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"Given the depth and scope of the present global downturn, the ECE transition economies are facing increasing downside risks" says Paolo Garonna, Acting Executive Secretary of the United Nations Economic Commission for Europe (UNECE) commenting on the new issue of the *Economic Survey of Europe, 2001 No. 2*. "Economic policy in the transition economies should try to counter weakening cyclical growth forces, but the extent to which this is possible will vary among countries. Due to the existing policy constraints, many of these countries will find it difficult to cope with the negative consequences of the external shock on their own. Policy measures undertaken in the transition economies should complement and strengthen a broader policy response to recessionary forces in western Europe and overseas."

Strong performance in 2001…

In the course of 2001, the ECE transition economies generally showed some resilience in the face of a deteriorating international environment. Due to the lags in the transmission of trade effects, the immediate impact of the global slowdown on eastern Europe and the CIS has so far been much less pronounced than on western Europe. During the first half of the year output remained relatively robust in many transition economies and growth even accelerated in some countries, especially in the CIS. Although this outcome looks outstanding against the background of a rapid general slowdown in the world economy, its significance should not be overstated. All the ECE transition economies are highly dependent on their international markets and the sharp deterioration in world market conditions will, sooner or later, start to take its toll – the varying lags depending on the specific transmission channels.

The Russian economy has been the main support of the continuing recovery in the Commonwealth of Independent States. Much of Russia's present economic strength is due to the effects of the ongoing restructuring of the economy after the 1998 financial crisis and, especially, the comprehensive reforms initiated by the current administration. The presently prevailing sense of political stability – after a decade of volatility and frequent changes of government – has also contributed to an improving business climate in the country. In addition, the Russian authorities have adopted a more forward-looking approach to policy, which has had a positive effect on business and consumer confidence and expectations in general.

As a result, and contrary to the situation in previous cases of global turmoil, the CIS as a whole so far was less affected by the immediate impact of the global economic downturn. In the present circumstances, the fact that intra-CIS trade still accounts for a significant share of the total trade of most of these countries provided some insulation from weakening demand in the rest of the world. The continuing strong recovery not only in Russia but in some of the other large economies in the Commonwealth (Ukraine and Kazakhstan) provided a source of growth for the rest of the CIS during much of 2001.

… but downside risks are growing fast, especially in eastern Europe, …

The continuing weakening in the global economy presents a serious challenge for all the transition economies but the immediate risks are especially pronounced for the countries of eastern Europe and the Baltic area. While the central European and the Baltic economies have made substantial progress towards establishing functioning market economies and strengthening their institutions, they are extremely dependent on trade with western Europe. Most of the south-east European transition economies – which are generally lagging behind in the reform process – still suffer from chronic weaknesses while at the same time also being rather dependent on west European markets. In the present circumstances this combination increases their susceptibility to external disturbances. Thus, if the west European downturn intensifies, the adverse consequences for eastern Europe and the Baltic area could be considerable. The manufacturing sector of these transition economies, which relies heavily on exports, is most exposed to such risks and would be the first to be affected; however, the negative repercussions would be wide-ranging and overall economic performance can be expected to suffer as well.

Somewhat surprisingly, the escalating global economic risks have not so far triggered major revisions to the official growth forecasts in eastern Europe (with the possible exception of Poland where the deterioration in output was mostly driven by domestic factors). It was only after the terrorist attacks on the United States on 11 September that some warnings were made about the possible economic fallout in the region. Nevertheless, as of early autumn, and despite some modest downward revisions of forecasts in some countries (apart from Poland, these included Bulgaria, Croatia, Hungary, Slovenia, Estonia and Latvia), governments remained generally optimistic about their short-term prospects despite the persistent lowering of output forecasts in

western Europe. Thus, according to the official October forecasts for the year 2002, aggregate GDP was still expected to grow by some 3.5 per cent in eastern Europe and by close to 5 per cent in the Baltic states (table 1.2.1).

