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# **PART ONE**

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

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## CHAPTER 1

# THE ECE ECONOMIES IN SPRING 2001: AN OVERVIEW OF THE CURRENT SITUATION AND SELECTED POLICY ISSUES

### 1.1 Introduction

The fragility of economic forecasts has again been highlighted by developments over the last six months. Last October global economic prospects looked better than at any time in the previous 10 years: forecasts for the world economy in 2000 were being raised to some 4¾ per cent and, despite some slowing down associated with the anticipated rebalancing of output towards Europe and away from the United States, growth was expected to remain at around 4¼ per cent. It is now apparent, however, that the world economy peaked in the first half of 2000. One negative factor was the higher price of oil but the forecasters were correct in forecasting that this would fall back to the OPEC target range in early 2001. The major downside risk had been recognized for some time but was essentially unpredictable as to scale and timing – and that concerned the inevitable correction of the United States stock market bubble and of the “irrational exuberance” about the future prospects for the United States economy.

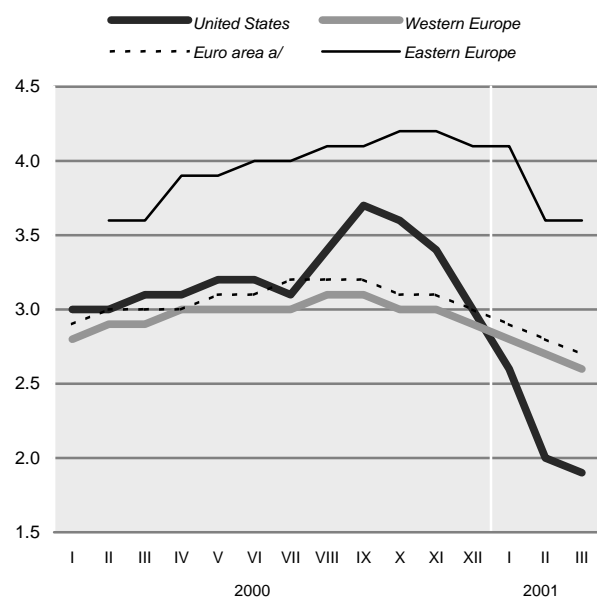
At the end of the first quarter of 2001, the short-term economic outlook for the western market economies looks much less favourable than in the autumn of 2000. The main factor behind this is the unexpectedly sharp slowdown in economic growth in the United States since the second half of 2000 and the stalled recovery in Japan. Activity in the two largest economies in the world is thus weakening rapidly or continuing to stagnate. This has started to feed through changes in net exports to other regions of the world economy. As a result, there has been a progressive lowering of growth forecasts, especially for the United States, since late 2000 (chart 1.1.1).

In the United States, real GDP is now expected to increase by only some 1¾ per cent in 2001, a very abrupt deceleration from an average growth rate of 5 per cent in 2000. In Japan, economic growth is expected to only slightly exceed 1 per cent in 2001, and even that is uncertain given disagreements over economic policy and delays in introducing another economic emergency programme. Growth forces are seen to hold up somewhat better in western Europe. In the euro area, real GDP is currently forecast to increase by some 2.5 per cent in 2001, down from 3.4 per cent in 2000 and half a percentage point less than was being forecast last autumn. Broadly similar changes are expected for the European Union and for

western Europe as a whole (table 1.1.1). For the industrialized economies in aggregate, the average rate of economic growth is likely to be only some 2 per cent in 2001, down from 3.8 per cent in 2000 and the smallest annual increase since 1993. As a result, the prospects for economic growth in the central and east European economies, as well as the CIS and other parts of the world economy, will also be adversely affected, leading to a mutually reinforcing process which will amplify the direct trade effects of the cyclical downturn in the United States. The upshot is that world output might now grow by only some 2.5-3 per cent in 2001, down from 4.7 per cent in 2000 and considerably less than was expected in the autumn of 2000.<sup>1</sup>

CHART 1.1.1

Real GDP growth in the ECE region in 2001: changes in consensus forecasts, January 2000-March 2001  
(Percentage change over previous year)



Source: Consensus Forecast.

a From January 2001 Greece is included.

<sup>1</sup> The IMF was forecasting 4.2 per cent in October of last year. IMF, *World Economic Outlook* (Washington, D.C.), October 2000.

TABLE 1.1.1

Annual changes in real GDP in the ECE region, 1998-2001  
(Percentage change over previous year)

	1998	1999	2000 <sup>a</sup>	2001 <sup>b</sup>
<i>Western Europe</i> .....	2.8	2.2	3.5	2.5
<i>European Union</i> .....	2.8	2.6	3.3	2.6
<i>Euro area</i> .....	2.8	2.6	3.4	2.6
<i>North America</i> .....	4.3	4.3	5.0	1.8
United States .....	4.4	4.2	5.0	1.7
<i>Eastern Europe<sup>c</sup></i> .....	2.0	1.1	3.9	4.2
<i>CIS</i> .....	-3.0	3.2	7.4	4.2
Russian Federation .....	-4.9	3.5	7.7	4.0
<i>Memorandum items:</i>				
<i>Europe</i> (east and west) .....	2.7	2.1	3.5	2.7
<i>Europe</i> (east and west) and <i>CIS</i> .....	2.0	2.2	4.0	2.9

Source: This Survey, tables 2.2.2 and 3.1.1.

<sup>a</sup> Preliminary estimates.

<sup>b</sup> Forecast.

<sup>c</sup> Including the Baltic states.

## 1.2 The market economies of western Europe and North America

### (i) Recent developments and the current outlook

In the United States, the long economic expansion, which, if maintained in the first quarter of 2001 will have lasted for 10 years, was expected to slow down in 2001 against the background of tighter monetary policy and the real income effects of higher energy prices. In fact, a slowdown was seen as highly desirable, given that actual output had grown at a rate significantly above potential for quite some time with increasing risks of overheating and a hard landing. There were, moreover, mounting concerns about the huge imbalances which had accumulated over the past five years as the result of an unsustainable investment and consumption boom. These were reflected in a decline of personal savings to a very low level (in fact, they turned negative in 2000), increases in corporate and personal debt to very high levels, a huge current account deficit and, last but not least, a stock market bubble, notably, but not only, in the market for high-technology shares.

