufacturing sectors (particularly in steel and chemicals, which benefited from increased external demand and favourable prices) contributed to an overall surge in real industrial output, which grew by 14.6 per cent year-on-year in the period January-August. The recovery of real incomes and private consumer demand continued at a strong pace and this contributed to robust growth in other important sectors such as trade (in the first six months of the year the volume of retail sales was almost 16 per cent higher than in the same period of 2002, table 1.4.3), other services and construction.

…and continued buoyancy in other economies

In the first half of the year GDP grew at double-digit rates in Armenia, Azerbaijan, Kazakhstan and Turkmenistan38 and at rates close to 10 per cent in Georgia and Tajikistan (table 1.4.1). However, the economic situation varies considerably among these countries. The recovery in Azerbaijan and Turkmenistan is very narrowly based on the energy sector and exports of fuels. While an FDI-led reconstruction of the energy sector has contributed to the recent strong economic performance in Kazakhstan, its economy is more diversified and growth has been broadly based. The acceleration of systemic reforms in this country has contributed to a better business climate and an increasing inflow of FDI. Despite their high rates of GDP growth, the economic situation in countries such as Armenia, Georgia and Tajikistan remains rather fragile.39 In these, as well as in other CIS economies, recent growth is from a very low base and so far has had little impact on living standards; widespread poverty still remains a major problem for a number of countries in the CIS.

In Belarus and the Republic of Moldova growth has also been relatively strong, with GDP increasing by more than 5 per cent in the first half of 2003.40 With a 2.3 per cent rate of GDP growth Kyrgyzstan was the slowest growing CIS economy in this period; however, this marks a positive turnaround in performance with the resumption of production at the Kumtor gold mine after a major accident in 2002. The mine accounts for a large share of the country’s industrial output and exports.

Moderate disinflation

Disinflation, which started in 2000 and accelerated through 2002, slowed somewhat in the first eight months of 2003. However, this was mainly due to large increases in food prices (which had been the major source of disinflation in 2002) during January-April.41 By mid-year, the downward trend in consumer prices had little impact on living standards; widespread poverty still remains a major problem for a number of countries in the CIS.

38 The officially reported rates of GDP growth in Turkmenistan should be treated with caution, see the note to table 1.4.1.

39 Georgia has been struggling with a rising level of foreign debt and in 2003 was unable to meet all of its scheduled repayments; in addition, in September the IMF temporarily suspended funding under its Poverty Reduction and Growth Facility due to the failure of the authorities to meet the targets for reducing the public sector deficit.

40 In July, IMF suspended its operations under the Poverty Reduction and Growth Facility in the Republic of Moldova due to considerable delays in the implementation of structural reforms that are part of the funding programme.

41 The main factor behind this rise in food prices was the Russian government’s intervention to support domestic grain prices in mid-November 2002 after they had collapsed as a result of oversupply. (Harvests were larger than usual in both 2001 and 2002 but subsequently Russia exported a large share of the surplus.) In the rest of the CIS, the depreciation of their currencies against the rouble exacerbated the impact of higher prices for grain imported from Russia, their major supplier.
price inflation resumed its rapid pace thanks to the seasonal fall of prices for fresh produce coupled with significant gains in industrial labour productivity. Their combined effect appears to have been sufficient to offset the inflationary pressure generated by the rapid growth in average nominal wages, which continued to grow at double-digit rates – table 1.4.4. In fact, for the first time since 2000, measured labour productivity in the first half of 2003 rose faster than real product wages\textsuperscript{42} in the industrial sector. *Ceteris paribus*, this suggests some recovery in operating surpluses, which is indispensable for raising fixed investment, particularly in those countries where bank lending is scarce and FDI inflows are limited to the few sectors related to natural resources.

As consumer price inflation was less than the rise in average nominal net wages, real household disposable incomes continued to increase strongly, with the exception of Belarus, where real wage growth slowed down and total employment declined. Thus, for the third consecutive year, consumer demand generally remained strong in most of the CIS region. The ensuing pressure on prices prompted anti-inflationary measures by some governments.\textsuperscript{43} Nonetheless, the sustained strength of consumer demand in most CIS economies is likely to continue to put pressure on prices in the remaining months of 2003 and a further resurgence of inflation cannot be ruled out.