One important reason for the absence of specific policy responses to an eventual slowdown may be the fact that policy makers in most transition economies have fairly limited degrees of freedom to design and implement such measures. Among the policy constraints these countries are facing are the existing macroeconomic imbalances such as current account and fiscal deficits. Moreover, these imbalances are likely to increase as a result of the global slowdown because of various factors such as different rates of adjustment of exports versus imports in response to the global downturn or insufficient flexibility of product or factor markets.

Another policy constraint stems from the rigid monetary regimes to which some countries adhere (such as the currency boards in Bosnia and Herzegovina, Bulgaria, Estonia and Lithuania or the fixed exchange rate regime in Latvia). Such regimes preclude the use of monetary policy to cushion the economy from an external shock. In principle, a rigid monetary regime such as a currency board implies that the external shock is fully absorbed by the real economy which, in turn, requires a sufficient degree of flexibility on the labour and product markets. Thus, an aggravation of the current economic situation will provide a test not only of the degree of flexibility of markets in these countries but also of the stability of their monetary regimes in the event of an external shock.

Among the advanced reformers, Hungary and Slovenia, which in recent years have enjoyed balanced growth and adhere to more flexible monetary regimes, appear to have more room for engaging in activist policies in response to a deteriorating external environment. With both external and internal balances broadly in check, a moderately expansionary policy would seem to be the proper response to an external shock. However, even in these countries the current macroeconomic equilibrium is rather delicate and much policy caution would be needed to avoid upsetting it. Slovakia and to a lesser extent the Czech Republic are facing some difficulties in keeping their macroeconomic balances under control: the latter is currently coping with a fiscal shock caused by the bailout of several large banks, while the former has been trying to scale down an ambitious public investment programme that has led to a dangerous escalation of both external and domestic imbalances. The policy response in such cases will have to be much more cautious and selective, avoiding measures that could further destabilize the macroeconomy. Poland is in an even weaker position due to the current fiscal crisis; possible counter-cyclical measures may only be envisaged in the context of an internal restructuring of an already shrinking government budget. The three Baltic states as well as Bulgaria adhere to rigid monetary regimes which, as noted above, leave very little, if any, degrees of freedom to policy makers to undertake counter-cyclical measures. At the same time, as indicated by past experience (for example in the aftermath of the Russian crisis in 1998), they are highly susceptible to external shocks. These economies are now exposed to a double risk: first, the extent to which they may be affected by an external shock and, second, whether the real economy can absorb it without jeopardizing macroeconomic stability. Most of the remaining south-east European transition economies also have limited room for manoeuvre due to their overall macroeconomic instability.

... and, with some lags, in the CIS as well.

"The immediate downside risks for the Commonwealth of Independent States are probably not so high; as long as the Russian economy continues to grow the direct negative repercussions of the global downturn on the rest of the CIS will be partly offset" stresses Paolo Garonna. In fact, while the Russian authorities envisage some slowdown in the rate of growth in the short run (the draft budget for 2002 submitted to the *Duma* assumes a 4.3 per cent rate of GDP growth), the prevailing expectation is that output will remain relatively strong in the medium term.

However, it should also be borne in mind that the main source of growth in Russia – and, indirectly, in much of the CIS as a whole – is the continuing strong recovery in Russian final domestic demand, in particular, private consumption. In turn, this has been largely driven by the windfall revenue gains due to the relatively high world oil prices in 2000 and part of 2001. Thus, in assessing Russia’s short-term economic prospects, the main issue is whether and to what extent this domestic demand-led growth is sustainable. If world oil prices were to follow the downward trend in the global economy (as suggested by their direction in autumn 2001), a key stimulus to growth in Russia and the CIS could soon peter out. In addition, the continuing real appreciation of the Russian rouble has already eroded much of the post-1998 competitive gains – acquired from the sharp real depreciation that followed the August 1998 financial collapse – which had given an additional boost to the economy (mainly through its stimulus to import substitution). In these circumstances, Russia’s currently good economic fundamentals would be unable to continue to support the growth of real incomes and private consumption at their present pace; or, to put it differently, if such a pattern of domestic demand-led growth were to continue, it would probably

be at the expense of macroeconomic stability.