The orderly unwinding of these imbalances is the central assumption of the "soft landing" scenarios, which assume a gradual slowing down in economic expansion to a rate somewhat below potential. This in turn would spread the inevitable adjustment costs to be borne by the rest of the world over a reasonable period of time. In the event, however, there was an unanticipated abrupt cyclical downswing in the United States economy after the second quarter of 2000, a development which serves as a sharp reminder of the inherent difficulties of forecasting cyclical turning points. The investment boom in information technology equipment, a major force behind the long expansion, petered out in the face of growing excess capacity in the manufacturing sector. To this was added a sharp fall in the demand for consumer

durables and for exports in the last quarter of 2000, which led to a build-up of excess inventories and a weakening of industrial activity. The reaction of the United States monetary authorities to the deteriorating economic conditions was very swift. The target for the federal funds rate was lowered in three steps by 1.5 percentage points between January and March of 2001. Against this background and the decline in actual and expected business profits, there has been a sharp decline in equity prices for a broad range of stocks in the first quarter of 2001, with adverse consequence for households' net wealth and the debt-equity ratios of the corporate sector.

While imbalances are more or less typical of any strong and sustained cyclical upswing – largely a reflection of overly optimistic production and profit expectations – there has been a degree of excess in the United States, especially in the financial markets, which would not have been possible without the generous credit expansion allowed by the United States Federal Reserve. But these kind of miscalculations are always easier to diagnose *post facto* and can often only be avoided *ex ante* by stifling the expansion itself.<sup>2</sup>

In Japan, against a background of deflationary tendencies and increasingly pessimistic business assessments of the country's short-term prospects, the monetary authorities reverted to the "zero interest rate" policy in March 2001, a policy which had been abandoned in the second half of 2000. This shift in monetary policy has been accompanied by a marked depreciation of the yen which should, in principle, support exports and increase imported inflation. In the face of deteriorating export prospects, notably to the United States market, the corporate sector is cutting back on planned investments. Given the limited room for manoeuvre left by the near-zero interest rates, the Bank of Japan has decided that it will target the inflation rate, i.e. it will inject liquidity – using outright purchases of government bonds – until the year-on-year rate of consumer price inflation has become slightly positive again. The government also intends to launch a new package of measures designed to prevent the economy sliding back into recession, but this had still not been introduced by the end of the first quarter of 2001.

In western Europe, the cyclical recovery held up relatively well in the second half of 2000, but there was also a noticeable slowing in the rate of economic expansion. The optimistic view that the European economies would be largely immune to the deterioration in the rest of the global economy, however, has been overtaken by events as evidenced by the significant lowering of forecasts for GDP in 2001. This is also reflected in the sharp drop in business confidence in Germany, the largest west European economy. Many forecasters now expect real GDP in Germany to increase by only 2 per cent in 2001, down from the 2¾ per cent forecast in the autumn of 2000.

<sup>2</sup> G. Haberler, *Prosperity and Depression*, New Edition (Cambridge, MA, Harvard University Press, 1964), pp. 471-472.

It is therefore fortunate that a number of European governments had already decided some time ago to shift to more expansionary fiscal policies, mainly by cutting income taxes in 2001. In the United Kingdom and Switzerland, the central banks also lowered interest rates in early 2001 to support economic activity.

In contrast, in the euro area, despite deteriorating growth prospects, the ECB has left its main refinancing rate unchanged at 4¾ per cent since October 2000, when it was raised by a ¼ of a percentage point, just at the time when the evidence of the slowdown was becoming available.

A major source of downside risks to the current growth forecasts are – apart from developments in Japan – the uncertainties surrounding future economic developments in the United States. The expected annual growth rate of some 1¾ per cent implies a moderate upturn in economic activity in the course of 2001, given a statistical carry-over effect of 0.8 percentage points from the final quarter of 2000.<sup>3</sup> The current consensus of forecasts is that this will be followed by a further strengthening of growth in 2002.

But this scenario could well turn out to be too optimistic and the cyclical downturn could well be more protracted. Much will depend on the extent to which private households desire, or are forced, to adjust their expenditures (and savings) in response to the deterioration in economic conditions and the loss of financial wealth implied by the marked decline in equity prices (a fall which had still not bottomed out at the time of writing). Also the response of business investment to the cyclical downturn is currently difficult to gauge. Relatively large margins of excess capacity in the manufacturing sector will tend to weaken the accelerator principle which links net investment to changes in output. This will add to the dampening effects of falling profits, higher financing costs associated with lower share prices and the need to reduce high levels of corporate debt. More generally, the effectiveness of the more expansionary monetary policy in the United States may be reduced in an environment dominated by excess capacity and the need for balance sheet adjustments in the private sector.

The need to rebuild private sector savings is the counterpart to the required United States current account adjustment given that the very large deficit (\$435 billion or some 4.4 per cent of GDP in 2000) cannot be sustained.<sup>4</sup> It depends crucially on the willingness of foreigners to hold dollar-denominated assets. In a deteriorating economic environment this willingness is likely to become

increasingly stretched with increased downside risks for the dollar exchange rate. There are mixed opinions as to whether the continued strength of the dollar, so far, reflects its “safe haven” properties in a more uncertain world outlook or expectations that the loosening of monetary policy will lead to a rapid recovery of domestic demand. But neither scenario bodes well for the stability of the world economy. A quick recovery based on domestic demand would only postpone the inevitable reduction of the domestic and external imbalances. This is a necessary condition for laying the foundations of a new sustainable upswing. The longer these adjustments are delayed the greater is the probability that when they do eventually occur they will involve very abrupt changes in behaviour with a much greater risk of international financial turmoil. A reduction of the United States external deficit implies a correspondingly smaller external surplus in the rest of the world, and the major policy challenge is to reduce these imbalances with as little disruption as possible to global economic activity.