\textbf{Labour markets: little change in unemployment}

In view of the continuing and strong economic recovery in the CIS, there were expectations of further improvement in labour markets in the first half of 2003. Assessing the current situation, however, is problematic due to the unreliable labour market statistics for many of these countries. So far only Kazakhstan, the Republic of Moldova, Russia and Ukraine conduct regular, quarterly labour force surveys, while registration data are the only source for unemployment data in the rest of the CIS; the latter are often inaccurate and sometimes quite misleading.\textsuperscript{44} In fact, the registered unemployment data do not indicate any notable changes in CIS unemployment rates in the 12 months to June 2003: these generally remained very low, varying mostly between 1.4 per cent (Azerbaijan) and 3.7 per cent (Ukraine), the main exception being Armenia (9 per cent) (table 1.4.5).

The available data from labour force surveys suggest much higher rates and, in some cases, somewhat different trends of unemployment than those based on registration data. Thus, according to the LFS data, unemployment rates in the second quarter of 2003 varied between some 7 per cent in the Republic of Moldova and 9 per cent in Ukraine (table 1.4.5). In Kazakhstan and Ukraine, LFS-based unemployment rates continued to decline, albeit slowly, for a third consecutive year, and in the second quarter of 2003 they were about one half of a percentage point below those of a year earlier. In contrast, unemployment in the Republic of Moldova and in the Russian Federation increased slightly in this period. But in Russia, the recent data are somewhat erratic and confusing. While the unemployment rate has been declining steadily since the beginning of 2000, this was reversed in the closing months of 2002 and in February 2003 the LFS unemployment rate was 1 percentage point higher than a year earlier. Although the rate started to decline after February, in August it was still 0.4 percentage points higher than in August 2002. While there was some slowdown in economic activity in the second half of 2002, the rise in unemployment is somewhat surprising, given the strong rate of growth in the first half of 2003. Some analysts believe that it may reflect an unspecified methodological change in estimating unemployment.\textsuperscript{45}

\begin{table}[h]
\centering
\caption{Volume of retail trade in the CIS, 2002-2003 (Percentage change over the same period of previous year)}
\begin{tabular}{|l|l|l|l|l|l|l|}
\hline
& 2002 & & & & & \\
& HI & HII & QII & QII & HI & \\
\hline
Armenia & 14.2 & 16.4 & 15.6 & 10.7 & 13.8 & 12.4 \\
Azerbaijan & 8.9 & 10.1 & 9.6 & 9.5 & 10.1 & 9.8 \\
Belarus & 14.3 & 11.9 & 12.9 & 11.1 & 6.4 & 8.6 \\
Georgia & 0.9 & 6.6 & 3.7 & 4.6 & 5.7 & 5.2 \\
Kazakhstan & 8.9 & 8.4 & 8.6 & 8.8 & 11.1 & 9.9 \\
Kyrgyzstan & 6.2 & 9.7 & 8.2 & 10.6 & 9.6 & 10.1 \\
Republic of Moldova & 21.4 & -22.3 & - & - & - & - \\
Russian Federation & 8.7 & 9.7 & 9.2 & 8.5 & 9.3 & 8.9 \\
Tajikistan & 19.2 & 15.3 & 17.4 & 35.1 & 30.4 & 32.6 \\
Ukraine & 17.1 & 15.2 & 16.1 & 13.2 & 18.5 & 15.9 \\
Uzbekistan & 5.7 & -2.1 & 1.7 & -0.2 & 0.8 & 0.3 \\
\hline
\end{tabular}
\end{table}

\textsuperscript{42} Nominal wages deflated by the producer price index.

\textsuperscript{43} Thus, in the Russian Federation tighter control over administered prices helped to contain the rate of service price inflation; in addition, the nominal appreciation of the rouble in the first eight months of the year also had an anti-inflationary effect. In Ukraine, there was a presidential ruling in the spring against price increases for medicine, food and public utilities.

\textsuperscript{44} A large proportion of the jobless, although willing to work, do not register as unemployed. This proportion varies in different countries between 50 and 80 per cent of total unemployment. Among the main reasons for this are the low unemployment benefits (often paid in arrears), and undeveloped employment services, as well as the inefficient operation of local labour offices. For a more detailed discussion see UNECE, \textit{Economic Survey of Europe, 2003 No. 1}, pp. 197-198.

