

## CHAPTER 3

### EASTERN EUROPE

For the most part, eastern Europe maintained a relatively strong rate of growth in 2003. The combination of an ongoing process of upgrading and modernizing of production capacities and the enduring strength of domestic demand allowed most of these economies to weather the protracted global economic slowdown. While the east European economies still face many structural challenges, their performance during a period of global turmoil is an important sign of their growing strength.

In 2003, economic performance was influenced by two countervailing developments. On the one hand, the revival of global economic activity gained momentum in the course of the year and provided a strong external stimulus to the trade-dependent east European economies. On the other, while private domestic demand generally remained relatively strong, the escalation of fiscal deficits led to retrenchment in a number of countries, resulting in a negative contribution of public expenditure to GDP growth. Overall, the rates of growth in most east European countries were little changed from 2002. The acceleration in their aggregate GDP was largely due to the strengthening of the recovery in Poland, the region's largest economy.

The year 2004 will mark an important and symbolic milestone in the process of economic transformation in eastern Europe: after a decade and a half of difficult and often painful economic and political reforms, eight east European countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) together with Cyprus and Malta will become full members of the European Union. This newly acquired status is a recognition of the fact that, in the main, the transition from plan to market has been successfully completed in a large part of eastern Europe. The present round of EU enlargement not only turns a page in the history of the acceding countries but is also reshaping the political and economic landscape of the continent for years to come.

#### 3.1 Macroeconomic policy

##### *A more cautious policy stance*

With the gradual improvement in the external environment in 2003, the macroeconomic policy focus throughout most of eastern Europe shifted, albeit slightly, from targeting aggregate demand (a major preoccupation

during the global slowdown) towards targeting macroeconomic equilibrium. Mounting concern about macroeconomic imbalances in some countries also encouraged such a shift in the focus of policy and there was a notable tightening of fiscal policy in a number of east European economies. This was a reversal of the expansionary policies pursued in 2001 and, especially, in 2002 (partly in response to worsening external conditions), which in some cases increased fiscal imbalances. According to preliminary and tentative data, almost all east European countries reported shrinking or unchanged general government deficits in 2003 (table 3.1.1). The average deficit in eastern Europe fell from 4.1 per cent in 2002 to 3.1 per cent in 2003. In Poland and Serbia and Montenegro, there was a further widening of already large general government deficits. And although there was some reduction in the deficits of Albania, Croatia, the Czech Republic, Hungary and Slovakia, they still remained large and a source of policy concern. Recently there was also a worrisome rise in the levels of public debt in Hungary and Poland (table 3.1.2). In only half of the EU acceding economies (the three Baltic states and Slovenia) were fiscal deficits within the Maastricht deficit target in 2003.

Two countervailing factors affected the stance of monetary policy. On the one hand, the continuing fall in inflationary expectations (partly due to relatively moderate rates of imported inflation) justified some relaxation in the policy stance and the monetary authorities in some countries did take, within the room available to them, steps in this direction.<sup>101</sup> However, the persistence of large fiscal imbalances, often coupled with current account deficits, limited such moves and some central banks even reverted to monetary tightening.<sup>102</sup> Thus, despite some relaxation, the overall stance of monetary policy in most east European economies remained relatively tight.

There were a few exceptions to this relatively cautious pattern in countries such as the Czech Republic

<sup>101</sup> Thus, over the course of the year, central banks lowered their key interest rates in Albania, the Czech Republic, Hungary (until June), Poland, Slovakia, Slovenia and The former Yugoslav Republic of Macedonia.

<sup>102</sup> In the second half of the year, the Croatian National Bank twice raised the mandatory reserve requirement for commercial banks, while the National Bank of Romania, after lowering its key intervention rates in the summer months, raised them considerably in November.

TABLE 3.1.1

Consolidated general government deficit (-) / surplus (+) in eastern Europe, 1999-2004  
(Per cent of GDP)

	1999	2000	2001	2002	2003 <sup>a</sup>	2004 target
Albania .....	-9.2	-7.9	-7.6	-6.3	-5.6	-5.0
Bosnia and Herzegovina ...	-5.8	-6.0	-5.0	-4.5	-2.4	-1.3 <sup>b</sup>
Bulgaria .....	0.2	-0.6	1.7	-0.7	-	-0.7
Croatia .....	-7.4	-5.9	-6.8	-4.8	-4.6	-3.8
Czech Republic .....	-3.2	-3.3	-5.5	-6.7	-6.6	-5.9
Estonia .....	-4.0	-0.4	0.2	1.3	1.3	-0.1
Hungary .....	-5.3	-3.0	-4.1	-9.2	-5.8	-4.6
Latvia .....	-5.3	-2.7	-1.6	-3.0	2.0	-2.2
Lithuania .....	-5.6	-2.7	-1.9	-1.7	-2.1	-2.9
Poland .....	-1.5	-1.8	-3.1	-3.8	-3.9	-5.0
Romania .....	-4.5	-4.5	-3.4	-2.2	-1.5	-2.3
Serbia and Montenegro .....	..	-0.9	-1.4	-4.5	-4.6	-4.3
Slovakia .....	-6.4	-12.8	-5.6	-7.2	-5.0	-3.9
Slovenia .....	-2.2	-3.2	-2.5	-2.4	-1.1	-1.5 <sup>b</sup>
The former Yugoslav Republic of Macedonia ....	-1.5	1.8	-7.2	-5.8	-2.5	-2.6

*Source:* UNECE secretariat estimates and calculations, based on direct communications from national ministries of finance; IMF, *Staff Country Reports* ([www.imf.org](http://www.imf.org)); Eurostat, *Statistical Yearbook on Candidate Countries* (Luxembourg), 2003.

*Note:* The consolidated general government deficit, or financing requirement, for the 10 EU acceding and candidate countries is reported in accordance with the Eurostat's ESA-95 accounting methodology. For the other countries it is in accordance with the IMF GFS method. National practices in applying these methodologies may differ. Deficits projected at the start of 2004 are official budget deficits, forecast in the initial budget proposals, necessarily involving GDP and inflation projections as well as fiscal data. The definitions of the projected deficits as well as some of the preliminary estimates of the deficits in 2003 may differ from those given above.

<sup>a</sup> Preliminary estimates.

<sup>b</sup> Central government deficit/surplus.

and Poland, among others, where policy makers remained preoccupied with revitalizing their economies. Thus, fiscal policies in these two countries remained generally expansionary, while at the same time their central banks loosened monetary policy with several consecutive cuts in key interest rates. While this stimulus provided a boost to economic activity in 2003 (especially in Poland), the scope for further activist policy in these countries appears to have been exhausted.

### Steps towards fiscal consolidation

As noted, the public sector financial balances improved in the majority of east European countries in 2003 reflecting a general movement towards fiscal consolidation. Thus, the large reduction in Slovenia's fiscal deficit was the result of a purposeful restructuring of government spending (including wage restraint in the public sector).<sup>103</sup> The improvement in Romania's fiscal

<sup>103</sup> This reduction was achieved despite a slight increase in the deficit target for the year (by 0.3 percentage points, adopted in June) due to the weaker than expected growth of GDP. However, the long-run effect of the 2003 restructuring measures is less clear as at the same time the authorities agreed to some future pension increases.

balance (for the third consecutive year – table 3.1.1 and chart 3.1.1) is partly due to measures which have tightened financial discipline, including the collection of taxes. In 2003, the authorities in The former Yugoslav Republic of Macedonia stepped up their efforts to consolidate the public finances, which were in serious disarray as a result of the internal military conflict in 2001. Year-on-year, the general government balance in Hungary improved substantially, but the deficit in 2003 remained fairly high and the authorities failed to meet their target for the year.<sup>104</sup>

In Estonia the general government balance in 2003 was in surplus for the second consecutive year, the policy of fiscal restraint being partly intended to contain any further expansion of the country's large current account deficit. The general government financial account in Bulgaria was balanced in 2003 reflecting a conservative fiscal policy that has been maintained for several years and which has contributed to a major improvement in the state of public finances.<sup>105</sup>

In general, the financing of fiscal deficits has not been a problem.<sup>106</sup> A positive recent development in south-east Europe has been the almost complete discontinuation of the practice of central banks providing direct credit to governments in most of these countries. The elimination of pro-inflationary deficit financing has greatly contributed both to the rehabilitation of public finances in the south-east European economies and to the overall improvement in macroeconomic stabilization.

In a number of east European countries further reductions in public sector deficits are planned in 2004. However, this is not a trivial policy task and fiscal consolidation is likely to be a lengthy and painful process. Part of the large deficits in some of these economies are related to major structural reforms as well as to some transition-specific policy measures. Thus, structural reforms in the social security and other institutional systems, which are underway in several countries, entail significant up-front costs; similarly, the public finances in some of them (such as the Czech Republic and Slovakia) are burdened with large costs of bank restructuring. Increased public spending on

<sup>104</sup> It should also be pointed out that if the considerable one-off expenditures incurred in 2002 are netted out of the fiscal balance, then the improvement in 2003 was only marginal.

<sup>105</sup> For a more detailed assessment see UNECE, *Economic Survey of Europe, 2003 No. 1*, box 3.1.1: "Fiscal consolidation in Bulgaria in the context of a medium-term fiscal strategy".

<sup>106</sup> Governments in some east European countries are relying to a considerable degree on foreign sources to cover their borrowing requirements due to the generally lower interest rate on government bonds issued in euros compared with that on bonds of similar maturity but issued in domestic currency. This type of debt is also appealing to foreign investors due to the relatively attractive yields in the absence of an exchange rate risk. However, the increased reliance on foreign financing increases the vulnerability of their public finances (and of the economies as a whole) to abrupt reversals in capital flows and to changes in monetary policy in other countries.

TABLE 3.1.2

**Public debt in selected east European economies, 2000-2003**  
(End of period values, per cent of GDP)

	Total public debt						Of which: foreign public debt					
	2000	2001	2002	2003			2000	2001	2002	2003		
				Mar.	Jun.	Sept.				Mar.	Jun.	Sept.
Bulgaria <sup>a</sup>	77.1	69.9	55.9	52.8	50.8	44.9	70.5	63.6	49.3	45.7	44.1	38.3
Croatia	35.2	39.1	41.8	44.5	44.1	43.7	25.6	25.7	25.5	27.3	26.3	26.5
Czech Republic	14.6	15.9	17.4	18.7	19.4	20.2	1.0	0.4	0.4	0.5	0.6	0.5
Estonia	3.1	2.6	3.0	3.0	2.9	3.0	2.9	2.5	2.9	2.8	2.8	2.9
Hungary <sup>b</sup>	54.9	52.0	55.1	57.3	57.9	57.7	19.0	15.7	13.5	14.1	14.7	14.3
Latvia	13.1	14.8	14.6	15.0	15.2	15.4	8.0	9.5	8.9	8.6	8.5	8.1
Lithuania <sup>a</sup>	28.5	27.2	27.4	27.7	25.0	24.8	22.1	20.8	18.1	19.7	17.1	17.1
Poland	37.4	37.8	43.6	46.4	46.2	46.4	16.9	13.2	14.3	15.4	15.1	15.5
Romania	31.3	28.8	28.3	..	28.2	..	22.1	20.8	21.2	20.7	20.4	21.3
Slovakia	23.8	36.2	35.2	34.3	35.4	34.9	11.7	9.4	10.3	9.6	8.3	7.9
Slovenia	24.0	25.9	27.0	26.5	26.6	26.5	12.0	12.5	11.1	10.9	10.7	10.5

**Source:** UNECE secretariat calculations, based on data from national Ministries of Finance, central banks and national statistical offices; IMF, *International Financial Statistics* (Washington, D.C.), various issues.

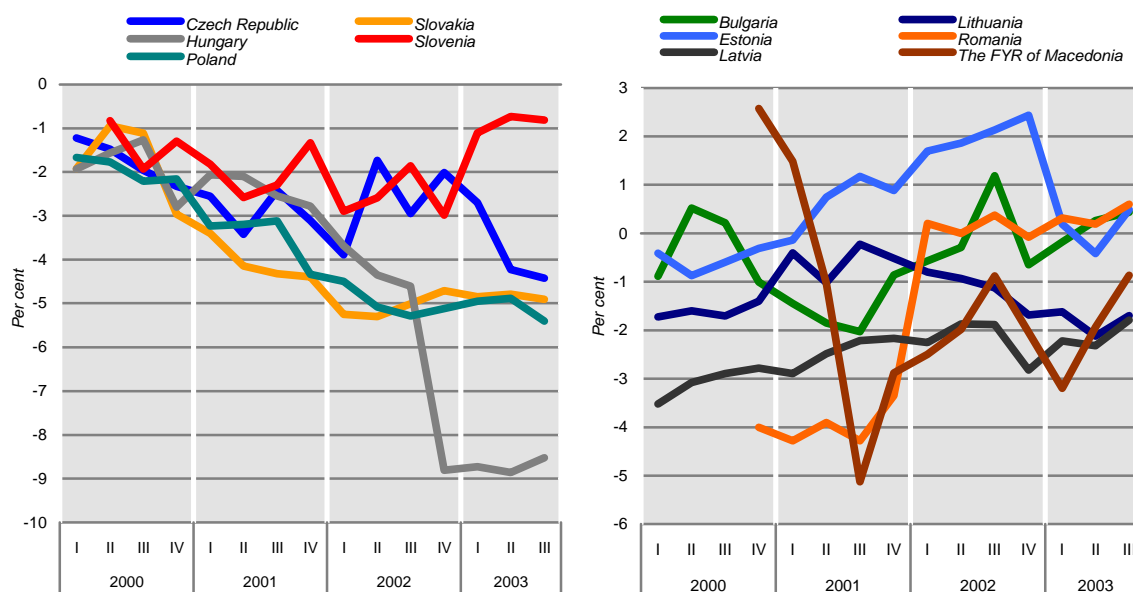
**Note:** Definition of public debt: central government debt for the Czech Republic, Estonia, Latvia, Lithuania, Poland, Slovakia; consolidated general government debt for Bulgaria, Hungary, Romania, Slovenia.

<sup>a</sup> Including government guaranteed debt.

<sup>b</sup> Excluding foreign debt in the books of the National Bank of Hungary.

CHART 3.1.1

**Fiscal deficits <sup>a</sup> in selected east European economies, 2000-2003**  
(Per cent of GDP)



**Source:** UNECE secretariat calculations, based on the data from national ministries of finance, central banks and national statistical offices; IMF, *International Financial Statistics* (Washington, D.C.), various issues; EIU country reports.

**Note:** The data presented in the chart are based on current (monthly) reporting of the fiscal deficit. Both the coverage and the methodology of the current reporting may differ from the annual data in table 3.1.1 even when both refer to the same level of reporting. Due to this the deficit levels presented in table 3.1.1 and chart 3.1.1 may differ for some countries. Definition of public deficit/surplus: consolidated general government deficit/surplus – Bulgaria, Estonia, Latvia, Romania and Slovenia; central government deficit/surplus – Czech Republic, Croatia (including extrabudgetary funds), Hungary, Lithuania, Poland, Slovakia and The former Yugoslav Republic of Macedonia.