Given the current cyclical weakness in the United States and the chronic weakness in Japan, this adjustment process will largely depend on a strengthening of economic growth in western Europe. This will not only help to reduce the downside risks to global economic activity but would match regional ambitions to turn Europe into the world’s strongest economy.<sup>5</sup>

## (ii) Is European monetary policy too cautious?

The ECB is now<sup>6</sup> the only central bank among the G-7 not to lower interest rates in the wake of the cuts made by the Federal Reserve. The reason for this is that the bank still believes that the balance of risks facing the euro area, between higher inflation and lower growth, are “evenly balanced” even though the economic environment is now very different from when it first set its key interest rate at 4.75 per cent in October 2000. Since then activity has slowed sharply, especially in Germany, where the prospective stimulus of tax cuts has been somewhat offset by the weakness of net exports and construction activity. Forecasts for 2001 have been generally lowered and business confidence has fallen. Most observers and forecasters are unable to see any serious inflation threat. The prospect of the large rise in oil prices triggering an upturn in inflation was dismissed by most forecasters and their prediction that the risk in oil prices would be temporary proved to be correct. Indeed the impact of higher oil prices in lowering effective demand seems to have been more important than its effect on the underlying inflation rate.<sup>7</sup>

<sup>3</sup> This is the difference between the fourth quarter 2000 real GDP and the average annual GDP. In other words, real GDP will increase by 0.8 per cent in 2001 compared with 2000, even if it remains at the fourth quarter 2000 level throughout 2001. For comparison, the statistical carry-over effect for 2000 was 2.3 per cent, which is another way of illustrating the considerable loss of momentum in the United States economy.

<sup>4</sup> See sect. 2.3 of this *Survey*.

<sup>5</sup> The French Prime Minister noted that “Europe is the main zone for stability and growth in the world”. Mr. Solbes, the EU’s commissioner for economic and monetary affairs stated that “Europe is by definition the economic safe haven of the developed world at the moment ...”, *Financial Times*, 24 March 2001.

<sup>6</sup> The position of “wait and see” with regard to its monetary policy stance was confirmed at the meeting of the ECB’s Governing Council on 29 March 2001.

<sup>7</sup> This is the reverse of the situation in 1973 when many governments concentrated on the demand effect and neglected the impact on prices.

There can be little doubt that a lowering of interest rates will be a help for economic growth. Neither of the two pillars of the ECB's monetary policy strategy stand in the way of a reduction in the interest rates. Money supply growth has been slowing down and was approaching the reference value of 4.5 per cent in the first quarter of 2001. In any case, it can be argued that the derivation of the reference value is based on rather cautious estimates of potential output growth and the trend decline in money velocity.<sup>8</sup> Inflationary expectations are, moreover, quite moderate. The ECB's own Survey of Professional Forecasters shows that inflation is expected to average 2 per cent in 2001 declining to 1.7 per cent by December 2001 and remaining at an average of 1.7 per cent in 2002.<sup>9</sup> Long-term inflationary expectations are even lower. Thus, the inflation rate implied by the difference between yields on French nominal and real (i.e. price index linked) bonds which mature in 2009 was only 1.4 per cent at the end of February 2001.<sup>10</sup> It is true that the actual inflation rate was about half a percentage point above the ECB's target rate of 2 per cent in February 2001, but the underlying, core rate of inflation is well below that and there is no sign of any acceleration in prices or in average wages.

It may be argued that the current situation constitutes a dilemma for monetary policy because a lowering of interest rates when inflation is above target could compromise the ECB's efforts to establish its credibility. On the other hand, there is general awareness that this overshooting of the inflation target reflects specific circumstances, mainly the sharp rise in oil prices, the effects of which have already started to diminish. And in view of the deteriorating external environment, the risks to both output and inflation are tilted to the downside.

In any case, given the long and variable lags with which monetary policy affects inflation, the actual inflation rate is not the appropriate focus for monetary policy. The objective is to maintain price stability in the medium term and this implies the need for a forward-looking, medium-term orientation of monetary policy, which the ECB itself correctly emphasized in its first monthly report at the beginning of 1999.<sup>11</sup> This provides at the same time a degree of discretion for the conduct of monetary policy to react to specific shocks in the short term without losing sight of the general objective of price stability. It goes without saying that this also requires the provision of clear explanations to the public as to why certain actions are taken or not. But, in practice, the bank's actions appear to many observers to be more backward than forward looking, and too sensitive to fluctuations in monthly price changes.

The apparent deflationary bias of the ECB arises not only from its actions but also from its terms of reference. Its target of 2 per cent inflation is asymmetric in that it is not required to take any action when the actual rate is below it for a sustained period of time (unlike the Bank of England, for example). Secondly, it has no formal responsibility for other policy objectives such as growth or employment (unlike the Federal Reserve, for example). Thirdly, there is no political influence on the setting of the inflation target, which could provide such a broader view of policy. Finally, the bank's target rate of 2 per cent inflation is very low, especially when the upward bias due to quality improvements and the effects of fixed base weights are taken into account.

In their public pronouncements ECB officials also give the impression that they believe nothing much has changed in the past two decades as regards inflationary expectations and wage-setting behaviour. At the end of January the bank's focus was said to be "on avoiding possible second-round effects of the temporary increase in inflation".<sup>12</sup> These fears would appear to discount heavily the many structural changes which have occurred in the world and European economies in the last two decades. As a result disinflationary pressures are now greater than at any time since the 1930s and there is no sign of the struggle over functional income shares that triggered the wage-price spirals of the 1970s. In Europe wage indexing has disappeared, union membership and strength have fallen drastically, and all economies are vulnerable to the intense competitive pressures from the global economy. The relation between inflation and the labour markets now appears to have returned to that prevailing before the oil crises of the 1970s, or even earlier given that perceptions of job insecurity in Europe seem to be greater than in the 1950s and 1960s. The examples of the United States and the United Kingdom, as well as a number of smaller European economies, suggest that expansionary policies can reduce unemployment now without setting off a new inflation. But the key appears to be the need to have a coherent mix of policies for employment and growth, not just a one-dimensional monetary policy.