Another possible explanation may be a more intensive shedding of excess labour as, according to anecdotal evidence, a number of Russian firms have stepped up the process of restructuring under the pressure of increased competition in the domestic product markets. However, the information available at the time of writing this Survey was not sufficient to draw any firm conclusions about recent changes in the Russian unemployment rate.

### Expansion of international trade

In the first six months of 2003, the dollar value of total merchandise exports from the CIS increased by almost a third, year-on-year, largely due to higher commodity prices (table 1.4.6).\(^{46}\) Imports were driven

\(^{46}\) In comparison with the first half of 2002, prices of key natural resources such as crude oil, natural gas and cotton were higher by 25-40 per cent (while there were smaller increases for metals and gold).
The large increase in the dollar value of CIS exports was mainly due to several individual countries with very substantial increases ranging between 20 and 50 per cent. Among them were all the commodity exporters except Azerbaijan, Kyrgyzstan and Tajikistan. In addition to higher commodity prices, Russian oil producers increased the volume of crude oil and oil products shipped by 11 and 7 per cent, respectively. In Ukraine, the substantial growth in the dollar value of exports reflected foreign demand for steel products and chemicals. Exports of steel and chemicals, which account for almost half of the Ukraine’s foreign earnings, rose by a third in value compared with the first six months of 2002. In Turkmenistan and Uzbekistan, where the reliability of official data is uncertain, the total value of exports is also reported to have increased substantially (by 25 and 20 per cent, respectively). The value of Turkmenistan’s exports of natural gas increased by almost 20 per cent, exports of oil products doubled and cotton fibre exports rose by 80 per cent. In Uzbekistan, the rise in export prices for cotton and gold contributed to the increase in total exports; exports of manufacturers are also reported to have risen.

In some CIS countries (such as Armenia, Belarus and the Republic of Moldova), the large increases in the value of total exports were accompanied by relatively larger increases in exports to non-CIS markets. In contrast, the composition of exports from Kyrgyzstan shifted towards traditional CIS markets due to flat gold sales to non-CIS countries and lower

47 However, all CIS currencies depreciated in real terms against the euro. Thus, expressed in euros, CIS exports increased by 5 per cent, while imports declined by 1 per cent.

48 In Belarus, in the first five months of 2003, the value of exports to Russia – the country’s dominant trade partner – increased by 18 per cent, while exports to non-CIS markets increased by 30 per cent. The Republic of Moldova’s exports to non-CIS markets also outpaced sales to traditional export markets within the CIS (by a factor of six). In Armenia exports of processed precious stones and metals to Belgium and Israel have continued to drive aggregate exports. However, because of the inward processing of diamonds and precious metals, the large increase in exports of jewellery is usually accompanied by a corresponding increase in imports.

### Table 1.4.6

<table>
<thead>
<tr>
<th>Country</th>
<th>2001 Merchandise exports (dollar)</th>
<th>2002 Merchandise exports (dollar)</th>
<th>2003 Merchandise exports (dollar)</th>
<th>Trade balance (per cent of GDP)</th>
<th>Current account (million dollars)</th>
<th>Current account (per cent of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CIS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Armenia</td>
<td>13.7</td>
<td>48.4</td>
<td>39.5</td>
<td>-23.5</td>
<td>-253</td>
<td>-201</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>32.6</td>
<td>-6.3</td>
<td>6.2</td>
<td>22.1</td>
<td>16.4</td>
<td>57.8</td>
</tr>
<tr>
<td>Belarus</td>
<td>1.6</td>
<td>8.7</td>
<td>25.3</td>
<td>-4.6</td>
<td>9.8</td>
<td>31.5</td>
</tr>
<tr>
<td>Georgia</td>
<td>-3.0</td>
<td>1.6</td>
<td>5.8</td>
<td>4.3</td>
<td>6.1</td>
<td>27.0</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>-5.2</td>
<td>12.3</td>
<td>50.2</td>
<td>26.0</td>
<td>2.0</td>
<td>18.8</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>-5.6</td>
<td>2.5</td>
<td>-0.2</td>
<td>-15.7</td>
<td>25.6</td>
<td>10.5</td>
</tr>
<tr>
<td>Republic of Moldova</td>
<td>20.9</td>
<td>16.8</td>
<td>25.6</td>
<td>15.6</td>
<td>17.3</td>
<td>30.6</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>-2.1</td>
<td>5.1</td>
<td>29.3</td>
<td>22.1</td>
<td>11.5</td>
<td>20.1</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>-16.9</td>
<td>13.0</td>
<td>-0.6</td>
<td>1.9</td>
<td>4.4</td>
<td>-1.5</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>8.0</td>
<td>5.6</td>
<td>26.9</td>
<td>26.4</td>
<td>-5.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Ukraine</td>
<td>11.6</td>
<td>10.4</td>
<td>26.9</td>
<td>13.0</td>
<td>7.6</td>
<td>29.0</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>-3.7</td>
<td>-14.8</td>
<td>19.5</td>
<td>6.0</td>
<td>-18.9</td>
<td>-8.3</td>
</tr>
</tbody>
</table>