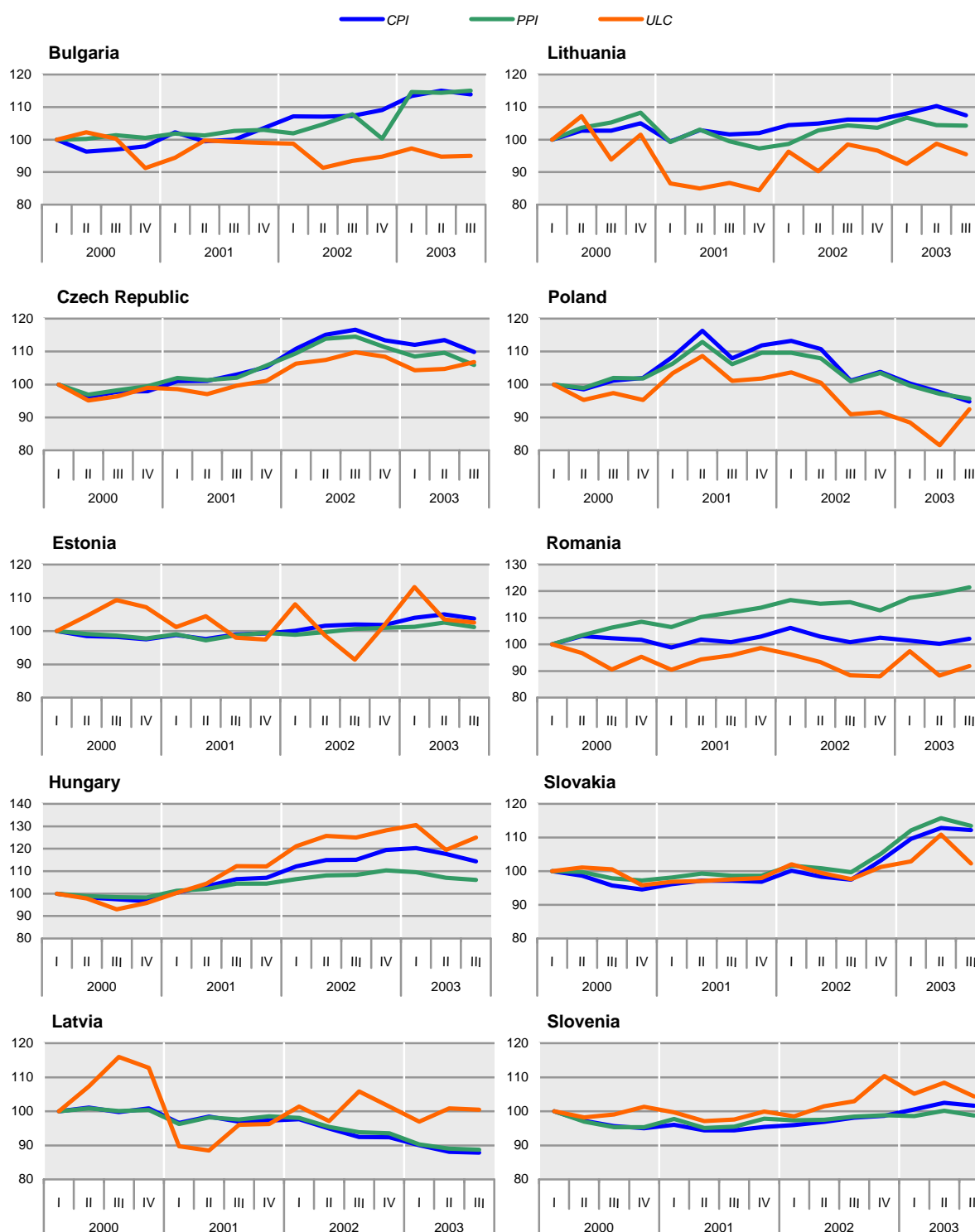
<sup>a</sup> The quarterly deficits in the chart are 12-month moving averages.

infrastructural investment and environmental protection has also raised public expenditure in a number of cases. While part of this increased spending is of a one-off nature, the demands on public funds is likely to remain high in the foreseeable future.

The need for fiscal consolidation, however, is likely to involve some unpopular cost-cutting measures. The implied restructuring of public expenditure will need to be carried out with great care and with a strategic, long-term view of the overall efficiency of public spending.

CHART 3.1.2

Real effective exchange rates in selected east European economies, 2000-2003  
(Indices, first quarter 2000=100)



Source: National statistics; UNECE Common Database.

Note: The real effective exchange rates were computed from the nominal exchange rates against the euro and the dollar, deflated respectively by the domestic and European Union or United States consumer and producer price indices, and by indices of estimated unit labour costs in industry, while the shares of the EU and the rest of the world in total exports of individual transition economies were used to determine the euro and the dollar trade weights, respectively. An increase in the index denotes a real appreciation and vice versa.

## Box 3.1.1

## The forint under attack

The year 2003 was one of unusual volatility in the Hungarian foreign exchange market: on three occasions – in January, June and November – the forint was the target of speculative attacks. What is unusual in this string of events is that speculators tested both the lower and the higher bounds of the fluctuation band suggesting considerable uncertainty on the part of the markets about the true equilibrium exchange rate of the Hungarian currency or about the consistency of economic policies.

In 2001, the Hungarian authorities made a unilateral commitment to operate a monetary regime which resembles ERM-2 (the main difference being the retention of central bank discretion regarding the central parity): the forint is pegged to the euro but its exchange rate is permitted to fluctuate within a band of  $\pm 15$  per cent around the central parity. Capital controls were also lifted in 2001. However, Hungary's recent experience exposed some of the risks associated with a premature adoption of this type of monetary regime.

After the Irish referendum on the Nice Treaty in 2002 (which eliminated the remaining uncertainty about the date of EU enlargement), most central European countries became the target of speculative capital attracted by the existing positive interest differentials ("convergence play"), which were especially pronounced in Hungary. In December 2002 and January 2003, the inflows to Hungary intensified as investors perceived a conflict in the policy targets of the National Bank of Hungary (NBH). In order to maintain exchange rate stability in the face of massive capital inflows the NBH would have to lower interest rates; however, in order to achieve its inflation target, the central bank needed to keep interest rates high. Speculators gambled that the NBH would stick to its inflation target ( $3.5 \pm 1$  per cent for 2003) and would eventually give up on the exchange rate target, allowing the forint to appreciate. In the event, the NBH gave up the inflation target, setting a new target of 4.5 per cent later in the year: it cut its intervention interest rate by 200 basis points (to 6.5 per cent) and intervened heavily on the foreign exchange market, purchasing some €5.3 billion in January.

On this occasion, investors appear to have overlooked the fact that, by law, exchange rate management in Hungary is a joint responsibility of the government and the NBH and that the government had openly voiced its strong opposition to any further appreciation of the forint. In fact the government, partly bowing to pressure from exporters, was concerned that the prevailing market exchange rate of the forint (which, after May 2001, had appreciated from its central parity) was already harming the competitiveness of local producers and thus contributing to the economic slowdown. Thus, it was actually advocating policies that would lower the market rate of the forint.

However, prior to the first attack, a disagreement had already emerged between the policy stance of the government and that of the central bank. After 2001, there was a considerable loosening of fiscal policy with a large increase in public spending (on public sector wages and infrastructural investment), partly as a countercyclical response to the weak external environment. In 2002 the general government fiscal deficit rose sharply to 9.2 per cent of GDP (against an *ex-ante* target of 5.5 per cent and a deficit of 4.1 per cent in 2001). The NBH was concerned about the possible inflationary impact of this fiscal expansion and, in view of its inflation target, tried to counteract it with a relatively tight monetary stance until the first speculative attack on the exchange rate.

In June the government and the NBH reached an agreement that the central parity of the forint would be lowered by 2.26 per cent while the government would reduce budgetary spending in 2003 by HUF 76 billion, equivalent to 0.5 per cent of GDP. These cuts were expected to keep the deficit for the year in line with the 4.5 per cent target (but, eventually, they failed to do so).

However, the rationale of this agreement was questionable as a depreciation of the central parity by such a small amount was unlikely to have a perceptible effect on competitiveness. At the same time, the new policy sent the wrong signal to the financial markets which interpreted it as a recognition by the authorities of structural weakness in the economy. In addition, the markets became concerned about central bank independence, fearing the NBH might continue to bow to pressure from the government to devalue the forint further. Consequently, investors reacted by withdrawing large amounts of forint funds resulting in a sharp fall of the exchange rate. In an emergency response, the NBH raised its intervention rate by 300 points (to 9.5 per cent) in June in order to prevent any further depreciation and a resurgence of inflationary pressure.

Although the foreign exchange market calmed down during the summer, investors remained anxious about a deepening structural weakness of the economy, namely, the persistently large twin deficits combined with an increasing dependence on foreign capital inflows to finance them. Thus about half of the outstanding Hungarian public debt was being held by foreigners and the government was relying increasingly on foreign investors to take up its new bond issues. The financing of the large current account deficit was also becoming problematic: while in previous years a large share of this deficit had been financed by FDI, in 2003 there was a massive net outflow of direct investment, amounting to some \$1.5 billion in the first three quarters of the year. This reflected both a redirection of FDI by foreigners and increasing Hungarian direct investment abroad. Thus, apart from financing an already large current account deficit, fresh sources of capital inflow (largely of a short-term nature) had to be attracted to close this new gap in the financing of the balance of payments.

Finally, in its *Quarterly Report on Inflation* issued in November 2003, the NBH admitted a long-standing irregularity in its balance of payments statistics, namely, that the current account deficit was being reported net of the reinvested profits of foreign-held entities in Hungary. If these are included (as required by the internationally accepted IMF methodology, which will be adopted in Hungary as of 2004) the actual Hungarian current account deficit is some 2 to 2.5 percentage points higher than actually reported: in 2002 the deficit was thus about 6.5 per cent of GDP rather than 4.1 per cent; the expected revised figure for 2003 is above 8 per cent. This revelation suggested that Hungary's external position was significantly weaker than had been previously perceived by market participants.

## Box 3.1.1 (concluded)

**The forint under attack**

In the second half of November, the withdrawal of forint funds resumed with renewed downward pressure on the currency. The NBH was again forced to take emergency action, raising its key interest rate by a further 300 basis points (to 12.5 per cent) at the end of November, 10 percentage points above the main refinancing rate in the euro zone. This monetary tightening is likely to have an adverse effect on economic activity and negative implications for the fiscal balance in 2004 (the higher interest rate will raise the cost of debt service while revenues will be lower if output weakens).

There are several lessons to be drawn from this experience. Exchange rate instability is never a problem on its own: it reflects either an inconsistency between the present exchange rate regime and the overall policy stance, or an underlying fundamental weakness of the economy, or both. While the perceived policy inconsistency led to the first attack on the forint, the NBH dealt with it relatively easily since a central bank has basically unlimited resources to defend the currency against appreciation. However, the selling pressure on the currency in the second and third attacks mainly reflected concern about the large macroeconomic imbalances, reinforced by incoherent policies. These speculative attacks, especially the last one, were more difficult and costly to resist and the effort to do so may lead to lasting fiscal and output losses. The credibility of the central bank has also been damaged.

More generally, this experience reveals some of the risks of a premature adoption by the EU acceding countries of a restrictive exchange rate regime (such as ERM-2) in the absence of sound fundamentals and a sufficient degree of nominal and real convergence with the euro zone. When the Hungarian authorities adopted a monetary regime close to ERM-2 in 2001, they were aiming at a rapid entry into the euro zone, but they appear to have underestimated the negative implications of the widening fiscal imbalance. Three years later the outcome seems to be the opposite of what the government had originally intended: EMU accession will probably occur much later than previously envisaged.

Thus a targeted rationalization of public expenditure is likely to be much more efficient than across-the-board cuts. Greater transparency and a wide public debate about the priorities of public spending can help to increase public support for the needed reforms.

***Volatile exchange rates***

With most exchange rates in eastern Europe now pegged to or targeting the euro, the major realignment of international currencies in 2003 has had important economic implications for these economies. As virtually all currencies in the region appreciated against the dollar, the east European economies have faced increased competitive pressure from countries whose trade is denominated in dollars, especially the south-east Asian economies, which are often competing directly with the products of east European countries. Major exchange rate realignments, such as occurred in 2003, significantly affect the cost and price competitiveness of east European exporters.

At the same time, as is clear from the dynamics of east European real effective exchange rates (chart 3.1.2), there were important country-specific developments as well. Thus, thanks to the fast rate of disinflation (in some cases, even deflation), in several countries (especially the Czech Republic and Poland) there was a notable real depreciation of their price-based real effective exchange rates in 2002 and 2003. But also in the other east European economies, the previous trend of appreciating price-based exchange rates was either reversed in 2003 or decelerated. Thus, low domestic inflation rates have – at least to some extent – mitigated the negative effect of the exchange rate realignments. It remains to be seen, however, to what extent low inflation rates will be sustained in eastern Europe.

The combined effect of price and exchange rate movements on eastern Europe's recent trade and economic performance is not yet clear. But, overall, the exchange rate changes have probably weakened global demand for east European exports. In addition, there may also have been a negative effect on FDI flows to eastern Europe, as cost-sensitive investors may have preferred lower-cost destinations. Exchange rate uncertainties may also lead to postponement of FDI, thus contributing to fluctuations in this source of finance.

Exchange rate realignments per se did not cause much turbulence on east European financial markets. The few cases of turmoil in the foreign exchange markets (such as the attacks on the Hungarian forint) were related more to domestic rather than international factors (box 3.1.1). Thanks to the strengthening of their financial systems and their overall macroeconomic stability, most east European economies are now capable of absorbing such realignments without damaging side effects.

***An ongoing credit expansion***

An important recent development in east European financial markets has been a long-lasting (in some cases, for several years) boom in credit demand. This credit expansion, which continued in many countries of the region in 2003, is an indication of the rising confidence of both investors and consumers in these countries as well as an evidence of progress in the restructuring and modernization of their banking systems.<sup>107</sup> The credit

<sup>107</sup> Thus in January-September 2003, the average amount of outstanding bank credit to the non-government sector (households and firms) in Bulgaria rose by 47 per cent compared with the same period of 2002; in Croatia the increase was 22 per cent, in Estonia 27 per cent, in

TABLE 3.1.3  
Short-term interest rates in selected east European economies, 2001-2003  
(Per cent per annum)

	Short-term credits						Short-term deposits						Average yield on short-term government securities		
	Nominal			Real			Nominal			Real			2001	2002	2003 <sup>a</sup>
	2001	2002	2003 <sup>a</sup>	2001	2002	2003 <sup>a</sup>	2001	2002	2003 <sup>a</sup>	2001	2002	2003 <sup>a</sup>			
Albania .....	16.4	15.0	11.9	15.0	5.1	8.5	7.7	8.5	8.6	4.5	3.1	5.5	7.7	9.5	9.3
Bosnia and Herzegovina .....	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Bulgaria .....	11.7	9.8	9.0	6.9	8.5	3.8	3.2	3.0	3.1	-3.9	-2.6	1.5	4.6	4.3	2.9
Croatia .....	9.6	13.0	11.5	5.7	13.4	8.1	3.2	1.9	1.5	-1.5	0.0	-0.6	5.9	5.6 <sup>b</sup>	4.5 <sup>b</sup>
Czech Republic .....	7.1	6.2	5.3	4.0	6.8	7.7	3.0	2.2	1.5	-1.6	0.4	1.5	5.2	3.8	2.4
Estonia .....	7.8	6.7	5.5	3.2	6.3	5.3	4.0	2.7	2.5	-1.7	-0.8	1.4	..	..	..
Hungary .....	12.1	10.2	8.9	6.6	12.2	7.2	9.3	7.5	6.3	0.1	2.1	1.6	10.7	8.9	7.5
Latvia .....	11.2	8.0	5.3	9.3	7.0	2.3	5.2	3.2	2.9	2.7	1.3	0.1	3.8	3.3 <sup>b</sup>	3.0 <sup>b</sup>
Lithuania .....	9.6	6.8	5.9	10.2	8.5	6.3	4.6	2.7	2.1	3.2	2.4	3.3	5.6	3.8	2.6
Poland .....	18.2	12.8	8.9	16.4	11.7	6.3	10.2	6.1	3.7	4.5	4.1	3.2	18.2 <sup>b</sup>	9.8 <sup>b</sup>	6.2 <sup>b</sup>
Romania .....	45.4	35.4	25.4	3.1	10.9	3.3	26.6	19.1	10.9	-5.9	-2.8	-4.0	42.2	27.2	15.7
Slovakia .....	11.2	9.9	8.4	4.5	7.7	0.3	5.2	4.6	3.3	-1.8	1.3	-4.5	8.3 <sup>b</sup>	7.7 <sup>b</sup>	6.4 <sup>b</sup>
Slovenia .....	15.1	13.2	11.0	5.7	7.7	8.1	9.8	8.2	6.3	1.3	0.7	0.3	11.8 <sup>c</sup>	11.0 <sup>c</sup>	9.2 <sup>c</sup>
The former Yugoslav Republic of Macedonia .....	19.4	18.3	15.5	17.0	19.4	15.1	10.0	9.6	8.3	4.3	7.6	7.4	..	..	..

**Source:** National statistics and direct communications from national statistical offices to the UNECE secretariat; IMF, *International Financial Statistics* (Washington, D.C.), various issues.

**Note:** Definition of interest rates:

**Credits** – Bulgaria: average rate on short-term credits; Croatia: until 2002 weighted average rate on new credits to non-government and government sector, from 2002 weighted average rate on new credits to enterprises and households only; Czech Republic: average rate on total short-term loans; Estonia: weighted average rate on short-term loans; Hungary: weighted average rate on loans of less than one year; Latvia: average rates on short-term credits; Lithuania: average rates on loans of one to three months; Poland: weighted average rate on low-risk short-term loans; Romania: average short-term lending rate; Slovakia: average rate on new short-term loans; Slovenia: average rate on short-term working capital loans; The former Yugoslav Republic of Macedonia: median rates for short-term loans to all sectors. The real lending rates are the nominal rates discounted by the average rate of increase in the PPI for the corresponding period.

**Deposits** – Bulgaria: average rates on one-month time deposits; Croatia: weighted average rate on new deposits; Czech Republic: average rate on short-term time deposits; Estonia: weighted average rate on short-term deposits; Hungary: weighted average rate on deposits fixed for more than one month, but less than one year; Latvia: average rates on short-term deposits; Lithuania: average rates on deposits of one to three months; Poland: weighted average rate (according to information collected from 15 biggest commercial banks) on short-term household deposits in domestic currency; Romania: average short-term deposit rate; Slovakia: average rate on time deposits; Slovenia: average rate on time deposits of 31-90 days; The former Yugoslav Republic of Macedonia: lowest reported interest rate on household deposits with maturities of three to six months. The real deposit rates are the nominal rates discounted by the average rate of increase in the CPI for the corresponding period.