There would now appear to be a strong case for a sharp reduction in euro area interest rates in order to tip the balance towards stronger growth in Europe and offset the effects of weaker net exports to the rest of the world. The behaviour of the euro exchange rate against the dollar over the last two years seems to be largely explained by capital flows responding to relative growth prospects in Europe and the United States and, hence, to expectations of relative stock prices. A large cut in euro interest rates is therefore likely to lead to an appreciation of the euro, encourage investment and growth, and dampen further any residual inflationary pressures in the system. (This goes against the view that it is the weakness of the euro that is inhibiting the willingness of

<sup>8</sup> DIW, *Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Herbst 2000*, Wochenbericht 43/2000, 26 October 2000, pp. 728-729.

<sup>9</sup> ECB, *Monthly Report* (Frankfurt am Main), March 2001, pp. 28-29, box 3.

<sup>10</sup> *Ibid.*, p. 19.

<sup>11</sup> ECB, *Monthly Report* (Frankfurt am Main), January 1999, p. 47.

<sup>12</sup> Speech of the President of the ECB to the Parliamentary Assembly of the Council of Europe, Strasbourg, 24 January 2001.

the ECB to lower interest rates.) But, as mentioned below, raising the growth rate and lowering unemployment will also require special attention to improving workforce skills, especially among the young. This in turn will probably require an increase in government spending, but this is likely to be a good investment, not least for ageing populations. One of the key lessons to be learned from the performance of the United States economy over the last decade is for policy to recognize the dynamic interactions between growth expectations, fixed investment, rising productivity and employment – and mild or falling inflation rates. This is not the new economy, but an older one that was lost sight of during the crises of the 1970s and the disinflation of the 1980s.

### (iii) Raising western Europe's growth rate: are labour markets a constraint?

Whenever suggestions are made for faster growth in western Europe official discussions invariably stress that this will only be possible if further supply-side improvements are made. The pessimism about the potential for growth in Europe is particularly focused on the alleged lack of flexibility of European labour markets. This leads to the conclusion that any aggressive lowering of euro interest rates would simply renew inflation rather than promote growth. For a decade or more unfavourable comparisons have been made between the United States and the European economies in their ability to generate employment and lower unemployment rates: in the United States, the average unemployment rate was only 4 per cent in 2000, down from a peak of 7.4 per cent in 1992. In contrast, in western Europe, unemployment was nearly twice as high at 7.9 per cent in 2000, but down from a peak of 10.5 per cent in 1994. Employment rose by some 15 per cent in the United States between 1991 (the cyclical trough) and 2000 (the cyclical peak). Over the same period, there was only a meagre increase in west European employment, by 5¼ per cent, although this is influenced by the difference in cyclical positions. Compared with the cyclical low point in 1993, employment was some 8 per cent higher in 2000.

The standard explanation for these differences is that the United States labour market is much more “flexible” than those in Europe. In the United States hiring and firing is not hampered by complicated rules and regulations, whereas in Europe social protection and an array of various labour market institutions create rigidities and resistance to necessary adjustments to market forces and changes in the global economy. In Europe gains in productivity quickly translate into higher wages for those already with jobs at the expense of profits, investment and increased employment for those unemployed. According to this view, which is shared by most of the international economic institutions, the problem in Europe is not one of macroeconomic policy but of supply-side rigidities, not only but especially in the labour market. Hence the stress in official briefings at the

recent Stockholm Summit of EU leaders on the urgency for European countries to “bite the bullet of reform”.<sup>13</sup>

Although this “story” about the differences between the United States and Europe is constantly repeated, it is badly flawed because it appears to be at variance with a number of key facts: in the first place, it is misleading to treat western Europe as a homogenous whole.<sup>14</sup> Labour market performance varies considerably and there are several smaller economies (e.g. Denmark, Finland, Ireland, the Netherlands, Portugal) which have performed as well or even better than the United States in the second half of the 1990s. Indeed these economies (among others) have also outperformed the “new economy” of the United States in terms of labour productivity and multi-factor productivity growth in the business sector.<sup>15</sup>

Secondly, labour market institutions are also very heterogeneous (including among the countries just mentioned). Although some of these arrangements are associated with higher levels of unemployment – for example, high levels of benefit paid indefinitely and with no pressure on recipients to seek work or high levels of unionization with no coordinated wage bargaining<sup>16</sup> – many of the institutions and practices blamed for higher unemployment turn out to have little effect either way and in some cases may even have a positive effect.<sup>17</sup> Thirdly, there is little evidence in Europe that productivity gains have been captured by employed workers in the form of higher wages. In fact wages in Europe, as in the United States, have lagged behind the growth of productivity in the 1990s. As is shown in chapter 2 of this *Survey*, the share of wages in national output has fallen in favour of gross profits on both sides of the Atlantic, but whereas the falling share in the United States has been associated with falling unemployment, in Europe the reverse has been the case.

Why should a falling wage share be associated with large increases in employment and falling unemployment in the United States and with only marginal

<sup>13</sup> Apart from making labour markets more flexible, another major current concern is to liberalize the gas, electricity and postal markets of the EU. This is part of the programme for completing the Single Market, although failure to push ahead is seen by the Single Market Commissioner, Frits Bolkestein, as sending an empty signal to investors. He also sees the reluctance of some EU governments to speed up reform of the public sector utilities as a “fear of modernity ... a mental block” that must be overcome. *Financial Times*, 24/25 March, p. 2.

<sup>14</sup> See also UN/ECE, *Economic Survey of Europe, 1998 No. 1*, pp. 24-25.

<sup>15</sup> S. Scarpetta, A. Bassanini, D. Pilat and P. Schreyer, *Economic Growth in the OECD Area: Recent Trends at the Aggregate and Sectoral Level*, OECD, Economics Department Working Papers, No. 248 (Paris), June 2000, p. 47, table 10.

<sup>16</sup> In fact a *coordinated* wage bargaining process is a feature of Austria, Denmark and the Netherlands. Ireland has had a series of incomes policies since the late 1980s (see below chap. 2.6).