**Note:** Foreign trade growth is measured on current dollar values. Trade balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. GDP values are in some cases estimated from reported real growth rates and consumer price index values.

**Source:** UNECE secretariat calculations, based on national statistics and direct communications from national statistical offices.
TABLE 1.4.7
CIS countries' trade with CIS and non-CIS countries, 2001-2003
(Values in million dollars, year-on-year, growth rates in per cent)

<table>
<thead>
<tr>
<th>Country</th>
<th>Export growth</th>
<th>Import growth</th>
<th>Trade balances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2003(^a)</td>
<td>2002</td>
</tr>
<tr>
<td>Armenia</td>
<td>-8.0</td>
<td>3.0</td>
<td>2.9</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>9.4</td>
<td>33.5</td>
<td>46.1</td>
</tr>
<tr>
<td>Belarus</td>
<td>-0.7</td>
<td>21.5</td>
<td>8.9</td>
</tr>
<tr>
<td>Georgia</td>
<td>-5.1</td>
<td>12.5</td>
<td>3.1</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>9.6</td>
<td>-1.7</td>
<td>11.2</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>-3.8</td>
<td>-4.8</td>
<td>25.6</td>
</tr>
<tr>
<td>Republic of Moldova</td>
<td>0.1</td>
<td>10.6</td>
<td>25.7</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>-36.9</td>
<td>52.4</td>
<td>15.1</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>3.9</td>
<td>8.6</td>
<td>20.7</td>
</tr>
<tr>
<td>Ukraine</td>
<td>-11.4</td>
<td>-39.8</td>
<td>1.3</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>-4.9</td>
<td>22.9</td>
<td>-19.3</td>
</tr>
<tr>
<td>Total above</td>
<td>-34.0</td>
<td>10.8</td>
<td>-18.2</td>
</tr>
<tr>
<td>Non-CIS</td>
<td>15.7</td>
<td>32.7</td>
<td>8.5</td>
</tr>
<tr>
<td>CIS total</td>
<td>-6.4</td>
<td>20.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>6.1</td>
<td>28.5</td>
<td>17.1</td>
</tr>
<tr>
<td>CIS total</td>
<td>6.8</td>
<td>33.8</td>
<td>-8.7</td>
</tr>
</tbody>
</table>

Source: CIS Statistical Committee (Moscow); UNECE estimates for Turkmenistan and Uzbekistan.
\(^a\) January-June.

output growth in the region. In all CIS countries, except Tajikistan, Turkmenistan and Uzbekistan, increases in the value of imports ranged from 11 to 58 per cent. Russian imports continued to increase rapidly as a result of robust growth in fixed investment and consumption. In the first half of 2003, imports of machinery and equipment rose by 25 per cent, year-on-year, and capital goods are expected to continue to be the most important component of Russian imports. In other countries, the continued modernization of the capital stock and investment in the new productive capacity have also contributed to increased imports. In Azerbaijan they rose by almost 60 per cent due to increased spending on the pipeline infrastructure and further exploration and development of the country’s oil and natural gas fields. Similarly, in Georgia increased purchases of pipe and the rising prices of energy, contributed to the increased value of total imports. In Kazakhstan, imports of machinery, equipment and transportation vehicles increased by almost a half and accounted for 40 per cent of total imports. In a number of countries, the increased dollar value of imports was closely related to the higher prices for crude oil and natural gas.\(^49\)

Current account balances of commodity exporters improve

In the first half of 2003, the combined current account surplus of the CIS countries continued to rise (table 1.4.6). While its growth in the second quarter slowed down somewhat compared with the first three months – owing, to some extent, to the dip in crude oil prices in April – it is widely expected that the continuing strength in commodity prices will ensure solid current account surpluses in the largest natural resource exporting CIS countries in 2003 as a whole. According to preliminary balance of payments data, Kazakhstan, Russia, Turkmenistan, Ukraine and Uzbekistan all had surpluses in the first six months of the year.