**Yields of government securities** – Bulgaria: average weighted yield of all issues during the calendar month; Croatia: interest rate on NBC bills, due in 91 days; Hungary: weighted average yield on 90-day treasury bills sold at auction; Latvia: weighted average auction rate on 91-day treasury bills; Lithuania: average auction rate on treasury bills with maturity of 91-days; Poland: weighted average yield on bills purchased with 13-week maturity; Romania: rate on 91-day treasury bills; Slovenia: BS tolar bills, 14 days overall nominal rate.

<sup>a</sup> January-September.

<sup>b</sup> Central bank 60-day discount rate.

<sup>c</sup> Central bank Lombard rate.

boom is all the more remarkable given the fact that real interest rates on credit (as well as nominal interest rate spreads) remain high in most east European countries (table 3.1.3) reflecting the large risk premia still charged by local banks. It can be expected that interest rates in these economies will continue to fall (especially in the new EU members) and that this will fuel further increases in credit demand. The surge in money demand has contributed to a continuing remonetization of these economies in recent years (table 3.1.4).

The increase in commercial credit to the non-government sector reflects a significantly improved system of financial intermediation in eastern Europe which now allows the increasing amounts of financial

resources available to be mobilized. In turn, intermediation has been facilitated by the rapid proliferation of new financial products in the local markets. FDI has been instrumental in the restructuring and modernization of east European banking systems.<sup>108</sup>

Through its supply and demand effects, expanding bank credit has been an important support for economic growth in eastern Europe both during the global slowdown and in 2003 as well. Thus, the greater availability of financial resources and easier access to credit have created an environment conducive to the growth of local firms. Easier access to credit has also provided households with new and better opportunities

Hungary 30 per cent, in Latvia 39 per cent, in Lithuania 40 per cent and in Romania 46 per cent. The Czech Republic and Slovakia are exceptions to this pattern due to the continuing restructuring of their banking sectors.

<sup>108</sup> The banking sectors in most east European countries have attracted considerable amounts of FDI and are now largely dominated by foreign-controlled banks, mostly from western Europe.

TABLE 3.1.4  
Monetization <sup>a</sup> in selected east European economies, 2000-2003  
(Per cent of GDP)

	M1 <sup>b</sup>				Total broad money <sup>c</sup>				Total credit <sup>d</sup>			
	2000	2001	2002	2003 <sup>e</sup>	2000	2001	2002	2003 <sup>e</sup>	2000	2001	2002	2003 <sup>e</sup>
Albania .....	19.9	20.6	22.1	19.9	55.5	57.9	59.0	58.1	4.2	4.8	5.9	6.2
Bosnia and Herzegovina .....	12.0	17.7	29.1	28.0	12.0	31.6	48.9	48.7	21.5	45.0	34.8	40.6
Bulgaria .....	12.6	14.3	14.6	15.7	32.0	36.6	39.3	40.0	11.8	12.9	16.5	21.0
Croatia .....	10.0	11.9	15.4	16.4	41.7	51.4	62.3	63.0	37.6	41.8	47.9	53.8
Czech Republic .....	24.0	25.3	25.8	27.9	66.1	67.7	66.9	65.8	47.6	39.9	30.1	29.3
Estonia .....	21.9	22.6	23.4	24.0	34.8	37.6	39.7	40.7	34.6	39.9	44.9	50.6
Hungary .....	16.0	16.0	18.9	17.5	42.3	41.0	42.6	43.2	26.3	29.5	31.8	35.1
Latvia .....	15.5	16.1	17.2	18.5	26.3	29.3	32.8	35.0	18.0	23.0	30.6	35.6
Lithuania .....	11.6	11.8	13.9	15.9	21.1	23.6	26.5	27.9	13.7	12.8	14.2	16.8
Poland <sup>f</sup> .....	14.5	14.2	16.0	17.1	39.6	42.2	41.7	40.5	27.4	28.9	30.4	30.9
Romania .....	4.1	4.0	4.3	4.7	18.8	18.5	20.1	21.1	11.7	10.7	10.7	12.7
Serbia and Montenegro <sup>g</sup> .....	5.3	5.0	7.4	8.3	9.9	10.8	15.3	17.9	27.2	28.1	12.0	15.5
Slovakia .....	17.1	19.3	19.8	20.8	60.5	62.5	61.8	60.7	44.0	32.8	29.8	30.0
Slovenia .....	9.2	9.0	11.8	12.8	48.7	52.4	59.1	61.0	34.3	36.2	36.8	39.1
The former Yugoslav Republic of Macedonia .....	8.2	8.9	10.8	16.7	17.0	20.0	27.9	34.8	17.6	18.0	18.3	17.9

*Source:* National statistics and direct communications from national statistical offices to the UNECE secretariat; IMF, *International Financial Statistics* (Washington, D.C.), various issues.

<sup>a</sup> Averages of monthly or quarterly figures.

<sup>b</sup> Currency in circulation plus demand deposits.

<sup>c</sup> M1 plus time deposits in domestic currency and foreign currency deposits.

<sup>d</sup> Total outstanding claims on firms and households (except claims on government).

<sup>e</sup> January-September. GDP data for 2003 are based on preliminary reports by national statistical offices.

<sup>f</sup> In March 2002 Poland changed the definitions of its monetary aggregates harmonizing them with ECB standards. Series for previous years were recalculated.

<sup>g</sup> Excluding Montenegro.

for consumption smoothing and housing investment. Indeed, the fastest growing segments of east European financial markets in recent years have been consumer credit and mortgage lending. The growth in consumer credit has been triggered by financial innovation, especially by the use of credit cards, which surged immediately after their introduction in the local markets. These developments also reflect intense and growing bank competition in the retail credit market.

At the same time, the rapid growth of commercial bank credit has in some cases added (directly or indirectly) to the increase in trade and current account deficits, an effect that was quite pronounced in 2003.<sup>109</sup> Given the already large current account deficits in these countries, this extra pressure is a source of policy concern: in Croatia and Romania, the central banks tightened monetary policy in the final months of 2003, while in Bulgaria and Estonia, where the currency boards preclude monetary policy action, it has prompted fiscal policies that are probably tighter than would otherwise have been the case.

<sup>109</sup> In some cases this link is direct as, in order to be able to meet the growing domestic demand for credit, local banks have either been borrowing additional funds abroad (as in Estonia), or have been drawing on their own funds deposited in foreign banks (Bulgaria). In other cases (Croatia, Romania), the link has been mostly indirect, through the credit-induced boost to import demand.

### 3.2 Output and demand

Economic growth picked up in eastern Europe in the first three quarters of 2003, remaining uneven across and within the principal subregions. In many countries, aggregate demand was supported by robust private consumption and supply-side responsiveness was enhanced by foreign direct investment. Real GDP in central Europe expanded by 3.4 per cent, about 1 percentage point more than in 2002. The Baltic region continued to have the most rapid pace of growth in eastern Europe, accelerating to 7.3 per cent. In south-east Europe GDP growth decelerated slightly but the rate was still a robust 4.3 per cent.

Output growth should accelerate again in 2004 if the recovery strengthens in western Europe boosting demand for goods and services from eastern Europe. Aside from trade, the influence of the EU is likely to continue to increase through foreign investment and deepening political alignments.

#### *Diverse growth patterns in central Europe*

National accounts for the first three quarters of 2003, as well as data for industrial production, indicate that GDP growth accelerated in the Czech Republic and Poland (table 3.2.1).<sup>110</sup>

<sup>110</sup> The Czech Statistical Bureau recently revised the annual national accounts, making them more compatible with the ESA95 standards of



TABLE 3.2.1

**GDP and industrial output in eastern Europe, 2002-2003**  
(Percentage change over the same period of the preceding year)

	GDP								Industrial output											
			2002				2003						2002				2003			
	2002	2003 <sup>a</sup>	QIII	QIV	QI	QII	QIII	QIV	2002	2003 <sup>b</sup>	QIII	QIV	QI	QII	QIII	QIV				
<b>Eastern Europe</b> .....	3.0	3.8	3.3	3.4	3.2	3.6	4.0	..	3.4	6.3	5.8	5.3	5.2	6.0	6.6	7.1				
Albania .....	4.7	6.0	..	..	..	..	..	..	10.7	8.0	20.5	20.2	15.8	3.9	5.4	8.1				
Bosnia and Herzegovina ....	3.7	3.2	..	..	..	..	..	..	9.2	4.8	11.8	13.9	2.2	7.3	4.1	-0.8				
Bulgaria .....	4.8	4.8	6.4	3.4	3.8	4.5	4.3	..	0.6	14.0	8.7	6.4	18.2	11.4	12.7	14.3				
Croatia .....	4.6	4.7	6.5	5.9	4.9	5.0	3.9	..	5.4	4.1	8.2	9.2	4.6	7.1	3.5	1.3				
Czech Republic .....	2.0	3.0	1.7	1.5	2.4	2.4	3.4	..	4.8	5.6	5.6	4.7	6.3	5.0	6.0	5.0				
Estonia .....	6.0	4.5	7.7	5.7	5.2	3.5	4.6	..	5.9	10.3	9.3	6.8	11.9	8.0	10.7	10.6				
Hungary .....	3.5	2.8	3.7	3.9	2.7	2.4	2.9	..	2.6	5.5	5.4	4.1	3.3	3.8	6.8	7.9				
Latvia .....	6.1	7.0	7.4	8.3	8.8	6.2	7.3	..	5.8	6.5	7.3	9.9	8.7	5.9	7.8	4.0				
Lithuania .....	6.8	8.9	7.7	7.0	9.3	6.7	8.8	10.6	2.7	16.3	3.6	1.7	21.0	4.3	20.1	19.7				
Poland .....	1.4	3.7	1.8	2.2	2.2	3.8	3.9	4.7	1.4	8.7	3.7	3.8	4.4	9.3	9.1	11.7				
Romania .....	4.9	4.8	4.4	5.4	4.4	4.2	5.5	..	6.0	3.0	8.2	8.4	1.1	4.3	4.4	2.0				
Serbia and Montenegro .....	3.8	1.0	..	..	..	..	..	..	1.7	-3.0	5.6	2.3	-3.1	-1.9	-4.3	-3.0				
Slovakia .....	4.4	4.1	4.3	5.4	4.1	3.8	4.2	..	6.7	5.0	9.5	9.9	10.7	4.7	2.3	2.9				
Slovenia .....	2.9	2.6	3.2	3.1	2.2	2.1	2.3	..	2.4	1.0	4.0	1.5	0.8	-0.3	0.2	3.3				
The former Yugoslav Republic of Macedonia .....	0.9	3.1	0.8	4.1	2.1	3.1	5.2	..	-5.3	6.5	-5.8	5.6	3.5	3.6	15.0	4.7				
<i>Memorandum items:</i>																				
<b>EU acceding countries</b> .....	2.5	3.7	2.7	3.0	2.9	3.4	3.9	..	3.0	7.0	5.0	4.5	5.7	6.4	7.3	8.5				
<b>Baltic states</b> .....	6.4	7.3	7.6	7.1	8.2	5.8	7.4	..	4.2	12.5	5.8	4.9	15.8	5.5	14.9	13.7				
<b>Central Europe</b> .....	2.2	3.4	2.4	2.6	2.5	3.2	3.6	..	2.9	6.7	5.0	4.5	5.1	6.5	6.9	8.2				
<b>South-east Europe</b> .....	4.5	4.3	4.7	4.8	3.9	4.0	4.5	..	4.4	4.1	7.8	7.7	3.7	4.9	4.6	3.1				

*Source:* National statistical offices and UNECE secretariat estimates.

*Note:* For aggregates see table 1.1.3.

<sup>a</sup> Estimates, preliminary results for Lithuania and Poland.

<sup>b</sup> Preliminary results.

Productivity growth has picked up, reflecting to some extent a decline in employment (table 3.4.1). In both countries, aggregate demand was stimulated by expansionary macroeconomic policies (section 3.1). In contrast, output growth in 2003 probably fell short of official projections in Hungary and Slovenia. Slovakia, where the outcome is likely to be close to the government's projection of 4 per cent, remained the most dynamic central European economy for the second year in a row, despite a slight deceleration due to the gradual withdrawal of the earlier fiscal stimulus.

The pace of economic expansion in central Europe has continued to be affected by the protracted slowdown in the EU that prevented external demand for goods and services from growing faster. Nevertheless, new foreign-controlled productive capacities as well as improving cost competitiveness have led to exports of goods and services being the major support of growth on the demand side in the Czech Republic, Poland and Slovakia (chart 3.2.1). All three economies have considerably raised their market share of extra-EU imports (table 3.5.4). Hungary and Slovenia have also increased their comparable shares albeit to a lesser extent. Following a slowdown since

2002, Hungarian exports started to recover in the second half of 2003. Slovenian exports decelerated in 2003, growing by some 3 per cent.

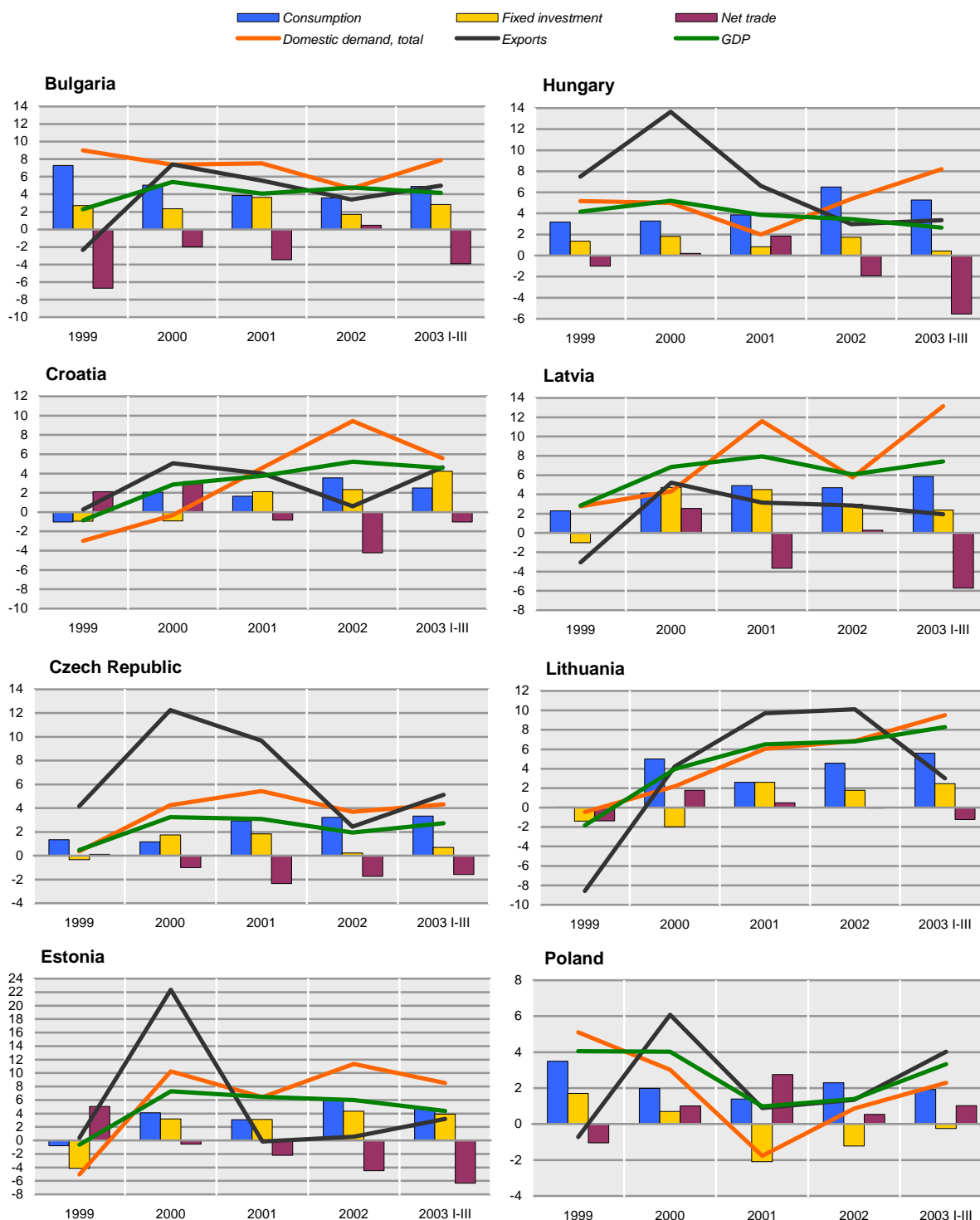
Imports of goods and services accelerated throughout central Europe in 2003, although there were considerable intercountry differences in the contribution of net exports to GDP growth. This contribution has become increasingly negative in Hungary and Slovenia, while remaining negative but steady in the Czech Republic. In contrast, real net exports have contributed decisively to overall economic growth in Slovakia and increasingly so in Poland. Growth in Poland was broadly based, with positive contributions from both domestic and external demand. Slovakia's reliance on exports as the engine of growth reflects new production capacity in the largest export firm (Volkswagen Slovakia); at the same time increases in regulated prices and indirect taxes reduced the purchasing power of households, resulting in a stagnation of consumer spending. The pattern of growth is likely to be more balanced in 2004 with both consumption and investment playing an increasingly positive role.