<sup>17</sup> S. Nickell, “Unemployment and labour market rigidities: Europe versus North America”, *Journal of Economic Perspectives*, Vol. 11, No. 3, Summer 1997, pp. 55-74.

improvements in Europe? A plausible explanation is that the stance of macroeconomic policy in the United States has provided a more supportive environment for the growth of domestic demand, and especially of fixed investment. Confident expectations of sustained output growth created a virtuous circle of rising investment and productivity which in turn led to rising levels of real wages, profits and employment. Part of the gains in productivity was also distributed to consumers via price reductions (or smaller price increases than might otherwise have occurred). In western Europe, in contrast, much of the 1990s were marked by fairly restrictive macroeconomic policies: fiscal policy was tight as the future members of the EMU strove to meet the Maastricht convergence criteria and real long-term interest rates were also relatively high, falling below those in the United States only in 1997. Fixed investment did occur in Europe but it was very weak in comparison with the United States<sup>18</sup> and much of it was focused on rationalization rather than capacity expansion (or employment creation). The gains from productivity that did occur in western Europe, which in terms of GDP per head were not very different from those in the United States (around 13-14 per cent between 1991 and 1999), went to profits (either retained by enterprises or distributed to shareholders) or to consumers in the form of lower prices (or smaller price increases than might have otherwise occurred).

The “defensive” nature of much European investment in the 1990s is understandable given the disappointment of expectations in the early years of the decade – when the Single Market programme was forecast to deliver an average annual rate of growth of 3 per cent over the decade – and continuing uncertainty as to whether a faster rate of growth would be cut short by an excessive concern with short-run fluctuations in the inflation rate. A key difference between the performance of the United States and that of Europe therefore lies both in the stronger rate of growth of domestic demand in the United States and greater confidence that the Federal Reserve would not bring it to a premature halt.

The need for increased “flexibility” and structural change is often presented, in both western and eastern Europe, as an institutional or behavioural problem which must be solved as a *pre-condition* for faster rates of output growth and employment. But this approach ignores three important points. The first is that a crucial requirement for a flexible economy and a fast rate of structural change is a high rate of gross investment. At any given time the structure of output and employment is fixed by the existing capital stock; the rate of structural change thus depends on rates of gross investment in new equipment sufficient to employ in new sectors the labour released by declining industries or activities, to maintain

reduced numbers in the latter, and to provide jobs for new entrants to the labour force.<sup>19</sup> In an open, global economy there will anyway be pressure on traditional industries to “downsize” and release labour, but without gross investment in new activities there will be a rise in unemployment (an example of passive or negative structural change). Second, the movement of labour into new jobs will also depend on the skills (human capital) of those who are forced to move or who are entering the labour market for the first time. Weak educational levels are recognized as a significant feature of European labour markets,<sup>20</sup> but this is more a failure of government policies and insufficient spending on education than a labour market rigidity *per se*. The admission of a serious shortage of IT skills in western Europe alongside a youth (under 25 years) unemployment rate in the EU of 16.4 per cent only serves to underline the deficiencies in European education systems.<sup>21</sup> And thirdly, economic growth and rising levels of GDP per head are, in themselves, powerful solvents of traditional rigidities and modes of behaviour. It is in periods of slow growth and uncertain prospects that attachment to existing practice is greatest – what is criticised by the policy maker as a rigidity is seen by those fearful of losing their jobs as perhaps their only chance for some hope of security.<sup>22</sup>

High rates of unemployment alter the balance of power in favour of employers (corporations and shareholders) and this affects not only functional income shares but also working conditions and the way most people live. Both anecdotal and survey evidence point to increasing hours of work, increasing levels of stress, more disruption of family life and leisure, and other welfare reducing features, as a result of the increasingly liberalized economies of the 1990s. Most of these changes were made under the duress of the high unemployment of the 1980s and the increased sense of

<sup>19</sup> A declining industry does not necessarily have to disappear. It may just have to adjust to a lower level, and different composition, of output. But different *levels* of output invariably involve different methods of production and hence will also require gross investment.

<sup>20</sup> S. Nickell, *loc. cit.*

<sup>21</sup> Some European governments are attempting to make up for these deficiencies by encouraging a brain drain of people with IT skills from poorer countries in eastern Europe and Asia, which can ill afford to lose them. Similar encouragement to immigration is being given to other professions, such as nurses and teachers, which have been hit by European fiscal restraint over the past decade. The ethics of such policies by the governments of some of the richest countries in the world are questionable, to say the least. Investment in European education to ease such skill shortages should not only focus on school-leavers but also on the lower-paid and part-time workers, many of whom are women who have suffered various forms of discrimination in their schooling. American Association of University Women, *Tech-Savvy: Educating Girls in the New Computer Age* ([www.aauw.org](http://www.aauw.org)).

<sup>22</sup> Adam Smith understood this very well: “... it is in the progressive state, while the society is advancing to the further acquisition, rather than when it has acquired its full complement of riches, that the condition of the labouring poor, of the great body of the people, seems to be the happiest and the most comfortable. It is hard in the stationary, and miserable in the declining state.” Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Vol. 1, edited by R. Campbell and A. Skinner (Oxford, Clarendon Press, 1976), p. 99.

<sup>18</sup> Between 1991 and 1999 real gross domestic capital formation increased by some 19 per cent in western Europe (some 13.5 per cent in the euro area) against 95 per cent in the United States (appendix table A.4.)



insecurity of those still in work. The spread of a more aggressive management culture in Europe has not led to better economic performance than in the period before 1973, although it has produced large returns to shareholders and very large salaries for the leaders of business and those engaged in financial intermediation. At the same time many of the social programmes and legislation introduced by governments in the 1990s are basically a response to high unemployment and an attempt to compensate for the relatively weak power of labour. However, their effect is limited when employees fear for their jobs because the prospects of getting another one is low. The best way to empower employees is to make enterprises compete for their services – without the pressure of full employment, employers will resist or evade concessions on greater flexibility in working hours and leisure, in providing support for working mothers, in reducing onerous working hours and conditions, and in general creating a more civilized working environment. In such circumstances, employees can thus do much to improve their own working conditions without the need for excessive help and legislation (and expenditure) from the state. Tight labour markets can also stimulate enterprises to increase fixed investment and, as has been happening in parts of the United States, to train not only their existing staff but also the young unemployed.