Most of the countries with current account deficits – these are either economies not endowed with natural resources or engaged in extensive upgrading of their capital base by purchasing investment goods abroad – do not appear to have had major difficulties in financing them. In some of the resource-rich CIS countries, FDI remains a major source of financing the deficits.\(^50\) However, other countries (especially the

\(^49\) For example, Belarusian imports increased by a third not only because of increased volumes of oil and natural gas from Russia, but also because of sharply increased contract prices, while Ukraine imported 60 per cent more oil in value. Rising mineral product prices also raised the value of imports in Kyrgyzstan and the Republic of Moldova.

\(^50\) For example, in Azerbaijan, the country with the largest current account deficit in the region (26 per cent of GDP) for January-June 2003, FDI inflows were equivalent to 31 per cent of GDP and there was a very large increase in investment outlays (64 per cent, year-on-year).
heavily indebted ones) were facing balance of payment constraints.\(^\text{51}\)

The aggregate current account surplus of the CIS was almost $23 billion in the first half of 2003, the Russian economy contributed over 90 per cent of it. Merchandise exports, particularly of crude oil and natural gas, accounted for most of the Russian surplus, which averaged 11.2 per cent of GDP in the first half of 2003 (against 9.5 per cent in the same period of 2002).

### 1.5 The short-term economic outlook

#### (i) Western Europe and North America

Most forecasters expect a continuing recovery in the United States in the second half of 2003, driven mainly by expansionary monetary and fiscal policies and the gain in price competitiveness stemming from the depreciation of the dollar. For the year as a whole, real GDP in the United States is forecast to increase by some 2.5 per cent in 2003. The stronger cyclical momentum will carry over into 2004, when real GDP is expected to rise by some 4 per cent (table.1.5.1). Against this background, baseline forecasts assume a gradual withdrawal of the sizeable monetary stimulus in the course of 2004.

In the euro area, economic activity is expected to remain very sluggish in the second half of 2003. This reflects persistently weak domestic demand and the restraining effects on exports of the sizeable real appreciation of the euro in an international economic environment, which is still relatively weak. Forecasts of growth in the euro area have been lowered to a mere 0.5 per cent in 2003. This very modest outcome reflects not only persistent economic stagnation in Germany but also a pronounced cyclical slowdown in France and Italy and in several of the smaller economies in the euro area (table.1.5.1). Economic growth in the remaining three EU members outside the euro area should remain significantly above the euro area average. Taking into account the performance of the non-EU economies, real GDP in western Europe is expected to increase by just 1 per cent in 2003.

Overall, the prospect is for a relatively lacklustre cyclical upturn, supported by low interest rates, the favourable impact of falling inflation on real personal disposable incomes and household spending, some inventory rebuilding, and the expected gradual improvement of the external environment. Given the weak rate of output growth, however, the situation in the labour markets will hardly improve and this will dampen consumer confidence. Against this background, current forecasts are for only a moderate acceleration of economic growth in the euro area in 2004, to an average annual growth rate of somewhat less than 2 per cent. For western Europe as a whole, the national forecasts add up to an aggregate growth rate of 2 per cent, reflecting the continuing stronger cyclical momentum outside the euro area.

#### Can the recovery be sustained?

The improved global economic outlook is dependent on the United States maintaining its role as the engine of growth for the world economy. As was pointed out earlier\(^\text{52}\) the problem with this scenario is...
that it will accentuate the already huge external imbalance of the United States and increase the risks of disruptive adjustments of capital flows and exchange rates of the major currencies. This points to the need to create a more conducive environment for growth of domestic demand in the rest of the world to better accommodate the external adjustment process in the United States. While the depreciation of the dollar is part and parcel of the necessary adjustment required of the United States, the burden has so far fallen disproportionately on the euro area, given the exchange rate policies pursued in Asian economies. On the other hand, persistent weakness of euro zone domestic demand also puts disproportionate emphasis on the dollar exchange rate as a means of adjustment.