Private consumption expenditure grew most rapidly in Hungary and the Czech Republic, reflecting very large and unsustainable increases in real wages and an explosion in consumer credit (table 3.2.2). The expansion of private consumption has been more subdued in Poland and Slovenia.

Eurostat. Although the revision increased nominal GDP levels considerably, by up to 8 percentage points, it did not affect significantly the rates of real growth. Quarterly GDP accounts based on the improved methodology should be released in April 2004.

CHART 3.2.1

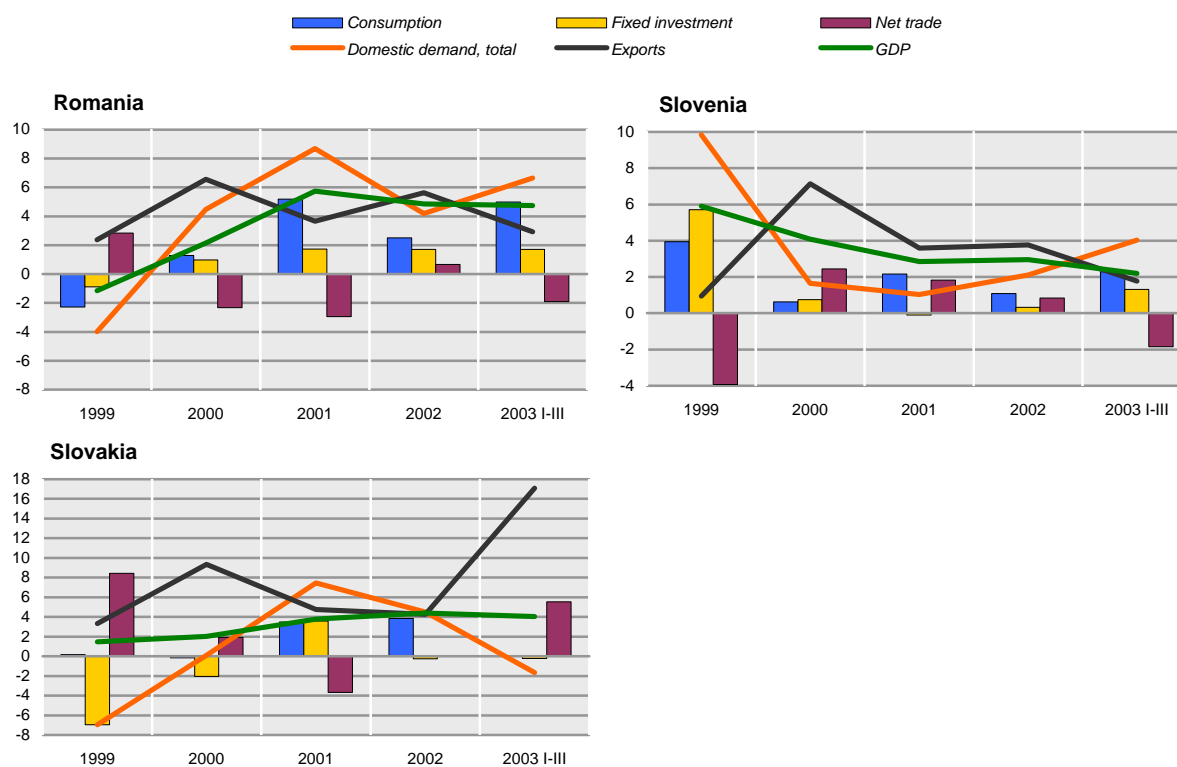
Contribution of final demand components to real GDP growth in selected east European economies, 1999-2003  
(Percentage points)



(For source see end of chart.)

CHART 3.2.1 (concluded)

Contribution of final demand components to real GDP growth in selected east European economies, 1999-2003  
(Percentage points)



Source: UNECE secretariat calculations, based on quarterly national accounts.

TABLE 3.2.2

Components of real demand in selected east European economies, 2001-2003  
(Percentage change over the same period of the preceding year)

	Private consumption expenditure <sup>a</sup>			Government consumption expenditure <sup>b</sup>			Gross fixed capital formation			Exports of goods and services			Imports of goods and services		
	2001	2002	2003 QI-QIII	2001	2002	2003 QI-QIII	2001	2002	2003 QI-QIII	2001	2002	2003 QI-QIII	2001	2002	2003 QI-QIII
Bulgaria .....	5.2	4.2	5.9	1.4	4.0	5.2	23.3	9.3	17.2	10.0	6.2	9.0	14.8	4.7	15.1
Croatia .....	3.8	6.4	4.3	5.3	-1.8	-0.4	7.1	10.1	17.5	8.1	1.2	9.5	9.8	8.8	10.2
Czech Republic .....	3.6	4.0	6.0	5.3	5.7	0.4	5.5	0.6	2.2	11.9	2.8	5.8	13.6	4.3	7.0
Estonia .....	5.2	9.4	6.2	0.9	5.0	5.5	12.2	16.1	13.7	-0.2	0.6	3.8	2.1	5.4	10.4
Hungary .....	5.7	10.4	8.6	4.3	4.9	2.0	3.5	7.2	2.1	8.8	3.8	4.2	6.1	6.1	10.9
Latvia .....	7.8	6.9	8.7	0.3	1.5	2.7	17.0	10.4	9.1	6.9	6.3	4.2	12.6	4.5	14.1
Lithuania .....	3.9	6.5	7.8	0.3	2.4	3.8	13.5	8.7	12.6	21.2	19.5	5.2	17.7	17.6	6.9
Poland .....	2.0	3.4	2.8	0.6	0.6	-	-8.8	-5.8	-1.5	3.1	4.8	13.5	-5.3	2.6	9.1
Romania .....	6.2	3.0	6.8	5.2	2.5	2.8	9.1	8.3	8.1	11.1	16.9	7.4	17.2	12.1	10.7
Slovakia .....	4.7	5.3	0.2	4.6	4.7	-0.5	13.9	-0.9	-0.9	6.3	5.5	22.0	11.0	5.2	14.6
Slovenia .....	2.4	1.1	3.0	4.0	2.5	3.2	-0.4	1.3	5.4	6.4	6.5	2.9	3.0	4.9	6.0
The former Yugoslav Republic of Macedonia .....	-11.6	..	..	29.7	..	..	-8.6	..	..	-15.7	..	..	-15.3	..	..

Source: National statistical offices.

<sup>a</sup> Expenditures incurred by households and non-profit institutions serving households.

<sup>b</sup> Expenditures incurred by the general government on both individual consumption of goods and services and collective consumption of services.

Its level was barely sustained with the aid of bank credits to households in Slovakia, where real wages and retail sales have declined (table 3.2.3). Following a remarkable growth of government current spending prior to the parliamentary elections

in 2002, public consumption decelerated sharply in 2003 in the Czech Republic, Hungary and Slovakia. It appears to have stagnated in Poland but in Slovenia it increased more than private consumption expenditure.

TABLE 3.2.3

Volume of retail trade in east European economies, 2001-2003  
(Percentage change over the same period of the preceding year)

	2001	2002	2003 <sup>a</sup>
Albania .....	-2.8	-1.4	20.6
Bosnia and Herzegovina .....	..	..	3.4
Bulgaria .....	4.8	2.6	4.4
Croatia .....	7.5	12.5	3.4
Czech Republic .....	4.5	3.0	4.9
Estonia .....	13.8	14.3	10.0
Hungary .....	5.7	10.5	8.4
Latvia .....	9.5	17.6	12.9
Lithuania .....	9.8	12.6	12.2
Poland .....	0.2	1.9	7.0
Romania .....	1.9	0.8	4.6
Serbia and Montenegro .....	17.5	17.4	..
Slovakia .....	4.5	5.8	-5.5
Slovenia .....	7.8	4.7	5.1
The former Yugoslav Republic of Macedonia .....	-10.7	5.6	13.0

Source: National statistical offices.

Note: Retail trade covers mainly goods. The most recent data for The former Yugoslav Republic of Macedonia are subject to regular and large revisions. The coverage in 2001-2002, based on current monthly statistics, may differ from the coverage of annual statistics.

<sup>a</sup> January-June for Albania; January-September for Bosnia and Herzegovina and Lithuania; January-October for Romania and Slovenia; January-November for Croatia and the Czech Republic; January-December for Bulgaria, Estonia, Hungary, Latvia, Poland, Slovakia and The former Yugoslav Republic of Macedonia.

Gross fixed capital formation has risen strongly in Slovenia, led by an ambitious public investment programme that has allocated about 1.5 per cent of annual GDP for road construction over the next 10 years. Investment spending has strengthened somewhat in the Czech Republic, driven by improved corporate profitability, record low interest rates and by anticipation of VAT increases on buildings. In Hungary, total fixed investment decelerated sharply in the first half of 2003 as a result of the slowdown in public infrastructure expenditure. However, it started to recover in the third quarter, reflecting a pick-up in private sector spending on machinery. In Poland, investment growth resumed in the third quarter, driven by private sector spending on machinery, and a similar recovery may have occurred in Slovakia in the last quarter when a large FDI project got underway. A significant improvement of profitability in the non-financial corporate sector has underpinned business investment in both Poland and Slovakia. With the exception of Slovenia, investment of the household sector in residential housing increased throughout central Europe, driven by generous mortgage subsidies and expectations of their curtailment.<sup>111</sup>

On the supply side, the productive capacity of the central European economies has been improving with the

increasing weight of foreign-controlled companies.<sup>112</sup> The growth of real value added in industry accelerated sharply in Poland to 8.3 per cent (year-on-year) in the second and third quarters, almost twice the rate of growth in the market services sector. In contrast, production in the construction sector continued to decline.<sup>113</sup> The services sector provided the main impetus to growth over the first three quarters of 2003 in Hungary and Slovenia (chart 3.2.2). Industry, however, matched the GDP contribution of market services to GDP growth in the Czech Republic and Slovakia. In the Czech Republic, the rising importance of industry mainly reflects the performance of the utilities sector and the export-oriented branches of manufacturing (table 3.2.4). In Slovakia, the new capacity installed by foreign investors in the manufacturing sector has been the key factor driving growth.

The emergence of a thriving automotive sector in central Europe is a good example of successful industrial restructuring. Its output continued to expand in 2003 (chart 3.2.3). In addition to existing capacity, three new plants owned by multinational corporations (Hyundai, PSA/Citroen, Toyota) are scheduled to start operations in the Czech Republic and Slovakia within a couple of years, increasing the regional output of cars by almost 1 million units per year. Recently announced investment plans confirm that the automotive sector is also likely to continue growing in Hungary and Slovenia (see box 3.5.2 below). Production by foreign-controlled firms in the electronics sector has also increased considerably in recent years. Despite these positive developments, however, the policy makers in central Europe are confronted with the rise of a “dual economy” due to the performance gap between foreign-controlled and domestically-owned firms. There is also awareness of the need to diversify investment as domestic wages move closer to west European levels.

### Rapid growth in Baltic economies

Over the first three quarters of 2003 real GDP grew rapidly and employment increased throughout the Baltic region. Aggregate productivity growth accelerated in Latvia and Lithuania but slowed in Estonia. Domestic demand was the main factor driving growth in all three economies. Private household expenditure continued to be fuelled by strong wage growth and rapidly expanding consumer credit. Gross fixed capital formation also increased remarkably throughout the subregion, with growth rates in double digits. Exports of goods and services accelerated in Estonia but slowed down in the other two Baltic economies, resulting in divergent contributions to

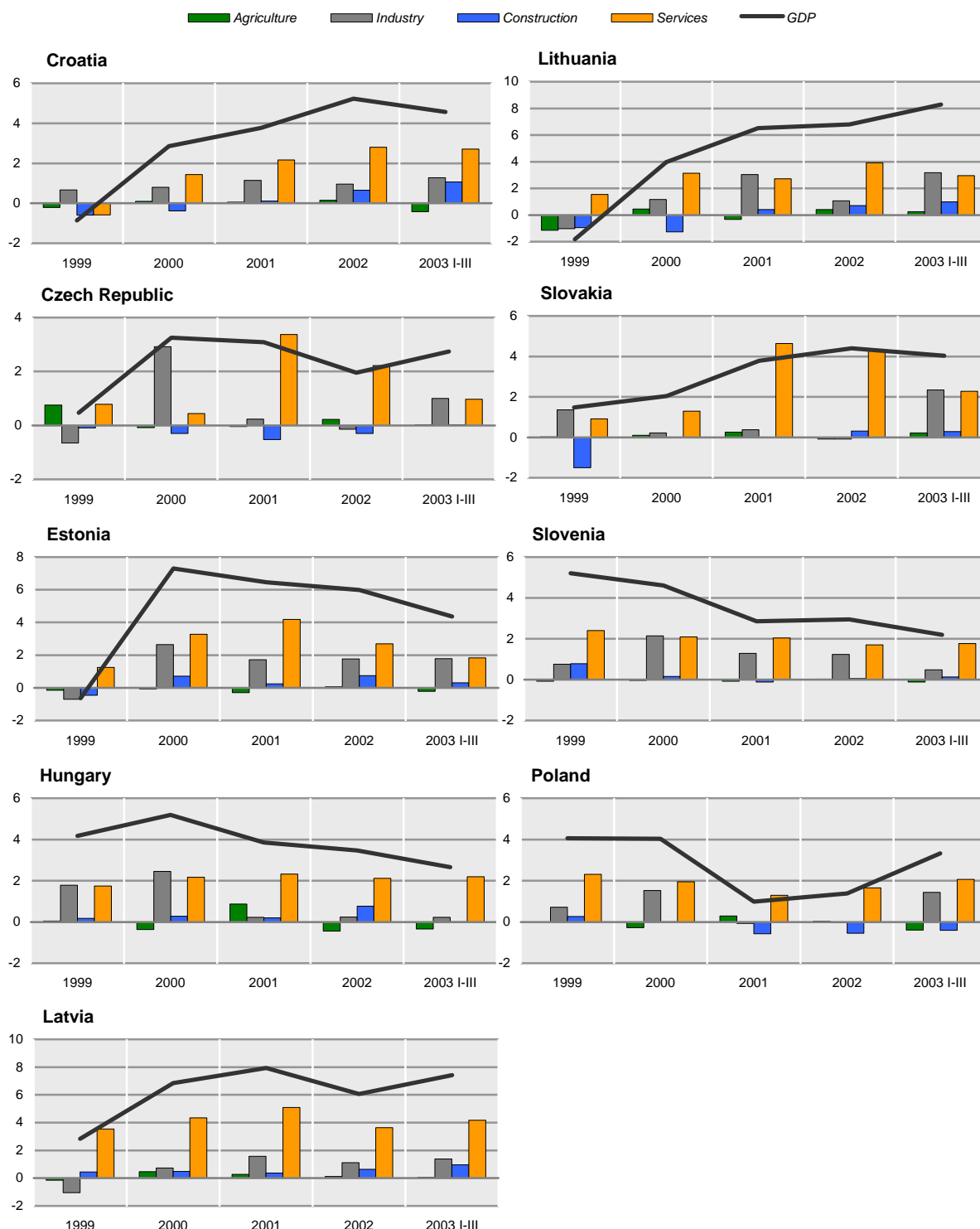
<sup>111</sup> The governments of the Czech Republic, Hungary and Slovakia ended their generous mortgage subsidies in January 2004. Households anticipated this change and also expected that the value of housing would increase considerably in the period following accession to the EU. These factors boosted demand for housing construction in 2003.

<sup>112</sup> Shares of foreign-controlled firms in output and employment in central Europe are much higher than the EU average and are approaching levels comparable with those in the most FDI-friendly OECD economies, i.e. Belgium (market services) and Ireland (manufacturing). OECD, *STI Scoreboard: Global Integration of Economic Activities* (Paris), 2003, pp. 117-119.

<sup>113</sup> National Bank of Poland, *Raport o inflacji w III kwartale 2003 roku* (Warsaw), November 2003.

CHART 3.2.2

Contribution of producing sectors to real GDP growth in selected east European economies, 1999-2003  
(Percentage points)



Source: UNECE secretariat calculations, based on quarterly national accounts.

GDP growth. Buoyant domestic demand has led to a rapid growth of imports and changes in real net exports were a drag on GDP growth in 2003, especially in Estonia and Latvia. In both countries current account deficits rose to high levels (see section 3.5).