### 1.3 The transition economies

#### (i) Recent developments and the current outlook

For the first time since the start of their economic and political transformation, the former centrally planned economies of eastern Europe and the former Soviet Union were all growing in 2000: their aggregate GDP increased by 6 per cent, significantly more than the world economy as a whole. This very high rate of economic growth was largely due to the unexpectedly strong recovery in Russia where GDP increased by 7.7 per cent, its highest growth rate in more than 30 years. After a weak performance in 1999, output also recovered strongly in eastern Europe and in the Baltic states, their aggregate GDP increasing by 3.9 per cent and 5 per cent, respectively.

These outcomes suggest that after 10 years of painful reforms, the prolonged and deep transformational recession in these economies has for the most part come to an end. Divergent experiences in coping with this difficult phase, as well as in the deepening and widening of the reform process, has left the region much more heterogeneous than it was 10 years ago. Most central European and Baltic states have already made considerable progress in instituting a functioning market economy and have enjoyed several years of strong economic growth which has placed them among the leading candidates for EU membership. At the same time, in a number of other countries the transformational recession and the process of introducing basic reforms has turned out to be much longer and much more strenuous than initially expected: for some CIS

economies 2000 was the first year of positive growth in a decade while in Yugoslavia real market reforms can only now get underway with the new, democratically elected government.

The strong growth in the transition economies in 2000 is a positive and encouraging outcome; at the same time, however, it must be borne in mind that for a number of countries this represents only a meagre recovery after a long economic slump. In fact, after 10 years of reform only four economies (Hungary in 2000, Poland in 1995, Slovakia in 1999 and Slovenia in 1998) have managed to surpass their levels of GDP prevailing before the start of transformation.<sup>23</sup> On average, the CIS economies are still some 40 per cent below their GDP levels of 1989 and in a number of individual countries GDP in 2000 was less than half of what was being produced a decade ago (appendix table B.1).

It should also be emphasized that, with the exception of a few central European economies, domestic demand generally remains weak despite its moderate recovery in 2000. This reflects the fact that in a number of countries, especially in south-east Europe, central Asia and Caucasus, large sections of the population have suffered considerable impoverishment during the prolonged recession, while investment fell dramatically in the face of highly uncertain economic prospects. The falls in output and incomes in these economies are of such magnitude that it will probably take many years, if not decades, before the population at large begins to sense the positive outcomes of the reform process.

Nevertheless, as a result of the sweeping reforms of the past decade, most transition economies have established most of the basic institutions of a market economy and have liberalized their domestic markets and foreign trade (admittedly, to widely varying degrees). With the exception of a few CIS countries, the transition economies can now be considered as open economies that have the potential to benefit from their increased trade with the rest of the world. In fact, the growth figures for 2000 underline the gains from trade that are now possible for the transition economies.

Thus, in 2000, many transition economies benefited from strong and diversified demand in their major export markets, principally for manufactured goods but also for services and a wide range of primary commodities and semi-manufactures. In particular, the east European and the Baltic economies capitalized on the sharp rebound in west European import demand while the recovery in Russia stimulated exports from neighbouring CIS countries. In addition, the commodity exporting countries (and especially the oil and natural gas exporters in the CIS) benefited from the upsurge in world market prices which led to a considerable improvement in their trade and current account balances.

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<sup>23</sup> According to the available statistics (appendix table B.1), Albania's GDP in 2000 may also have regained its 1989 level; however, it is difficult to be sure of this given the poor quality of Albanian statistics.

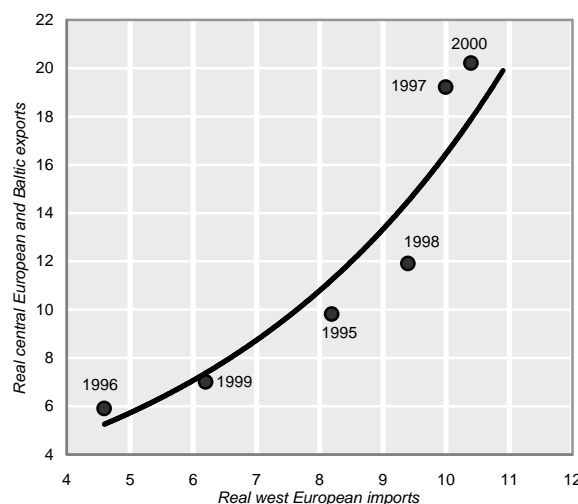
The EU is now the main trading partner for all the east European and Baltic economies, accounting for about two thirds of their exports and imports. Due to their differences in size, the exposure of the transition economies to the EU in terms of the relative importance of these trade flows, is much greater than the exposure of the EU to eastern Europe and the Baltic states. Hence, eastern Europe and the Baltic area are extremely susceptible (in both positive and negative directions) to changes in west European import demand. Another element in their greater sensitivity is the fact that supply-side constraints in the transition economies have been generally low in recent years due to the availability of underutilized resources (labour and, to a lesser extent, physical capital) and the start-up of large new capacities thanks to greenfield investments, usually involving FDI, and especially in those countries bordering the EU. This, in turn, has amplified the gearing effect of west European demand, on the one hand allowing eastern manufacturers to export even more during periods of boom but on the other hand reinforcing the probability of negative shocks during the downturn. During the second half of the 1990s the approximate elasticity of total central European and Baltic exports with respect to total west European import demand has been roughly of the order of 2 to 3 (chart 1.3.1).

The contrast between the development of trade in 1999 and 2000 is especially revealing. In 1999 total west European imports rose by just 6 per cent which contributed to an increase in central European and Baltic exports by a little over 7 per cent, which for the latter was one of the smallest increases during the second half of the 1990s (chart 1.3.1). Given the persistence of weak domestic demand, aggregate GDP in eastern Europe rose by a meagre 1.3 per cent, while the Baltic area as a whole went into recession (the aftershocks of the Russian crisis reinforcing the general economic weakness in 1999). In contrast, the acceleration in the volume of west European imports in 2000 (increasing in aggregate by a little over 10 per cent) was the major factor behind central European and Baltic exports increasing by some 20 per cent in volume. This strong export performance made a major contribution to the recovery of output in eastern Europe and the Baltic area in 2000.