The most important external influence on the continuation of recovery, not only in Russia but in the whole of the CIS, is the direction of world commodity prices. These economies can probably weather a temporary drop in world oil prices and, actually, some governments in the region have been preparing for such a turn. Thus, some of the CIS oil exporting countries (Azerbaijan, Kazakhstan and Russia) have already instituted, or are in the process of doing so, special off-budgetary reserve funds, which accumulate some of the windfall revenue in periods of boom. When conditions reverse, some of the accumulated resources may be used as a cushion against the shock. However, as this is a relatively recent development, the reserve funds have not yet accumulated sufficient resources to cope with a prolonged period of distress. Thus, a deep and lasting fall in commodity prices will inevitably have a direct detrimental effect on the economic performance of all the commodity exporters, including Russia, and, indirectly, further negative repercussions due to any weakening in the Russian economy.

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"The transition economies obviously are not shielded against the negative consequences of the present synchronous global downturn," concludes Paolo Garonna. "Within their degrees of policy freedom, governments in these countries need an active policy stance to respond to the current threats. In fact, the most productive long-term policy response would be to widen and deepen the process of market-oriented structural and institutional reforms, which would make these economies more resilient to external shocks. This would also be instrumental for their further integration in the European and global economy."

TABLE 1.2.1

Basic economic indicators for the ECE transition economies, 1999-2002

(Rates of change and shares, per cent)

	GDP (growth rates)	*Industrial output*	*Inflation (per cent*	*Unemployment rate*											
			2001		*(growth rates)*	*change, Dec./Dec.)*			*(end of period, per cent)*						
	1999	*2000*	*Apr. official forecast*	*Jan.-Jun. actual* ***a***	*Oct. official forecast*	*2002 official forecast*	*1999*	*2000*	*Jan.-Jun. 2001* ***a***	*1999*	*2000*	*2001* ***b***	*Jun. 1999*	*Jun. 2000*	*Jun. 2001*
Eastern Europe	1.5	3.7	4.2	3.1	3.1	3½	-0.4	8.3	4.8	..	..	..	13.6	14.7	14.9*
Albania ***c***	7.3	7.8	5-7	..	7	7	16.0	12	-20*	-1.0	4.2	4.0	18.0	17.6	15.1
Bosnia and Herzegovina ***d***	..	9.1	7-9	..	7-9	..	10.6	8.8	14.6	-0.4	3.4	3.3	39.1	39.1	39.3
Bulgaria	2.4	5.8	5	4.8	4.5	4	-9.3	5.8	1.7	6.9	11.2	9.3	12.8	18.2	17.1
Croatia	-0.4	3.7	3-4	4.5	4	3-4.2	-1.4	1.7	5.9	4.6	7.5	5.0	18.9	20.5	21.5
Czech Republic	-0.4	2.9	3	4.0	3.6-3.8	3.8	-3.1	5.4	8.6	2.5	4.1	5.5	8.4	8.7	8.1
Hungary	4.2	5.2	4.5-5	4.2	4.3	3.7-4.2	10.4	18.3	7.4	11.3	10.1	10.6	9.4	8.9	8.4
Poland	4.1	4.0	4.5	1.6	1.5	2.0-2.5	3.6	6.8	1.6	9.9	8.6	6.1	11.6	13.6	15.9
Romania	-2.3	1.6	4.1	4.9	4.5	5.1	-7.9	8.2	10.4	54.9	40.7	35.8	11.4	10.8	8.8
Slovakia	1.9	2.2	3.2	2.9	2.8-3.0	3.6	-3.1	9.0	6.2	14.2	8.3	7.9	17.7	19.1	17.8
Slovenia	5.2	4.6	4.5	2.9	3.7	3.6	-0.5	6.2	3.2	8.1	9.0	9.6	13.4	11.8	11.1
The former Yugoslav Republic of Macedonia	4.3	4.3	6	-5.0	-5	4	-2.6	3.5	-8.8	2.3	10.8	6.3	42.3	43.6	..
Yugoslavia ***e***	-17.7	7.0	5	..	5	..	-23.1	10.9	-2.4	54.0	115.1	125.1	26.7	26.5	27.1
Baltic states	-1.7	5.4	4.7	6.3	5.7	4¾	-8.0	7.6	11.7	..	..	..	8.1	9.3	9.8
Estonia	-0.7	6.9	6	5.4	4.8	4	-3.4	12.8	5.9	3.9	4.9	6.9	6.4	6.2	7.5
Latvia	1.1	6.6	5-6	8.8	8	5-5.5	-5.4	3.2	7.9	3.3	1.9	3.1	10.0	8.4	7.8
Lithuania	-3.9	3.9	3.7	5.1	4.5-5.1	4.7	-11.2	7.0	16.4	0.3	1.5	1.7	7.5	11.1	12.1
CIS	4.5	7.8	4.2	6.1	6.1	5	9.2	11.6	7.6	..	..	..	8.1	7.2	6.4
Armenia	3.3	6.0	6.5	6.6	6.5	6	5.2	6.4	2.7	2.1	0.4	4.1	10.4	11.9	10.4
Azerbaijan	7.4	11.1	8.5	8.4	8.5	8.5	3.6	6.9	5.1	-0.5	2.1	2.1	1.2	1.1	1.3
Belarus	3.4	5.8	3-4	3.7	3-4	4-5	10.3	7.8	4.1	251.3	108.0	65.3	2.1	2.0	2.2