On the supply side, the contribution of industrial activity to GDP growth increased sharply in Lithuania, reflecting a remarkable acceleration in the output of utilities and manufacturing. In Estonia, aside from industry, the contribution of other sectors to GDP growth

TABLE 3.2.4

Growth rates of real industrial output by sector in east European economies, January-October 2003  
(Per cent, year-on-year)

	NACE sectors <sup>a</sup>										
	C	D	15,16	17-19	20-22	23-25	26	27,28	29-35	36,37	E
Czech Republic .....	1.3	5.5	2.7	-4.7	7.9	7.1	5.0	4.1	8.7	-0.7	9.1
Hungary .....	-4.2	5.6	-0.9	-9.4	3.6	1.3	1.3	9.9	11.8	-23.9	5.5
Poland .....	-1.4	9.6	5.1	-0.9	3.4	11.5	5.6	9.9	13.7	29.2	1.2
Slovakia .....	-5.0	8.6	-1.2	-0.3	-0.9	4.3	4.4	8.0	17.3	61.7	-3.9
Slovenia .....	5.6	0.6	0.6	-12.4	-1.4	5.1	-0.4	2.3	3.5	-3.4	-1.6
Estonia .....	0.9	9.2	0.4	5.4	6.7	21.9	15.5	33.7	7.8	1.0	18.6
Latvia .....	3.3	8.0	6.6	-3.7	13.7	-3.7	3.7	18.6	11.9	12.8	4.3
Lithuania .....	6.4	13.2	8.0	1.7	25.0	10.2	34.7	37.9	23.1	25.1	34.1
Bulgaria .....	4.7	19.9	18.6	31.5	22.0	13.4	15.5	25.4	13.6	45.0	2.6
Croatia .....	2.9	5.0	6.2	-6.5	11.8	-0.9	9.1	17.1	2.4	8.2	4.5
Romania .....	-2.2	4.0	13.4	-0.9	7.6	6.0	-5.6	-12.8	6.3	5.8	2.1
Serbia and Montenegro .....	-1.1	-4.9	-2.3	-29.8	-14.9	10.8	-13.3	0.4	-13.9	-3.0	3.6
The former Yugoslav Republic of Macedonia ....	-6.5	2.2	6.2	-26.4	-10.0	-20.9	-9.2	23.3	35.2	75.2	13.2

Source: UNECE Common Database.

<sup>a</sup> The NACE sectors are as follows: mining and quarrying (C); manufacturing (D); manufacture of food products, beverages and tobacco products (15,16); manufacture of textiles, wearing apparel, leather and fur products (17-19); manufacture of wood, paper and printing products, and publishing (20-22); chemical industry (23-25); manufacture of other non-metallic mineral products (26); manufacture of basic metals and fabricated metal products (27,28); manufacture of machinery and equipment (29-35); other manufacturing industries, recycling (36,37); electricity, gas, steam and water supply (E).

declined, notably of services and agriculture where it was negative. In Latvia, the sectoral contributions to the growth of aggregate output increased, with the exception of agriculture. Activity in the large transit sector, which accounts for one tenth of GDP, expanded due to increased trans-shipments of Russian oil and in spite of a temporary shutdown of the pipeline to the Ventspils oil terminal.<sup>114</sup> All the Baltic economies rely considerably on the export-oriented electronics industry that is dominated by foreign-invested firms (chart 3.2.3). Estonia has now recovered from a temporary setback in 2001, while production in this key sector has risen uninterruptedly in Latvia and Lithuania.

#### Uneven development in south-east Europe

FDI in this subregion has risen in the last few years as the business environment has improved and as significant labour cost advantages over central Europe appear to offset the disadvantages of a less developed infrastructure.<sup>115</sup> Among the principal FDI recipients, Bulgaria, Croatia and Romania, there was strong output growth in 2003. In contrast, economic activity in Serbia and Montenegro has stagnated despite relatively large FDI inflows.<sup>116</sup> Albania

continued to have the fastest rate of economic growth (6 per cent) in south-east Europe in 2003. Real GDP increased by some 3 per cent in Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia. All the economies of south-east Europe were affected by the drought in the summer of 2003 that reduced agricultural production.

The two EU candidate countries in the subregion, Bulgaria and Romania, as well as Croatia, achieved rapid GDP growth of around 5 per cent in 2003. The main stimulus to growth on the demand side was provided by exports and consumption in Bulgaria and Romania. In Croatia, exports and investment were the main supports of growth. All countries had a very successful tourist season that helped to boost their export of services. In Croatia, the growth of private consumer spending decelerated noticeably, partly reflecting its already high level in 2002. Real fixed investment grew in double digits in Bulgaria and Croatia and by 7.5 per cent in Romania. This dynamism reflects to some extent the impact of FDI mentioned above. The rapid growth of domestic demand stimulated import growth, resulting in negative net export contributions to GDP growth in all three countries. This pattern highlights the danger of overheating, especially in Romania where structural reforms are proceeding slowly.

On the supply side, agricultural output fell and its contribution to GDP growth was negative in Croatia. In contrast, contributions of construction and industry to overall growth have increased. Industry has become an increasingly important source of growth in Bulgaria,

<sup>114</sup> Increased oil deliveries by rail and road have helped to increase the volume of Russian exports shipped through Latvia, and also resulted in the accelerating quarterly growth of activity in the transport sector.

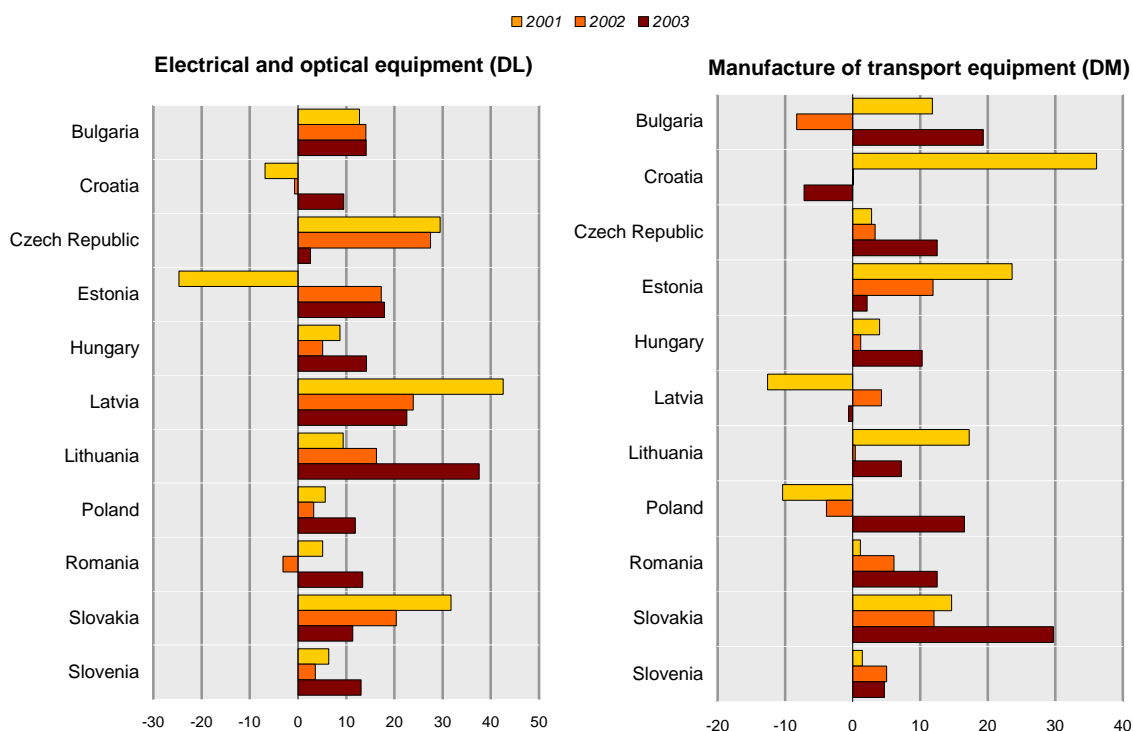
<sup>115</sup> The labour cost advantage of south-east over central Europe can be illustrated by comparing wages in Bulgaria and the Czech Republic. In euros, industrial wages in the Czech Republic were about 3.5 times higher than in Bulgaria in 2003. In turn, Czech labour costs (in euros) were about one quarter of the average German level. For a comprehensive assessment, see K. Pashev, *Competitiveness of the Bulgarian Economy*, Bulgarian National Bank Discussion Papers, No. 34 (Sofia), August 2003.

<sup>116</sup> Although inflows of FDI in 2003 were broadly similar in Bulgaria, Croatia, Romania and Serbia, its composition differed. Whereas FDI in

Serbia was dominated by the acquisition of privatized assets, in the other three countries it went mainly into greenfield projects.

CHART 3.2.3

Production of electrical, optical and transport equipment in selected east European economies, 2001-2003  
(Percentage change over the same period of the preceding year)



Source: UNECE secretariat calculations, based on national statistics.

Note: 2003 data refer to the period January-November, except for the Czech Republic, Hungary, Latvia (January-October) and Romania (January-September). DL and DM refer to NACE sectors 30-33 and 34-35, respectively.

propelled by the dynamic performance of manufacturing. Within manufacturing, in all three economies there has been double-digit growth of electronics output, a sector where capacity has been recently increased by foreign-controlled firms. Production of transport equipment fell in Croatia after spectacular growth in 2001 in the shipbuilding sector (chart 3.2.3). It increased strongly in Bulgaria and Romania. In the latter, both the production and export of cars increased rapidly in 2003, albeit from a relatively low base.<sup>117</sup>

Developments in the other four economies of south-east Europe in 2003 are difficult to describe accurately due to the lack of reliable and timely data. Three of them have reported growth of GDP and industrial output. GDP grew by some 6 per cent in Albania and by about 3 per cent in Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia. Industrial growth on a quarterly basis slowed down in Bosnia and Herzegovina, and was negative in the final quarter of 2003. In The former Yugoslav Republic of Macedonia industrial output has

grown steadily since the last quarter of 2002, reflecting a recovery from the disruptions caused by internal conflict.

Real GDP appears to have grown marginally, by some 1 per cent in Serbia and Montenegro: it was affected by a 10 per cent fall in agricultural output, which has a relatively large weight in total output. Industrial production fell by some 3.5 per cent (year-on-year) in January-November, more so in Serbia, the larger partner in the union, as it increased by some 0.4 per cent in Montenegro.<sup>118</sup> Real fixed investment in both republics has reportedly increased slightly over the same time period. There appears to have been some growth in the market services sector (retail trade and tourism), offsetting declines in agricultural and industrial output.

The economic prospects of the four low-income Balkan countries remain clouded by the fragile political environment. On the positive side, FDI has increased significantly, especially in Serbia where over a thousand industrial enterprises have been privatized over the last couple of years. Following the cuts in employment and output that are usually associated with the initial

<sup>117</sup> The government has reportedly improved incentives for the local car-maker (Dacia) that was taken over by Renault of France in 1999. These will enable the company to launch production of a new model that could considerably increase output in the automotive sector and boost Romanian exports in the coming years. *Business Eastern Europe*, Automotive Sector: Romania, 12 January 2004.

<sup>118</sup> These divergent trends are implied by statistics reported by the Montenegrin Central Bank. Serbia and Montenegro have independent monetary authorities and different currencies (the dinar and euro, respectively).

reconstruction of balance sheets by new owners, Serbian industrial output and exports could pick up in 2004 or 2005, provided that the new government continues with structural reforms.

### 3.3 Costs and prices

#### *Further progress towards price stability*

Disinflation in most of the east European economies continued in 2003, for the third consecutive year. With few exceptions, annual rates of change in consumer prices fell to historic lows and well below the reduced official targets; in some of them inflation was even below the EU average of 2.1 per cent. In contrast to the previous two years, relative price stability in 2003 as a whole was not so much the result of good harvests and exchange rate appreciation combined with weaker world market prices. In 2003 there was also increasing industrial labour productivity and more cautious macroeconomic policy stance: monetary policy remained relatively tight and there was some improvement in fiscal discipline throughout the region, but particularly in those countries that will join the EU in May 2004 and will have to prepare for EMU accession in due course.<sup>119</sup>

The terms of trade, in terms of domestic currency, improved, especially in those countries where the currency is pegged to or targeting the euro. Imported inflation therefore continued to fall reflecting the dampening effect of both the large depreciation of the dollar on world market prices of raw materials and energy<sup>120</sup> and the deflationary effect of the world market prices of manufactured goods.<sup>121</sup>

On the domestic side, wage inflation continued to moderate although it still rose faster than the producer prices. Given the significant gains in labour productivity, however, unit labour costs rose only moderately or even declined in most of the region's economies. Given the continued rise in real wages, real household disposable incomes increased in most countries, especially in those where household credit expanded rapidly and where the

labour market conditions continued to improve. Thus, private consumption was dynamic and demand pressures on consumer prices intensified albeit to varying degrees across countries.<sup>122</sup>

The disinflationary trend is likely to be checked in much of eastern Europe in 2004 and particularly in those countries becoming EU members in May, as they will have to implement a broad range of price deregulations, increases in indirect taxes and excise duties, etc. Some of these adjustments have already taken place in early 2004.<sup>123</sup>

#### *Consumer prices slow down their pace*

The downward trend in consumer price inflation intensified in 2003 in spite of the strong growth in private consumption (table 3.3.1). In many of the region's economies prices actually fell during the summer reflecting better than average supplies of fresh produce and lower domestic fuel prices. Over the 12 months to December, service prices, albeit rising more slowly than a year ago, remained the major inflationary force.<sup>124</sup> Summer drought and poor grain harvests were also sources of pressure on consumer prices in the latter months of 2003. Non-food goods prices, mainly reflecting much weaker industrial unit labour costs and moderate imported inflation, rose much less than the other two components and even declined in some countries.

Annual rates of consumer price inflation in 2003 were higher than in 2002 only in Croatia, Latvia and Slovakia, although in the first two the rates remained low. In Croatia the major inflationary factor was the sharp rise in food prices in the second half of the year. However, falling unit labour costs, low imported inflation and relatively moderate consumer demand kept the annual rate of inflation at just over 2 per cent. In contrast in Latvia, both a weaker nominal effective exchange rate and strong consumer demand put upward pressure on prices. Falling unit labour costs helped to contain the inflation rate at 3 per cent, but this was about 1 percentage point higher than in 2002. In Slovakia the headline inflation rate surged in 2003, mostly as a result of the administrative price adjustments and an increase in indirect taxes. However, the underlying inflationary

<sup>119</sup> One of the five Maastricht criteria is that the annual average rate of inflation should not exceed by more than 1.5 percentage points the average of the best three performers among the present EU members (see section 3.1. above).

<sup>120</sup> During the 12 months to December 2003, world commodity prices increased by 14 per cent in dollar terms. Excluding energy the index rose by 18.8 per cent reflecting a more than 20 per cent increase in industrial and agricultural raw material prices. However, in euro terms, the total index and that excluding energy fell by nearly 6 and 2 per cent, respectively, the former reflecting a nearly 10 per cent decline in crude oil prices, expressed in euros, over the year (see also section 2.1(i) above).

<sup>121</sup> In the EU, the major trading partner of the east European economies, export unit values in dollars for manufactured goods increased in the first nine months of 2003 by 10.7 per cent, year-on-year. However, expressed in euros, in which most of the region's trade is denominated, these unit values were some 8 per cent lower than in the same period of 2002, a consequence of the appreciation of the euro against the dollar by nearly 17 per cent over the same period (see also section 3.5(ii) below).

<sup>122</sup> See section 3.2 above.

<sup>123</sup> See section 3.1(i) for a more detailed assessment of the challenges facing these acceding countries including catch-up inflation and nominal convergence.

<sup>124</sup> This relatively faster rate of increase in service prices can be explained mainly by two factors. First, the continuing adjustments in regulated prices usually concern utilities, public transport and communications, which are included in the services component of the CPI. Second, real wage increases tend to be set by sectors with rapid productivity growth (mainly export-oriented manufacturing branches) and these then tend to be matched, either as a result of labour market forces or the action of trade unions in relatively less productive sectors (i.e. most of the non-tradeable service branches, which are much less exposed to international competition), the so-called "Balassa-Samuelson" effect.



TABLE 3.3.1  
Consumer prices in eastern Europe, 2002-2003  
(Percentage change)

	Consumer prices, total								Food	Non-food	Services
	Annual average		2003, year-on-year				December over previous December		December over previous December		
	2002	2003	QI	QII	QIII	QIV	2002	2003	2003	2003	2003
Albania .....	5.3	2.7	1.2	3.0	3.2	3.3	2.0	3.3	2.7	..	..
Bosnia and Herzegovina .....	0.9	0.2	-1.2	0.4	0.8	0.9	-0.6	1.1	2.7	1.3	0.5
Bulgaria .....	5.8	2.3	0.6	1.1	3.1	4.7	3.8	5.6	8.3	-0.2	7.9
Croatia .....	1.8	2.2	1.4	1.8	3.0	2.7	1.8	2.4	4.2	0.1	2.5
Czech Republic .....	1.8	0.2	-0.3	0.2	-	0.9	0.6	1.1	3.6	..	..
Estonia .....	3.5	1.1	2.0	0.3	0.9	1.1	2.3	1.2	0.6	-0.6	3.2
Hungary .....	5.4	4.9	4.8	4.1	4.9	5.6	5.0	5.8	6.2	4.4	6.9
Latvia .....	1.9	3.0	1.9	2.9	3.5	3.5	1.5	3.6	2.3	..	3.6
Lithuania .....	0.4	-1.2	-1.6	-0.8	-1.0	-1.3	-0.9	-1.4	-0.9	..	..
Poland .....	1.9	0.7	0.3	0.3	0.8	1.5	0.7	1.7	2.2	..	..
Romania .....	22.5	15.4	16.7	14.9	15.1	14.9	17.9	14.2	13.8	14.4	15.0
Serbia and Montenegro .....	19.3	9.6	11.8	11.6	7.9	7.6	11.7	8.0	3.4	6.8	16.4
Slovakia .....	3.3	8.5	7.5	7.8	9.1	9.5	3.3	9.3	8.1	..	..
Slovenia .....	7.6	5.7	6.5	5.7	5.6	4.9	7.4	4.7	..	..	6.9
The former Yugoslav Republic of Macedonia .....	2.3	..	-	0.5	2.1	..	1.0	..	..	..	..