There are several other important downside risks facing the United States economy. The recovery has so far not led to any significant improvement in the labour market, and a continued “jobless recovery” could erode consumer confidence and dampen household spending, which has been the mainstay of economic growth even during the cyclical downturn. Consumer spending could also be adversely affected by a further rise in long-term interest rates, especially given the very high levels of household debt. This could trigger an end to the housing boom with concomitant downward pressure on house prices and adverse wealth effects. In any case, rising interest rates are bound to restrain consumer spending, inter alia, because of their adverse effects on mortgage refinancing, which has been a major source of additional spending power over the past few years. Rising long-term interest rates would also affect business investment, the future strength of which is in any case uncertain because of the considerable margins of excess capacity. A weaker than expected recovery would also risk frustrating the currently optimistic profit expectations, reflected in the surge in equity prices during the first three quarters of 2003, with associated risks of negative wealth effects on aggregate demand.

In the United States, both monetary and fiscal policy have responded forcefully to the progressive weakening of economic activity. The federal funds rate is now only 1 per cent and it is clear that the margin for conventional monetary policy measures to stimulate economic activity is now largely exhausted. The fiscal position has deteriorated significantly, leaving little scope for additional expansionary measures and raising concerns about its sustainability in the medium and longer term. There is also the persistent risk of adverse reactions in the capital markets to the large “twin deficits” with concomitant negative effects on interest-sensitive expenditure.

In the euro area, there is still scope for a further relaxation of monetary policy, and this is desirable in view of the moderate outlook for growth, forecasts of inflation falling below 2 per cent, and the fact that the earlier relaxation of monetary policy was largely offset by the sizeable real appreciation of the euro. As regards fiscal policy, at the current juncture it would be counterproductive to prevent the automatic stabilizers from operating fully and to enforce procyclical policies.

Although it has to be acknowledged that insufficient effort was made during the good years to bring public finances in line with the Maastricht criteria, and so provide a cushion against adverse shocks, the present is hardly an appropriate time to make up for previous sins of omission.

(ii) Eastern Europe and the CIS

Having demonstrated resilience to the global slowdown, eastern Europe and especially the CIS are poised to remain the most dynamic parts of the ECE region. However, the outlook for 2003 as a whole in eastern Europe has deteriorated somewhat since the assessments made at the beginning of the year. The more optimistic expectations about the economy of the euro area have failed to materialize and in some east European economies growth has fallen below expectations. As discussed above, growth in many of the region’s economies in 2003 was predominantly consumption-led but this may prove to be unsustainable unless the recent modest recovery in business fixed investment gains momentum and leads the way to a healthier structure of output growth accompanied by further productivity improvements and job creation. There are uncertainties about export growth in the short run in view of the dim prospects for a west European recovery and the increasingly strong competitive pressures coming from Asian producers. In addition, the adverse effects of the poor harvests will only be fully apparent in the second half of the year and in some cases, especially in the more agricultural countries, they may pull down the overall rates of output growth.

At the time of writing this Survey, aggregate GDP in the east European region was forecast to increase by 3.6 per cent in 2003 as a whole, compared with the 3.9 per cent expected at the beginning of the year. This mainly reflects the lowering of forecasts in some of the central European economies, in particular the Czech Republic, Hungary and Slovenia (prompted, in turn, by their worse than expected performance in the first half

53 On this issue, see also the Statement of G-7 Finance Ministers and Central Bank Governors (Dubai), 20 September 2003 [www.g7.utoronto.ca].

54 In western Europe, there are similar risks of a downturn in housing markets following a surge in house prices, especially in the United Kingdom, but also in Ireland, the Netherlands, Spain and Sweden.
of the year). Growth forecasts were lowered also in Estonia and Romania. In other countries such as Bosnia and Herzegovina and Serbia and Montenegro, GDP growth for the year as a whole is also expected to fall short of earlier forecasts. In contrast, Poland's economy (with a considerable weight in aggregate regional output) has been recovering faster than expected, and there has been a slight upward revision in the GDP forecast for the year as a whole. Similarly, the official forecasts for Lithuania and for Latvia have also been raised.