The upsurge in world market prices of oil and other primary commodities, coupled with a stronger dollar in which most commodities are traded, provided a substantial terms of trade gain for the commodity exporting transition economies that underpinned their growth in 2000. As discussed in chapter 3 of this *Survey*, the effect of such a terms of trade gain is indirect: in the first place it helps to raise final domestic demand and imports; and subsequently, the increase in demand may lead to higher domestic output as well. When such a transmission channel is functioning in a large economy, the increase in its import demand can boost the exports of its main suppliers: this is how Russia's terms of trade gains in 2000 not only contributed to the strong recovery of the Russian economy but also served as an engine of growth for a number of neighbouring CIS economies.

CHART 1.3.1

Real west European imports and real exports of central Europe and the Baltic states, 1995-2001  
(Annual percentage change)



Source: UN/ECE secretariat calculations, based on national data.

Note: Real imports of west European countries (goods and services); real exports of central Europe and Baltic countries does not include Slovakia, for which data are not available.

Indeed, the Commonwealth of Independent States was the fastest growing regional group among the transition economies in 2000: in nine of the 12 CIS economies GDP growth was 5 per cent or more, resulting in an average of 7.4 per cent for the Commonwealth as a whole.

Despite the generally favourable outcome for economic growth in 2000, there are no grounds for complacency among policy makers. The fact is that most transition economies, including those most advanced in the reform process, are still rather fragile and vulnerable to external and other disturbances that are capable of causing painful setbacks in economic performance. Indeed, as already emphasized, the strong performance in 2000 underlines the considerable sensitivity of these economies to changes in the external environment, not least in the short run. Commodity exporters and economies specializing in exports of resource intensive, low value added goods are especially vulnerable. Given their large exposure to west European demand, the more advanced economies of central Europe and the Baltic area are also very susceptible to changes in demand in their major external markets. Thus, as the favourable external trends of 2000 are likely to be reversed, the transition economies may well suffer a negative external shock.

Due to their high degrees of export concentration, whether by commodities or export markets, the short-term outlook for the transition economies hinges on the two main factors that contributed to strong growth in 2000: west European import demand and world commodity prices (especially for oil). As discussed

above, the sudden and rapid deceleration of the United States economy in the second half of 2000 and early 2001 has triggered a gradual lowering of the forecasts for economic growth in western Europe as well. In addition, oil prices have been falling since the last quarter of 2000 and it seems likely that their average level in 2001 will be below that in 2000 (although still higher than in 1999). The first of these developments will have a serious impact on all the transition economies, increasing the downside risks to their short-term prospects, but the second will affect net oil importers and exporters differently.

The recent and rapid changes in the world economy do not appear to have been always taken into account in the official forecasts for eastern Europe and the Baltic states, most of which were made in the context of the budgetary preparations for 2001 when the global slowdown was not yet visible (table 3.1.1). These forecasts indicate that governments throughout eastern Europe and the Baltic area were generally expecting a further strengthening of the recovery in 2001 and, in many cases, an acceleration of their rates of economic growth.<sup>24</sup> In fact, the most recent data indicate that, in a number of east European and Baltic economies, the growth of output was already decelerating in the closing months of 2000 and at the beginning of 2001.

Against this background, the actual short-term outlook for eastern Europe and the Baltic area largely depends on the success or failure of western Europe in countering the weakening of its own prospects for output growth. A benign scenario (along the lines of the official forecasts in eastern Europe and the Baltic states) is conditional on success in arresting the slowdown in western Europe and, especially, in Germany.<sup>25</sup> A significant deceleration of growth in western Europe (involving a deceleration in import growth from around 10 per cent to 7 per cent) would have highly detrimental consequences for eastern Europe and the Baltic area, which could effectively translate into a reduction of their average GDP growth by 1-2 percentage points.

The unprecedented growth of Russia's GDP in 2000 reflected the combination of a low base (due to the 1998 crisis) and an extremely favourable external environment which is unlikely to be sustained. Indeed, all the indications are that the Russian economy (in particular industrial output) was also slowing down at the beginning of 2001. If oil prices continue to fall, domestic demand in Russia will be negatively affected and the official forecast for the year as a whole (GDP growth of 4

per cent) will be difficult to achieve. The prospects for most of the other CIS economies are conditional both on the outlook for world oil and commodity prices and on the performance of the Russian economy, including the development of rouble exchange rate. Hence, the uncertainties concerning the outlook for Russia are largely translated into uncertainties for the Commonwealth as a whole.

This uncertain outlook, and the increasing downside risks, implies the need for a more active role of economic policy in the transition economies in 2001 and modifications to the policy stances embodied in government budgets already adopted for the year. Policy makers will have to maintain a close monitoring not only of their own economic performance but also of current developments in their main trading partners and on the world markets. If external conditions continue to deteriorate, policy makers in the transition economies will have to be prepared to act swiftly with counter cyclical measures in order to offset, at least partly, an eventual negative shock. Although a full offset may not be in their power, given the risk of aggravating existing imbalances, timely policy responses may help to dampen its negative repercussions.

A prolonged slowdown, first in western Europe and then in the transition economies as well, would pose significant risks for the process of economic transformation and the future prospects of these economies. A slowdown will undoubtedly have a strong negative impact on the labour markets of the transition economies which are already in distress. At the end of 2000 the average unemployment rate in eastern Europe was still around 15 per cent: despite the high rate of economic growth, enterprise restructuring was still releasing more labour than was being employed in new jobs. A slowdown in economic growth will not only worsen unemployment but the likely social tensions may put a brake on the necessary but painful process of economic restructuring and systemic reform.

As seen from recent experience, growth in the most successful transition economies has been based on the expansion of exports and the upgrading of their commodity structure, both of which are conditional on large amounts of fixed investment, and especially of FDI. A slowdown of output growth in western Europe (which is a major source of FDI for the transition economies) may also lead to the weakening of direct investment in the transition economies. All these increasing downside risks in the transition economies, together with those in western Europe, reinforce the case for a counter cyclical policy stance.