Source: UNECE secretariat estimates, based on national statistics.

pressures remained muted with core inflation (excluding administered prices) remaining at 3.1 per cent, year-on-year, in November. The strong appreciation of the koruna combined with stagnating private consumption (a result of reduced real wages and persistently high unemployment) ensured that the secondary effects of the administrative price increases were marginal. The absence of underlying price pressures provided room for monetary policy to be eased in order to check the appreciation of the koruna and so allow the boom in exports to continue.

Although the rate of inflation in Romania fell by some 7 percentage points in 2003, at 15.4 per cent it remained the highest among the 15 east European countries, a reflection of still strong inflationary expectations. Rising real wages and credit expansion in the latter part of the year maintained strong household consumption. On the cost side, the continued double-digit rise in unit labour costs in industry offset the disinflationary impact of non-food goods prices, unlike what happened in other countries of the region. Furthermore, the rise in food prices and the adjustment of some utility prices as part of the reform of the energy sector added to inflationary pressure. In contrast, there was rapid disinflation in Serbia and Montenegro, the rate falling by nearly 10 percentage points and into single digits for the first time since 1989. The combined effect of a tight monetary policy and very weak labour markets largely offset the inflationary pressures arising from the weak dinar and poor harvests.

Compared with the other acceding countries (excluding Slovakia), inflation in Hungary and Slovenia decelerated more slowly and remained high. In Hungary, real disposable incomes were boosted by a nearly 12 per

cent increase in real wages,<sup>125</sup> rising employment and a rapid expansion of household credits. Partly due to the depreciation of the forint,<sup>126</sup> imported inflation started to climb during the second half of the year. However, this pressure was partly offset by increased productivity in industry. The headline inflation rate in Slovenia decelerated in 2003 and reached the target set by the Bank of Slovenia. Disinflation was largely the outcome of the government's check on some controlled service prices and the lowering of excise taxes. Import price pressures were negligible as the nominal effective exchange rate of the tolar remained stable, as in 2002, and the terms of trade improved slightly. On the demand side, reflecting the continued growth in real disposable incomes, household consumption maintained a certain pressure on prices in 2003.

In contrast, prices actually fell in Lithuania and rose by only about 1 per cent or less in Bosnia and Herzegovina, the Czech Republic, Estonia, Poland and The former Yugoslav Republic of Macedonia. In Bulgaria, the rate of inflation was just a little above 2 per cent. In Lithuania, household consumption demand grew rapidly but inflationary pressures were dampened by the continued strong appreciation of the litas and increases in productivity. Furthermore, food prices continued to decline during the first three quarters.

In Poland both the core and the headline inflation rates remained well below the lower end of the national bank's target band of 2-4 per cent, despite a recovery of

<sup>125</sup> In 2002-2003 the cumulative growth rate of average real net wages was some 25 per cent.

<sup>126</sup> See box 3.1.1 for the forint crisis in 2003.

consumer demand and a depreciating zloty. Inflationary pressures were dampened by wage restraint (particularly in the private sector) partly reflecting the high rate of unemployment. Furthermore, industrial labour productivity growth accelerated to nearly 11 per cent. The net result was that the annual average rate of inflation fell to a record low of 0.7 per cent. In the Czech economy there was virtual price stability in 2003, mainly as a result of the previous three year's monetary policy, which dampened the effect of large increases in wages and consumption. A stable exchange rate of the koruna, lower import prices, increased competition in the retail sector and rising labour productivity all helped to alleviate the pressures stemming from higher real wages and some increases in food prices in the last quarter. In Estonia the low inflation rate was mainly due to the appreciating kroon, which lowered the domestic prices of imported food and fuel. At the same time, a boom in consumer credit and the continued rapid growth of wages boosted household incomes and consumption. Estonia was one of the few east European economies where unit labour costs in industry were still increasing in 2003.

In Bulgaria the year-on-year inflation rate in December 2003 was 5.6 per cent against the government's target of 3.9 per cent. However, this overshooting was almost entirely due to a very large increase in food prices over the last two months of the year (8.9 per cent). Over the first 10 months of 2003, the cumulative inflation rate was only 1.9 per cent. In fact, the average annual rate was halved in 2003, largely reflecting a rise in industrial labour productivity and the effect of the exchange rate appreciation on import prices. In Albania, Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia subdued domestic demand kept inflation rates low. There was also a recovery of industrial labour productivity that, combined with relatively strong exchange rates, alleviated some of the cost pressures in these three economies, which are still far from being fully recovered from the disruptions caused by the recent wars in the region.

#### ***Moderation in wage growth accompanied by significant rise in productivity***

After an interruption in the last quarter of 2002 (due to the lagged effects of rising world commodity prices exacerbated by the sharp appreciation of the dollar in late 2001), the downward trend in industrial producer price inflation resumed in the second quarter of 2003 throughout most of the region. Monthly year-on-year rates of change were less than those for consumer prices in most countries<sup>127</sup> (chart 3.3.1). With few exceptions, namely Albania, Bulgaria, Romania, Serbia and Montenegro and Slovakia, the rates of change remained at low single digits and in the Czech Republic and

Lithuania prices continued to fall, in the latter for the third consecutive year.

Wage inflation in industry in the first three quarters of 2003 also continued to moderate in most economies (table 3.3.2). However, wage growth still exceeded the rise in producer prices except in Bulgaria, Latvia, Poland, Romania and Slovakia. The largest increases in real product wages were in Serbia and Montenegro (some 20 per cent), and in the Czech Republic, Estonia and Hungary (some 8 to 10 per cent). However, with a marked acceleration of industrial output growth accompanied by enterprise restructuring in the majority of these economies, measured labour productivity in industry improved significantly in 2003 and increased more than average nominal gross wages. As a result, there was a sharp deceleration in unit labour costs in the first three quarters of 2003. Nevertheless, their rate of change still remained in double digits in Romania where there was a sharp slowdown of industrial production growth (particularly in the first quarter) with negative effects on labour productivity.<sup>128</sup> In Slovenia also, the rate of increase in unit labour costs remained high at 5.5 per cent as the growth of industrial output weakened, for the third consecutive year, and reduced the labour productivity growth to just 2 per cent (the smallest increase among all the east European economies). At the same time, wage inflation was still running at nearly 8 per cent. The relatively high and still increasing wages have recently become a major problem for the Slovenian economy and particularly for its export performance.<sup>129</sup>

In contrast to 2002, real unit labour costs (which basically measure labour's share in value added) weakened rapidly in 2003. They fell, albeit at varying speeds, in all the east European countries except in Estonia and Slovenia, although in the latter the increases were under 3 per cent.<sup>130</sup> In Bulgaria and Poland real unit labour costs fell by some 10 per cent, in the main reflecting the rapid growth of labour productivity in both economies (around 11 per cent). In contrast, the 6 per cent decline in Slovakia mainly reflected the acceleration in price inflation due in turn to increases in regulated utility prices and related energy costs in manufacturing. In fact, Slovakia was one of the few east European economies where nominal unit labour costs increased, albeit by only 1.5 per cent.

The relatively smaller increase in unit labour costs compared with producer prices in many east European countries suggests, *ceteris paribus*, that unit operating profits

<sup>127</sup> The differential reflects in the main the persistent pressure of service prices on the consumer price index.

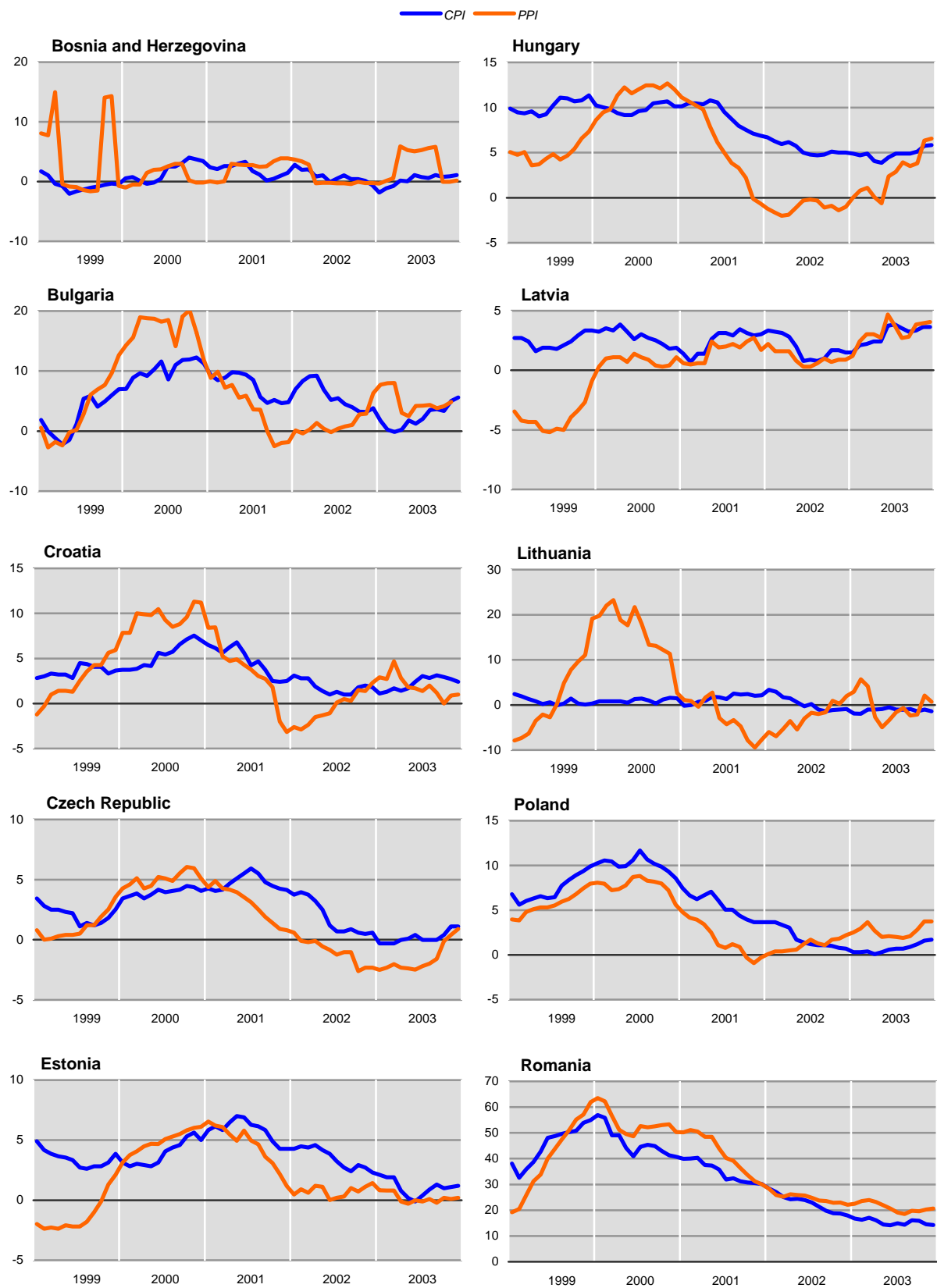
<sup>128</sup> Industrial labour productivity in Romania is already held back by the slow implementation of micro-level structural reforms to reduce overemployment, particularly in the large state-owned enterprises in mining and some manufacturing branches.

<sup>129</sup> See section 3.5(ii).

<sup>130</sup> They probably increased also in Serbia and Montenegro where real product wages rose by 20.5 per cent and industrial production declined by 3 per cent in the first three quarters in 2003.

CHART 3.3.1

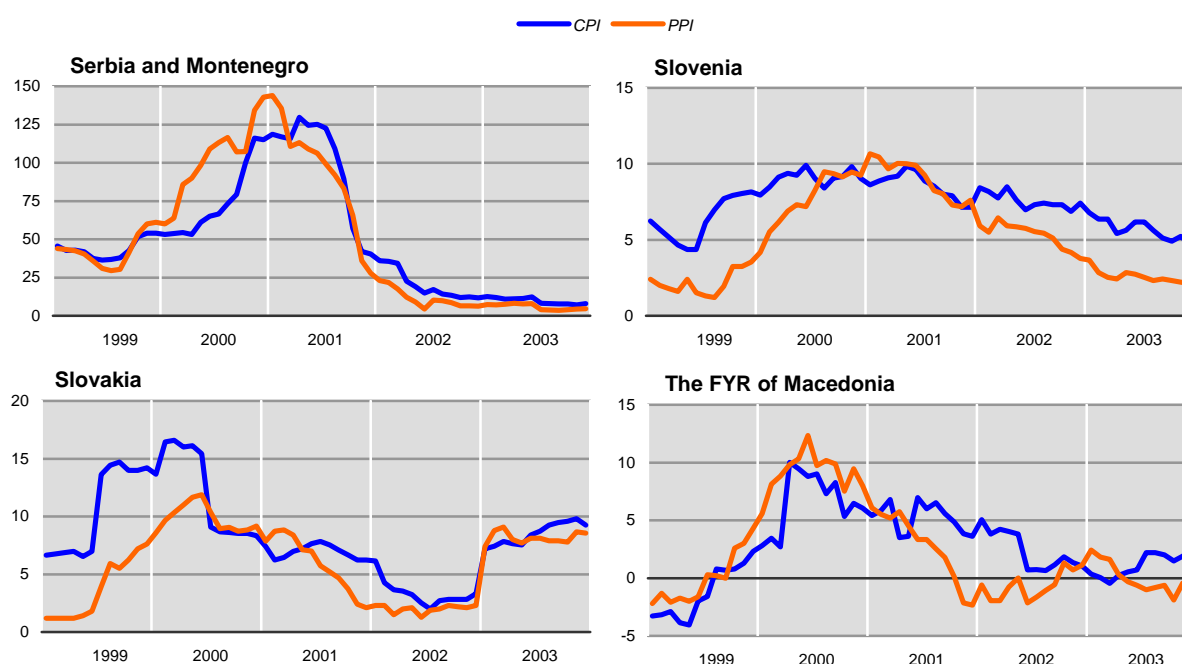
Consumer and industrial producer prices in eastern Europe, 1999-2003  
(Monthly, year-on-year percentage change)



(For source see end of chart.)

CHART 3.3.1 (concluded)

Consumer and industrial producer prices in eastern Europe, 1999-2003  
(Monthly, year-on-year percentage change)



Source: National statistics and UNECE secretariat estimates.

TABLE 3.3.2

Producer prices, wages and unit labour costs in industry<sup>a</sup> in eastern Europe, 2002-2003  
(January-September over same period of previous year, percentage change)

	Producer prices <sup>b</sup>		Nominal wages <sup>c</sup>		Real product wages <sup>d</sup>		Labour productivity <sup>e</sup>		Unit labour costs <sup>f</sup>		Real unit labour costs <sup>g</sup>	
	2002	2003	2002	2003	2002	2003	2002	2003	2002	2003	2002	2003
Albania .....	6.4	..	..	..	..	..	..	..	..	..	..	..
Bosnia and Herzegovina .....	0.7	2.6	9.0	9.5	8.0	5.7	10.0	10.1	-0.9	-0.6	-1.9	-4.0
Bulgaria .....	1.3	4.9	0.4	4.6	-	-0.5	5.7	11.0	-5.0	-5.8	-5.4	-10.3
Croatia .....	-0.5	1.9	7.3	5.7	8.6	3.3	5.0	6.8	2.2	-1.0	3.4	-3.3
Czech Republic .....	-1.0	-1.6	6.8	5.5	7.3	7.9	6.4	8.7	0.4	-2.9	0.9	-0.7
Estonia .....	0.8	0.2	10.8	9.9	10.1	9.7	12.2	7.2	-1.3	2.6	-1.9	2.4
Hungary .....	-1.1	2.5	13.2	9.3	14.4	7.7	2.1	8.7	10.9	0.6	12.1	-0.9
Latvia .....	1.0	3.2	15.4	2.1	14.1	-0.8	0.9	3.4	14.4	-1.2	13.1	-4.0
Lithuania .....	-2.8	-0.3	4.8	4.1	9.2	4.5	-0.3	10.9	5.2	-6.2	9.5	-5.8
Poland .....	1.1	2.7	4.3	2.5	3.5	-	7.3	10.9	-2.8	-7.6	-3.5	-9.8
Romania .....	24.6	21.1	25.9	19.4	0.4	-1.6	7.1	3.4	17.6	15.5	-6.2	-4.8
Serbia and Montenegro .....	10.9	5.8	69.3	28.1	50.3	20.5	7.2	..	57.9	..	40.2	..
Slovakia .....	2.0	8.2	8.1	6.7	6.1	-1.3	5.6	5.1	2.4	1.5	0.4	-6.1
Slovenia .....	5.3	2.6	9.2	7.6	3.3	4.7	1.8	2.0	7.2	5.5	1.5	2.7
The former Yugoslav Republic of Macedonia .....	-0.6	-	6.2	5.5	7.5	5.2	-10.9	11.1	19.2	-5.0	20.6	-5.3

Source: UNECE secretariat estimates, based on national statistics and direct communications from national statistical offices.