The speed of the recovery in the CIS region in the early months of 2003 has prompted upward revisions of growth forecasts. According to the official forecasts available in mid-October, aggregate GDP in the CIS was expected to grow by 6.3 per cent in 2003 as a whole, substantially above the 4.4 per cent forecast at the beginning of the year. According to the latest forecasts, Russia's GDP is expected to grow by some 6 per cent in 2003, which is 1.5 percentage points above the January forecast. Growth forecasts have been raised in many of the other CIS countries, in particular Armenia, Kazakhstan and Ukraine, among others. If the present rates of growth continue through the end of the year, the growth of aggregate GDP in the CIS in 2003 as a whole may well exceed these revised forecasts.

The east European forecasts for 2004 generally assume a more favourable external environment than in 2002 and 2003, and in particular a more solid recovery in western Europe. Consequently, the rate of growth of the region's aggregate GDP is expected to rise to 4.4 per cent.

In central Europe it is expected that the strengthening of west European import demand, coupled with the positive effects of EU accession on business and consumer sentiment may well lead to stronger growth next year. The Polish budget for 2004 envisages an acceleration of GDP growth to some 5 per cent, based on the assumption of a further strengthening of the export-led recovery in the manufacturing sector and a notable revival of private fixed investment. In Hungary, the strengthening of GDP growth (to 3.5 per cent) forecast by the authorities presupposes improved competitiveness and profitability resulting from wage moderation and rapid productivity growth, leading to a stronger recovery of business investment and a revival of FDI inflows. The forecast also assumes a significant tightening of fiscal policy – in order to deal with the twin deficit problem – while rising net exports are expected to offset the expected deceleration of private and public consumption. In Slovakia solid growth is expected to continue next year building on dynamic external demand, the confidence-enhancing effects of EU membership, and structural reforms focused on improving the fiscal position and providing better work incentives. The forecast of GDP growth in the Czech Republic in 2004 is more cautious (2.8 per cent) in view of the difficult policy choices related to the threat of unsustainable twin deficits.

The forecasts for the Baltic states in 2004 are sanguine, with rates of GDP growth expected at around 6 per cent, comparable to those in recent years. According to official forecasts, growth in south-east Europe is expected to pick up to 4.6 per cent, although differences in performance among the individual countries are likely to remain considerable.

There are, however, serious downside risks to these rather optimistic forecasts. In the short run, the most serious risk for east European growth in general would be another delay to recovery in western Europe. In addition, if the efforts to consolidate public finances in central Europe fail to arrest the current fiscal expansion, this may provoke a tightening of monetary policy (driven by the policy effort of meeting the Maastricht targets), with negative consequences on economic activity. In the longer term, growth in the region will be decisively influenced by the progress achieved in implementing key structural reforms, particularly of the financial, labour and product markets.

In the CIS, some moderation of growth rates is expected in 2004, with aggregate GDP increasing by some 5 per cent. This reduction in the average rate of GDP growth reflects expectations of some slowdown in the region's largest economies (in the first place, Russia), which, in turn, is largely related to uncertainties surrounding the external environment. Thus, the government agencies responsible for preparing economic forecasts for Russia have produced a range of scenarios for 2004, with the expected rate of GDP growth ranging from 3.8 per cent to 5.2 per cent, depending on the future of world oil prices. Russia's budgetary framework for 2004 is based on the high projection which envisages a GDP growth rate of 5.2 per cent. Russia's public finances are expected to continue to remain in surplus (which as of next year will be allocated to a special stabilization fund), while monetary policy will remain moderately expansionary, trying to strike a balance between the policy goals of gradual disinflation, on the one hand, and the prevention of a strong real appreciation of the rouble, on the other. Ukraine's budget for 2004 is based on the assumption that real GDP will grow by 4.8 per cent, which is at the lower end of the earlier range of official forecasts. Economic growth is expected to remain strong in Kazakhstan, albeit at a somewhat slower pace than in the period 2001-2003: the macroeconomic framework for the 2004 budget envisages a rate of GDP growth of some 7 per cent. Rates of GDP growth ranging between 4 and 7 per cent are expected for most of the other CIS economies.