Georgia	3.0	2.0	3-4	5.5	3-4	3.5	7.4	6.1	-3.1	11.1	4.6	6.0	5.5	..	..
Kazakhstan	2.7	9.8	4	14.0	10	7	2.7	15.5	13.6	18.1	10.0	9.1	3.5	4.2	3.3
Kyrgyzstan	3.7	5.0	5	6.7	5.6	4	-4.3	6.0	6.0	39.8	9.5	8.4	3.1	3.2	3.2
Republic of Moldova ***f***	-3.4	1.9	5	3.1	5	6	-11.6	2.3	12.1	43.8	18.5	9.1	2.3	2.0	2.0
Russian Federation	5.4	8.3	4	5.1	5.5-6.0	4.3	11.0	11.9	5.5	36.6	20.1	23.7	12.1	10.1	8.4
Tajikistan	3.7	8.3	6.7	10.3	6.7	8	5.6	10.3	13.0	30.1	60.6	49.3	3.2	3.1	2.5
Turkmenistan ***g***	16.0	17.6	16	15.0	16	18	15.0	28.6	8.5	..	..	..	..	..	..
Ukraine	-0.4	5.8	3-4	9.1	7.3	6	4.3	12.9	18.5	19.2	25.8	11.6	4.0	4.3	3.8
Uzbekistan	4.4	4.0	4.4	4.2	4.4	4.5	6.1	6.4	7.5	26.0	28.2	28.0	0.6	0.7	..
Total above	3.2	6.2	4.2	5.0	5.1	4½	4.6	10.2	6.5	..	..	..	..	..	..
Memorandum items:															
CETE-5	3.0	3.8	4.1	2.7	2.6	3	2.4	8.7	4.7	..	..	..	11.4	12.6	13.8
SETE-7	-2.3	3.4	4.5	4.4*	4.2	4½	-9.4	7.2	5.2	..	..	..	16.2	17.1	16.6*

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

Note: Aggregates are UNECE secretariat calculations, using PPPs obtained from the 1996 European Comparison Programme. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index. Unemployment generally refers to registered unemployment at the end of the period (with the exceptions of the Russian Federation, where it is the Goskomstat estimate according to the ILO definition, and Estonia where until October 2000 it refers to job seekers). Aggregates shown are: Eastern Europe (the 12 countries below that line), with sub-aggregates CETE-5 (central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and SETE-7 (south-east European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and Yugoslavia); Baltic states (Estonia, Latvia, Lithuania); and CIS (12 member countries of the Commonwealth of Independent States).

a January-June 2001 over January-June 2000.
b June 2001 over June 2000.
c Industrial output covers state sector only.
d Data reported by the Statistical Office of the Federation; these exclude the area of Republika Srpska.
e Gross material product instead of GDP. Data for 1999, 2000 and 2001 exclude Kosovo and Metohia.
f Excluding Transdniestria.
g Officially reported growth rates are of dubious reliability.

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