Note: Annual averages are calculated on the basis of monthly data, except for employment which are quarterly.

<sup>a</sup> Industry = mining + manufacturing + utilities.

<sup>b</sup> January-December over same period of previous year.

<sup>c</sup> Average gross wages in industry except in Bosnia and Herzegovina: net wages in industry; in Estonia: gross wages in total economy; in The former Yugoslav Republic of Macedonia and Serbia and Montenegro: net wages in total economy.

<sup>d</sup> Nominal wages deflated by producer price index.

<sup>e</sup> Gross industrial output deflated by industrial employment.

<sup>f</sup> Nominal wages deflated by productivity.

<sup>g</sup> Real product wages deflated by productivity.

started to rise in 2003 after being squeezed in 2002. Stronger external and domestic demand in many of the east European economies probably increased the pricing power of producers in 2003. Finally, the appreciation of most of their exchange rates against the dollar checked the increase in industrial raw material and other imported input costs. Unit material input costs therefore probably rose only modestly or even fell. Thus, despite deflationary trends abroad and relatively restrictive monetary policies at home, many east European enterprises enlarged their profit margins in 2003 in tandem with disinflation, mainly thanks to the sharp rebound in labour productivity.

### 3.4 Labour markets

#### *Ongoing adjustment dominates labour markets in central Europe...*

There were some signs of improvement in the east European labour markets in the first three quarters of 2003. Employment in the region stopped falling and in most countries unemployment fell. The current improvement follows several years of adjustment in the east European labour markets that involved a massive relocation of labour as part of an intense process of enterprise restructuring. In this period, the number of jobs lost as a result of restructuring obviously outnumbered the number created in new or growing firms, the net result being rising unemployment. The balance started to change in 2002 when unemployment rates in the region stabilized and even started to decline in some countries. In 2003, the revival became widespread and in the 12 months to November 2003, the average registered unemployment rate fell for the first time since 1998 by 0.4 percentage points.

Despite this improvement, unemployment rates remain very high in many countries. In November 2003, the total number registered as unemployed, although some 300,000 less than a year earlier, amounted to 8 million people and the average unemployment rate was close to 15 per cent of the labour force. The situation, however, differs considerably among subregions and countries reflecting the diversity of macroeconomic situations and the different patterns of labour market adjustment.

In *central Europe*, employment continued to increase in Hungary and Slovakia in the first three quarters of 2003, in both cases at an accelerated rate of growth of some 2 per cent (table 3.4.1). In Hungary most of the new jobs were in the rapidly growing service sector. In Slovakia, in addition to services, manufacturing and construction also contributed to the creation of new jobs. In contrast, employment continued to fall in the Czech Republic and Poland, although in the latter the decline was somewhat less than in 2002. After several years of improvement, employment fell, albeit slightly, in Slovenia, the main reasons being a weak

economic performance, continued industrial restructuring and a sharp fall in the agricultural sector due to a severe drought. Employment in the service sector continued to expand although the increase was not sufficient to absorb the losses in manufacturing and particularly in agriculture.

The average registered unemployment rate in central Europe declined only slightly (by 0.3 percentage points) in the 12 months to November 2003 (table 3.4.2). In November 2003, the rate ranged from some 8 per cent in Hungary to almost 18 per cent in Poland. The more accurate and more internationally comparable labour force survey (LFS) data based on the ILO definitions enlarge these differences. In the third quarter of 2003, the LFS unemployment rate was some 6 to 8 per cent in the Czech Republic, Hungary and Slovenia, but was 17 per cent in Slovakia and over 19 per cent in Poland (table 3.4.2).

The trends in unemployment have also differed among the central European countries. In Slovakia, the fastest growing economy in the region for the second consecutive year, unemployment has been declining steadily for the last three years, having peaked at nearly 20 per cent of the labour force at the beginning of 2001. In November 2003, the registered unemployment rate was 14.2 per cent (its lowest since 1998), nearly 3 percentage points lower than a year earlier. This reduction is largely a consequence of rapid GDP growth and an especially impressive growth of exports. The recent inflow of foreign direct investment appears to have contributed to job creation both in manufacturing and in the service sector. The notable decline in the registered unemployment rate, however, also reflects a tightening of the rules governing access to unemployment benefits introduced by the government in early 2003.<sup>131</sup> In the 12 months to November 2003, the unemployment rate was broadly unchanged in Hungary, and there was a small decline in Slovenia; in the latter, however, it occurred against a background of declining employment suggesting departures from the labour force rather than the creation of new jobs.<sup>132</sup>

Unemployment, however, continued to increase for the second year running in the Czech Republic and in February 2003 the registered unemployment rate was at a record high of above 10 per cent. After some seasonal easing in the summer the rate rose again and stabilized at around 10 per cent of the labour force by the end of the

<sup>131</sup> The stricter rules for registration and eligibility for benefits, which were introduced to prevent the abuse of unemployment benefits, considerably reduce the incentives to register. Indeed, data based on the labour force survey indicate a more modest reduction in unemployment over the same period: in the third quarter of 2003 the survey-based rate declined year-on-year by only 1.2 percentage points, compared with 2.6 percentage points indicated by registered statistics (table 3.4.2).

<sup>132</sup> Indeed, LFS data indicate a 0.6 percentage point increase in the unemployment rate between the third quarters of 2002 and 2003 (table 3.4.2).

TABLE 3.4.1

**Total and industrial employment in eastern Europe, 2002-2003**  
(Percentage change over the same period of preceding year)

	Total employment <sup>a</sup>					Employment in industry <sup>a</sup>				
	2002		2003			2002		2003		
	Annual	QIV	QI	QII	QIII	Annual	QIV	QI	QII	QIII
<b>Eastern Europe</b> .....	-0.9	..	-0.4	0.2	0.2	-1.6	-2.6	-1.2	-1.7	-0.7
Albania .....	-	0.1	0.9	1.1	1.0	-5.1	..	..	..	..
Bosnia and Herzegovina <sup>b</sup> .....	-3.2	-3.9	-4.2	-0.8	-0.8	-2.2	-2.3	-5.5	-4.7	-4.7
Bulgaria .....	0.4	2.9	2.0	2.7	4.6	0.3	-1.7	2.9	3.5	1.7
Croatia .....	0.8	0.7	0.1	0.1	0.1	-0.1	-1.6	-1.9	-2.0	-1.2
Czech Republic .....	-0.4	1.3	0.4	-0.7	-1.0	-6.0	-2.3	-2.7	-2.8	-2.7
Estonia .....	1.4	1.0	0.3	1.4	1.9	-4.6	-0.4	2.3	0.1	5.1
Hungary .....	0.3	1.0	0.8	1.7	1.8	0.1	-1.6	-3.8	-3.9	-3.5
Latvia .....	2.8	3.7	4.6	1.7	1.6	3.8	6.8	5.1	1.0	5.6
Lithuania .....	4.0	5.1	2.4	3.7	1.1	4.3	5.2	5.8	3.3	2.0
Poland .....	-2.2	-1.9	-2.5	-1.2	-1.0	-2.6	-4.0	-3.2	-3.3	-2.3
Romania .....	..	..	-0.1	0.4	-	1.8	..	0.2	-0.6	2.0
Serbia and Montenegro <sup>c</sup> .....	-1.7	..	..	..	..	-7.2	..	..	..	..
Slovakia .....	0.2	0.5	1.2	2.6	2.3	0.2	0.9	1.5	-0.3	0.8
Slovenia .....	0.6	-0.1	-0.5	-0.7	-0.9	0.9	1.0	-1.2	-2.3	-1.9
The former Yugoslav Republic of Macedonia .....	-6.0	-5.1	-5.0	-2.1	-1.8	-9.5	-1.8	-3.9	-3.5	-2.7
<i>Memorandum items:</i>										
<b>EU acceding countries</b> .....	-0.8	-0.2	-0.7	-	-0.1	-2.3	-1.8	-2.0	-2.5	-1.7
<b>Baltic states</b> .....	3.1	3.8	2.7	2.6	1.4	2.0	4.4	4.8	1.9	3.8
<b>Central Europe</b> .....	-1.3	-0.6	-1.1	-0.3	-0.3	-2.7	-2.5	-2.7	-2.9	-2.3
<b>South-east Europe</b> .....	-0.6	..	0.2	0.7	0.9	-0.6	..	0.2	-0.2	1.2

*Source:* National statistics and direct communications from national statistical offices to UNECE secretariat.

*Note:* Changes in employment based on quarterly statistics are not always fully comparable with annual data due to differences in coverage.

<sup>a</sup> Regional quarterly aggregates of total employment exclude Serbia and Montenegro; those of industrial employment also exclude Albania.

<sup>b</sup> Figures cover only the Bosnian-Croat Federation.

<sup>c</sup> Data exclude Kosovo and Metohia.

year. Given weak external demand, increased competition from foreign-owned firms on the domestic market and the ongoing restructuring of industrial firms, the rate of unemployment is unlikely to fall much below its current level before 2006.<sup>133</sup>

In 2003, some early signs of stabilization appeared in the Polish labour market suggesting that it might have reached a turning point after several years of deterioration. The economic recovery in 2003 was accompanied by a marginal fall in unemployment and although employment continued to decline it did so at a reduced rate in the first three quarters of the year. There were also some signs of an increasing demand for labour.<sup>134</sup> However, due to massive job losses over the last four years,<sup>135</sup> labour market problems in Poland

remain a burning economic, social and political issue.<sup>136</sup> After its peak in February 2003, unemployment has been falling, albeit slowly, as a result of the improvement in the general economic situation. In November 2003, the registered unemployment rate stood at 17.6 per cent, 0.2 percentage points lower than that a year earlier. Given the structural character of Polish unemployment, national analysts believe that the forecast 5 per cent growth of GDP in 2004 may only stabilize unemployment. According to the government's forecasts, the rate of unemployment will still be 17.7 per cent of the labour force at the end of 2004.<sup>137</sup>

*...but the situation is improving in the Baltic states  
and some south-east European economies*

Rapid economic growth in the *Baltic states* since 2000 has resulted in a notable improvement in their labour markets. In the first three quarters of 2003, employment

<sup>133</sup> *Interfax Czech Republic Business News Service*, 6 October 2003, reported in Dow Jones Reuters Business Interactive (Factiva).

<sup>134</sup> Vacancies reported to job centres continued to rise steadily during 2003 and in the third quarter reached nearly 250,000, an increase of more than 70,000 compared with the same period of the previous year.

<sup>135</sup> The unemployment rate increased by more than 8 percentage points between February 1998 and February 2003 when it peaked at 18.8 per cent. A more accurate LFS measure based on the ILO methodology indicates that in the first quarter of 2003 the rate was close to 21 per cent.

<sup>136</sup> The tense situation is aggravated by the fact that some 85 per cent of more than 3 million Poles registered as unemployed in November 2003 had no right to unemployment benefit, and over 40 per cent of 15-24 year olds were jobless.

<sup>137</sup> A forecast by the Ministry of Finance. *Interfax Daily Financial Report*, 19 December 2003, reported in Dow Jones Reuters Business Interactive (Factiva).

TABLE 3.4.2  
Registered and labour force survey estimates of unemployment in eastern Europe, 2000-2003  
(Per cent of labour force)

	Registered unemployment <sup>a</sup>								Labour force survey unemployment							
	2000		2001	2002			2003			2002				2003		
	Nov.	Nov.	Nov.	Mar.	Jun.	Sep.	Oct.	Nov.	QI	QII	QIII	QIV	QI	QII	QIII	
<b>Eastern Europe</b> .....	14.3	14.6	15.1	15.8*	14.8*	14.5*	14.5*	14.7*	..	..	..	..	..	..	..	
Albania .....	17.0	15.5	15.9	15.5	15.2	15.0	..	..	..	..	..	..	..	..	..	
Bosnia and Herzegovina .....	39.2	39.9	42.6	43.1	43.1	43.8	..	..	..	..	..	..	..	..	..	
Bulgaria .....	17.7	17.7	16.9	15.7	13.7	12.8	12.9	13.2	19.5	17.6	17.3	16.8	15.6	13.7	12.7	
Croatia .....	22.4	22.5	21.6	21.0	18.9	18.3	18.6	18.9	..	15.2 <sup>b</sup>	..	14.4 <sup>b</sup>	..	14.1 <sup>b</sup>	..	
Czech Republic .....	8.5	8.5	9.3	10.0	9.5	10.1	9.9	9.9	7.7	7.0	7.2	7.3	7.6	7.5	8.0	
Estonia .....	7.1	7.9	6.9	7.4	6.5	6.0	6.0	6.0	11.2	9.4	9.1	11.3	10.6	10.7	9.5	
Hungary .....	8.6	7.7	7.7	9.0	7.8	8.0	7.9	7.8	5.8	5.6	5.9	5.9	6.4	5.8	5.7	
Latvia .....	7.8	7.6	8.6	8.9	8.6	8.5	8.5	8.5	12.9	13.3	10.5	11.6	10.7	10.6	10.7	
Lithuania .....	12.1	12.5	10.7	11.8	9.4	9.3	9.2	9.7	17.1	13.0	11.9	13.0	13.6	12.9	11.6	
Poland .....	14.5	16.8	17.8	18.7	17.8	17.5	17.4	17.6	20.3	19.9	19.8	19.7	20.6	19.4	19.4	
Romania .....	10.3	8.0	8.1	8.6	7.3	6.7	7.0	7.2	10.0	8.0	7.5	8.0	8.1	6.9	6.2	
Serbia and Montenegro <sup>c</sup> .....	20.9	22.3	24.7	..	28*	..	..	..	..	..	..	13.8 <sup>d</sup>	..	..	..	
Slovakia .....	16.7	17.7	16.8	16.5	14.6	13.9	13.8	14.2	19.4	18.6	18.2	17.9	18.4	17.0	17.0	
Slovenia .....	11.9	11.6	11.5	11.3	10.8	11.2	11.3	11.0	6.9	5.9	6.0	6.5	7.0	6.6	6.6	
The former Yugoslav Republic of Macedonia .....	45.1	41.7	45.3	44.2	44.4	44.6	45.1	45.4	..	31.9 <sup>e</sup>	..	..	..	36.7 <sup>e</sup>	..	
<i>Memorandum items:</i>																
<b>EU acceding countries</b> .....	12.5	13.7	14.1	14.9	13.9	13.8	13.7	13.9	15.6	14.9	14.7	14.8	15.4	14.5	14.5	
<b>Baltic states</b> .....	9.8	10.0	9.3	10.0	8.6	8.4	8.3	8.6	14.6	12.4	10.9	12.2	12.1	11.7	10.9	
<b>Central Europe</b> .....	12.9	14.1	14.7	15.5	14.5	14.4	14.3	14.4	15.7	15.2	15.2	15.1	15.8	14.9	14.9	
<b>South-east Europe</b> .....	17.0	16.5	16.7	17.3*	16.1*	15.7*	15.9*	16.2*	..	..	..	..	..	..	..	

**Source:** National statistics and direct communications from national statistical offices to UNECE secretariat; for Bosnia and Herzegovina: The Economist Intelligence Unit (these figures cover only the Bosnian-Croat Federation; data for Republika Srpska are not available).

<sup>a</sup> Unemployment rates in Estonia and The former Yugoslav Republic of Macedonia are UNECE secretariat estimates. The Estonian Statistical Office calculates the rate as a percentage of the number of registered unemployed to the number of people between 16 and pensionable age. The official figure for November 2003 based on this methodology was 5 per cent. The National Statistical Office of The former Yugoslav Republic of Macedonia reports only the number of registered unemployed. The estimated rate is calculated as a percentage of the officially reported number of registered unemployed to the labour force obtained from the labour force surveys conducted annually in April.

<sup>b</sup> Average for the first and the second half of the year.

<sup>c</sup> Data exclude Kosovo and Metohia. Registered unemployment rates for 2000, 2001 and 2002 are annual averages; the figures have been recently revised by the national statistical office.

<sup>d</sup> October.