A slowdown in western Europe also carries risks for the prospects of EU enlargement. As repeatedly stressed in this *Survey*, if the transition economies are to catch up with the industrialized west European economies in terms of per capita incomes and levels of development (an important condition for a smooth accession to the EU),

<sup>24</sup> Aggregate GDP in eastern Europe was expected to grow by some 4.2 per cent in 2001 (0.3 percentage points more than in 2000) while the forecast for the Baltic states was an average 4.7 per cent, slightly below the 2000 outcome (table 3.1.1).

<sup>25</sup> The share of Germany in the trade of most east European and Baltic economies is much larger than the share of Germany in the aggregate output of the EU.

they need to sustain high rates of economic growth (of the order of 5-6 per cent per annum, or even more) for a sufficiently long period of time. The candidate countries from eastern Europe and the Baltic area are crucially dependent on robust import demand in the west European markets for making a reality of such a strategy. Hence, if the eastern enlargement of the EU is to occur sooner rather than later, the EU and its policy makers have a double responsibility in maintaining steady growth in the Union: this is not only in its own self-interest but even more so in the interest of its potential future members and, therefore, in the broader, regional interest of a future, United Europe.

### (ii) The Yugoslav economy and stability in south-east Europe

The new, democratically elected government of Yugoslavia is facing one of the most complex and serious set of economic problems to be faced by any transition economy since 1989. The 1980s were already problematic for the former SFR of Yugoslavia, a lost decade in terms of development; but the 1990s were disastrous, a decade of economic regress. Yugoslavia's GDP per head was some 46 per cent of the EU average in 1980; in 1990 it had fallen to some 34 per cent, and rough estimates put it at somewhat under 25 per cent in 2000.<sup>26</sup> Devastated by a series of wars culminating in the Kosovo conflict of 1999, by the chronic misallocation of resources under authoritarian rule, by economic sanctions and isolation from the international community, and debilitated by extensive corruption among the ruling elite which appropriated a considerable proportion of the state's resources to itself, the present government is faced with an economy wracked by macroeconomic imbalances which are far greater than those encountered in any other transition economy, including Russia. Many of these imbalances were hidden by the previous regime in the form of suppressed inflation and hidden subsidies to the enterprise sector.

An enormous quasi-fiscal deficit – swollen by the losses of publicly owned firms, which amounted to 123 per cent of GDP at the end of 1998 – has accumulated as an alternative to confronting the structural causes of the hyperinflation of 1992-1994 and is the largest single imbalance facing the government. The government debt and the country's foreign debt, which amounts to some \$12.2 billion, are both equivalent to well over 100 per cent of GDP.<sup>27</sup> But attempts to correct these imbalances

quickly run into a series of connected problems. Dealing with the stock of enterprise debt will require large-scale public funding to restructure their balance sheets, while stopping the further accumulation of debt will require hard budget constraints in a market environment. But hard budget constraints will threaten at least 30 per cent of the total employed labour force, which are estimated to be underemployed in state owned firms, in a country where registered unemployment is already running at some 27 per cent of the labour force. Enterprise restructuring, in turn, will require a reform of the complicated system of social and public ownership, and the highly distorted structure of relative prices will have to be liberalized if there is to be any significant movement to a more efficient allocation of resources.

At the same time the government will have to confront two other major tasks: the reform of the public finances and the tax system, and the restructuring of the banks. The net worth of the banks is probably close to zero and so huge amounts of fresh funds will be needed to recapitalize them.

The government must attempt to introduce this major programme of reform in a country where the population, after more than a decade of drastically falling living standards and the loss of a major part of its savings through hyperinflation and government sequestration, has little or no confidence in the country's financial institutions, is distrustful of state institutions, and is resentful of what it sees as excessive foreign interference. Whatever reforms are introduced further hardship for many groups in Serbian society seems inevitable. In these circumstances it may be dangerously counter-productive to withhold assistance to the Yugoslav government until international demands are met for the former President to be handed over to the International War Crimes Tribunal in The Hague. As stressed in previous issues of this *Survey*, the economic recovery of Yugoslavia is essential for the peace, prosperity and stability of south-east Europe as a whole. The stability of the region remains highly fragile as recent events in The former Yugoslav Republic of Macedonia and Bosnia and Herzegovina have underlined. Without in any way compromising Yugoslavia's legal obligations to the Tribunal in The Hague, the immediate priority is for the Yugoslav government to get a comprehensive programme of reforms underway and to bring about some improvement in the living standards of the population. But it will not be able to do this without massive help from abroad. There are signs that the international financial institutions are now acting more rapidly and effectively in south-east Europe than they did in central Europe in the 1990s,<sup>28</sup> but they are unlikely to be able to

<sup>26</sup> UN/ECE, *Economic Survey of Europe, 2000 No. 1*, chap. 5.

<sup>27</sup> A foreign debt to GDP ratio of 118 per cent is based on a GDP figure of \$10.3 billion, which is an estimate adjusted for the multiple exchange rates (official, black market and inter-enterprise) existing during most of 2000. P. Petrovic, D. Dragutinovic and M. Arsic, *The FRY Economy: Macroeconomic Developments and Main Imbalances* (Belgrade), February 2001. Use of a dollar GDP, based on the unrealistically high official exchange rate, yields a debt-to-GDP ratio of 49 (table 3.6.13). The foreign debt-export ratio of Yugoslavia was some 500 per cent in 2000, far beyond the 200-220 range that is

normally taken to signal debt sustainability. Foreign exchange reserves amounted to only 1.6 months of import coverage (imports themselves being very depressed).

<sup>28</sup> PlanEcon, *Monthly Report* (Washington, D.C.), 23 February 2001, pp. 2-6.

provide all that is needed. A large and generous – and prompt – effort will also be required from the EU, which should include a significant proportion of non-debt finance in its assistance, as well as efforts to prepare Yugoslavia for eventual accession to the Union. A rescheduling and reduction of the country's foreign debt is also urgent. So far the sums being discussed by the international community fall far short of the Yugoslav government's estimates of its needs. Without speedy and

adequate assistance there is a considerable risk that support for the government's liberal reforms will evaporate into outright opposition and that the economy will collapse into chaos with the risk of a renewed hyperinflation. The crisis in Yugoslavia and the threat of further instability in south-east Europe, together with the programme for its eastward enlargement, present two major challenges to the capacity of the European Union to act as the major economic power in the region.