<sup>e</sup> April.

increased throughout the region (table 3.4.1), by 1 per cent in Estonia and by more than 2 per cent in Latvia and Lithuania. The pattern of labour demand was similar in all three economies: new jobs were created in construction, manufacturing and particularly in the service sector, while employment in agriculture continued to decline. Unemployment in the region fell for the second consecutive year. In November 2003, the average registered unemployment rate was 8.6 per cent, nearly 1 percentage point lower than a year earlier (table 3.4.2). The rate was broadly unchanged over the year in Latvia but fell in the other two countries. LFS data traditionally indicate a higher incidence of unemployment in these countries: in the third quarter of 2003, the survey-based unemployment rate varied between 9.5 per cent in Estonia and 11.6 per cent in Lithuania. As to the more recent dynamics, the survey-based unemployment rates suggest stabilization of unemployment rather than a decline. This is particularly true for Estonia, where the LFS rate even went up year-on-year in the second and the third quarters of 2003.

In 2003 there were clear signs of improvement in the labour markets of *south-east Europe*. In the first three quarters of 2003, employment increased in the region for the first time since 1998 by nearly 1 per cent (table 3.4.1). It continued to decline only in Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia,<sup>138</sup> but in both cases the decline decelerated. In Croatia and Romania employment was broadly unchanged from the first three quarters of 2002, but it increased in Albania and, especially, in Bulgaria where the rate of growth accelerated in the third quarter to nearly 5 per cent. New jobs were created in manufacturing and construction, but the main source of job creation in Bulgaria (more than 80 per cent of the total jobs) was in the service sector.

There was also some slight easing of unemployment, the average unemployment rate in south-eastern Europe of

<sup>138</sup> Data for Serbia and Montenegro were not available at the time of writing this *Survey*.

## Box 3.4.1

## Discrepancies between registered and labour force survey estimates of unemployment

The unemployment statistics in most of the east European economies are now obtained from two main sources. The most widely available measure comes from a monthly count of those registered with state labour offices as looking for work. This administrative measure is known as *registered unemployment*. The other source is the quarterly (or less frequent) survey of households, the labour force survey (LFS). This survey measure, also known as the *ILO unemployment measure*, is broadly accepted as the international standard and is most widely used for comparing unemployment among countries. As table 3.4.3 indicates, all the east European countries except Albania and Bosnia and Herzegovina conduct regular quarterly LFS (Croatia on a semi-annual basis and Serbia and Montenegro and The former Yugoslav Republic of Macedonia once a year). Labour force surveys are much less common in the CIS countries.

A comparison of unemployment rates obtained from the two sources indicates large discrepancies between the administrative and LFS measures in most of the east European and CIS countries for which both data sets are available (chart 3.4.1). It should be noted that the discrepancy between the two measures is not a specific feature of the east European and CIS countries but can also be observed (to a different extent) in many western economies. In Finland, for example, between 1990-2001, the number of unemployed attending employment exchanges, on average, was over 25 per cent higher than the number of unemployed given in the LFS. Annual changes in unemployment, however, followed a similar pattern in both sets of statistics.<sup>1</sup>

The difference between the two measures results from the different methods of obtaining information on unemployment in the two sources. First of all, the two sources use different criteria for unemployment. Employment in the LFS is defined more broadly than in the administrative statistics; accordingly, the definition of unemployment is more narrow in the LFS. According to the ILO definition (ILO Convention No. 160 concerning Labour Statistics, adopted by the International Labour Conference in 1985 and in force since April 1988), a person is defined as *employed* if he or she during the reference week: performed some work for at least one hour for payment in cash or in kind; did not work but had a job or a business from which he or she was temporarily absent due to leave, illness, full-paid maternity leave, bad weather, strike or other similar reasons. A person on unpaid leave initiated by the employer is also considered as employed if the duration of this leave does not exceed three months. In turn, a person is qualified as *unemployed* if he or she satisfied all of the following three conditions during the reference period: was without work; was actively seeking work; was currently available for work, that is, was available for paid employment or self-employment immediately or within 14 days. A person who fails to meet even one of these conditions would be classified as employed or economically inactive.<sup>2</sup>

On the other hand, labour offices exclude from registration certain groups such as pensioners and full-time students. These definitional differences are one of the major reasons for the different quantitative measures of the number of jobless and the rate of unemployment. In Croatia, for example, in the first half of 2003, the average number of unemployed persons derived from the LFS was 253,000, whereas the registered statistics reported 347,000 (the corresponding unemployment rates being 14.1 and 20.4 per cent respectively). When the LFS asked interviewees whether they had registered with the Employment Service, only 221,000 or some 88 per cent answered that they had done so. At the same time, 126,000 (some 36 per cent) of the total number of those registered as unemployed with the Employment Service did not fulfill the international criteria of unemployment.<sup>3</sup>

As illustrated by the data for the second quarter of 2003, there were significant differences between the registered and LFS unemployment rates in most east European and, particularly, CIS countries (chart 3.4.1). These differences can be seen clearly when the two measures are expressed in relative terms (chart 3.4.2). First, in 7 out of 17 countries the registered unemployment rate is higher than the survey measure, whereas the opposite holds in the other 10. Second, the discrepancies differ considerably across countries. In Croatia, Hungary and Slovenia the registered unemployment rates exceeded those of the LFS by 40 to 60 per cent, while elsewhere in eastern Europe the two measures are closer (particularly in Bulgaria, Poland and Romania). In all the Baltic states, the administrative statistics tend to underestimate unemployment considerably (particularly in Estonia, by nearly 40 per cent). But the downward bias is especially pronounced in the CIS countries. In Ukraine, the registered unemployment rate is less than half the rate derived from the LFS. In the other CIS countries, the registered measure captures barely more than one quarter of the rate according to the ILO definition.

The discrepancies between the two measures also reflect specific features of the national legislation and regulations concerning the registration of the unemployed and their entitlement to benefits. Moreover, as the registered data are directly influenced by changes in legislation and derived rules, these discrepancies can change over time. In Bulgaria, for example, the number of unemployed derived from the LFS was some 35 per cent above the registered figures in 1993-1996. From 1997 to 1999 the difference diminished to some 3-5 per cent. In 2000, the number of registered unemployed exceeded the LFS figures by more than 20 per cent. Since March 2001, the difference narrowed again to around 5 per cent.<sup>4</sup>

Three important factors affect the accuracy of the registration data: the generosity of the unemployment benefit system, its accessibility and the effectiveness of labour services. In some countries the existence of a large informal sector (shadow economy) can also influence the labour market statistics. Thus, in those countries where the administrative figures exceed considerably the LFS measure, this may suggest that the labour services register a large number of persons who are actually not out of work according to the ILO definition. However, the reasons for this "over-registration" can differ from country to country. For example, in Hungary and Slovenia it is probably the result of relatively generous unemployment benefits that



## Box 3.4.1 (concluded)

## Discrepancies between registered and labour force survey estimates of unemployment

encourage people to register as unemployed.<sup>5</sup> In Croatia and The former Yugoslav Republic of Macedonia, where the figures for registered unemployment largely overstate the actual number of the jobless, the likely reason for the discrepancy is that a large number of people who register as unemployed are in fact self-employed in agriculture or work in the large informal sector of the economy.<sup>6</sup> The existence of such “hidden employment” suggests that the registration data may include people who are not actively searching for work but for whom registration in labour offices is necessary to gain access to other social services such as social assistance, health care, etc. The Croatian government recently announced tougher measures to combat the fictitious unemployment that seems to be on a large scale.<sup>7</sup>

In the CIS countries the large discrepancies between the two measures are most likely the result of the low incentives to register (low unemployment benefits, often paid in arrears, as well as the inefficient operation of local labour offices). More generally, the discrepancies in the east European and CIS countries reflect different models of unemployment assistance. The model of unemployment insurance that has emerged in eastern Europe differs from that in the CIS and reflects a different approach to social policy. East European systems rely much more on the role of unemployment benefits as an incentive than is the case in the CIS. While the east European approach shifts responsibility for supporting redundant workers away from enterprises and onto public institutions, the CIS system continues to rely mainly on employment protection within enterprises, while the assistance provided by the public labour services is still relatively poor.<sup>8</sup>

<sup>1</sup> European Commission, 20<sup>th</sup> CEIES Seminar, *Labour Statistics – Towards Enlargement*, held in Budapest, 14-15 November 2002 (Luxembourg), 2003, p. 160.

<sup>2</sup> For a more detailed discussion see, M. Suhto, “Statistics on employment and unemployment: international comparability and national needs”, in European Commission, 20<sup>th</sup> CEIES Seminar, op. cit., pp. 159-165.

<sup>3</sup> Direct communication from the Croatian Statistical Office to the UNECE secretariat.

<sup>4</sup> European Commission, 20<sup>th</sup> CEIES Seminar, op. cit., p. 180.

<sup>5</sup> In mid-2002, Hungary and Slovenia had the highest unemployment benefits (some 26 and 39 per cent of national average wage, respectively). In Slovenia, in addition, the definition of registered unemployment is broader than the ILO one. Slovenian registered unemployment counts as unemployed each person who comes to the employment office and seeks help in declaring himself to be unemployed. In reality, about 20 per cent of the registered unemployed have part-time jobs and 15 per cent, for various reasons, are not actively seeking employment. Institute of Macroeconomic Analysis, *Analysis of Economic Trends in 1994 and Projections for 1995* (Ljubljana), 1995, pp. 13-14.

<sup>6</sup> According to some estimates, the shadow economy in The former Yugoslav Republic of Macedonia accounts for nearly 40 per cent of GDP and employed some 240,000 persons in June 2002. The official figure for employment was some 285,000 persons. *Macedonian Press Digest*, 5 June 2002, as quoted by Dow Jones Reuters Business Interactive (Factiva).

<sup>7</sup> According to the Minister of Public Works, Reconstruction and Construction, while some 75,000 construction workers were registered as unemployed with the Employment Bureau, about 5,000 vacancies for work on the Zagreb-Split motorway could not be filled. *Hina-Croatian News Agency*, 27 September 2002, as quoted by Dow Jones Reuters Business Interactive (Factiva).

<sup>8</sup> UNECE, *Economic Survey of Europe, 2003 No. 1*, pp. 197-198.

16.2 per cent in November 2003 being 0.5 percentage points lower than a year earlier. In the 12 months to November 2003, the rates of unemployment fell by 1 or more percentage points in Bulgaria, Croatia and Romania, and there was also some reduction in Albania. These declines generally reflect a relatively strong economic recovery supported in some cases by rising FDI. More active state-sponsored employment programmes, including incentives for investment in areas of high unemployment and the launch of public works programmes, have also contributed to falling unemployment in some of these countries.<sup>139</sup>

<sup>139</sup> Bulgaria is an outstanding case. The registered unemployment rate peaked at 19.3 per cent in February 2000. Subsequently, job creation in the private sector brought the rate down to 17.7 per cent by the end of 2002. A further reduction in 2003 also reflected a more active job creation policy on the part of the state. As a result, the unemployment rate was 13.2 per cent in November 2003, nearly 4 percentage points lower than a year earlier.

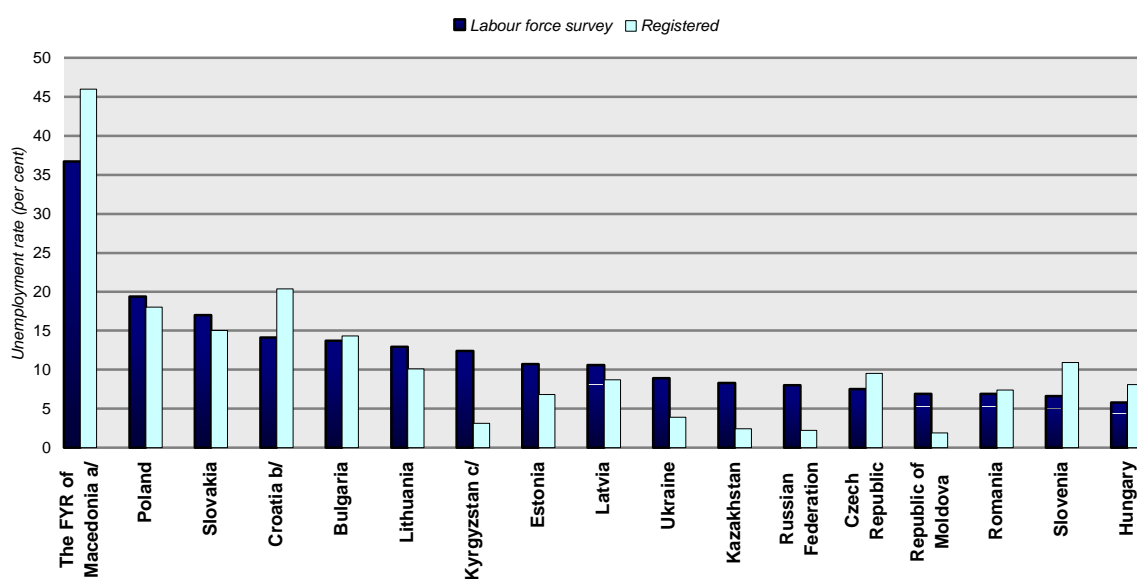
The situation in the labour markets, however, remains very heterogeneous. At the end of 2003, the unemployment rate varied between some 7 and 15 per cent in Albania, Bulgaria and Romania, and was nearly 19 per cent in Croatia.<sup>140</sup> An accurate assessment of developments in the other three economies of south-eastern Europe is difficult due to the lack of reliable and timely data.<sup>141</sup> The available partial data indicate, however,

<sup>140</sup> In Croatia, registered statistics overestimate the incidence of unemployment considerably; for a more detailed analysis see box 3.4.1.

<sup>141</sup> Both Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia report only the number of unemployed; unemployment rates are not provided in the official statistics. The National Statistical Office of Serbia and Montenegro has stopped reporting basic monthly data on the labour markets since mid-2002. In the latest issue of the revised *Yearbook*, lower figures for annual average unemployment rates in 2000-2002 are given. According to unofficial estimates, the unemployment rate at mid-2003 was around 28 per cent.

CHART 3.4.1

Registered and labour force survey (LFS) data on unemployment in selected east European and CIS countries, 2003QII  
(Per cent of labour force)



**Source:** National statistics and direct communications from national statistical offices to UNECE secretariat.

**Note:** Countries are ranked by the LFS unemployment rate.

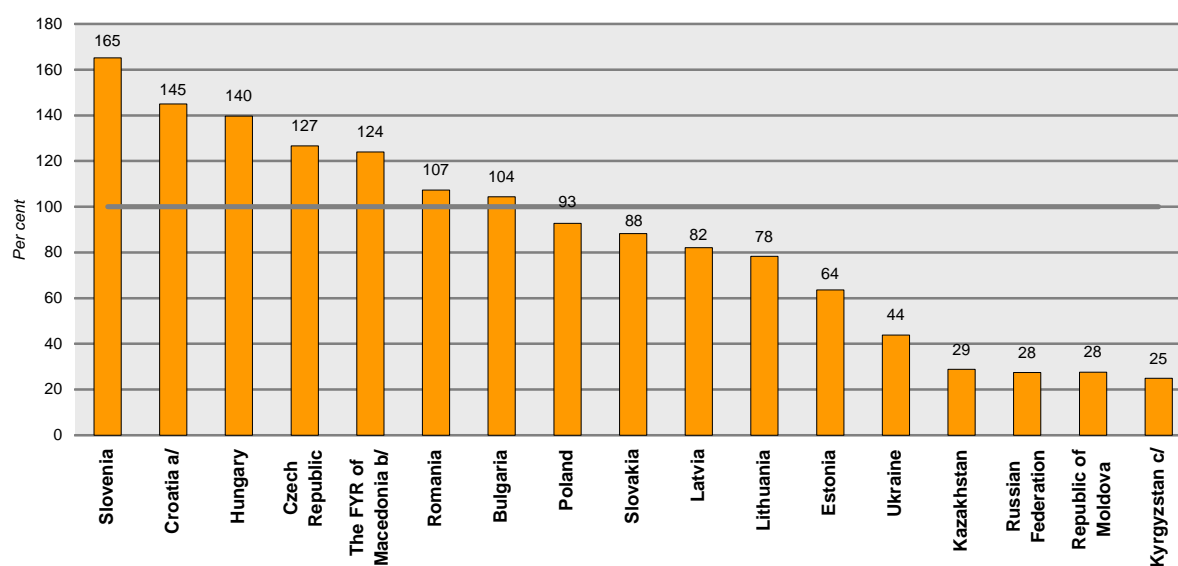
**a** April.

**b** Average for the first half of the year.

**c** First quarter.

CHART 3.4.2

Relationship between registered and survey-based unemployment rates in eastern Europe and the CIS, 2003QII  
(Labour force unemployment rate=100)



**Source:** National statistics and direct communications from national statistical offices to UNECE secretariat.

**Note:** Countries are ranked by the absolute difference between the two measures.

**a** Average for the first half of the year.

**b** April.

**c** First quarter.

TABLE 3.4.3

## Labour force surveys in eastern Europe and the CIS, 2003

	Starting date	Frequency	Coverage (age of population)
<b>Eastern Europe</b>			
Bulgaria .....	1993	Quarterly	15 and over
Croatia .....	1996	Semi-annually	15 and over
Czech Republic .....	1992	Quarterly	15 and over
Estonia .....	1995	Quarterly <sup>a</sup>	15-74
Hungary .....	1992	Quarterly	15-74
Latvia .....	1995	Quarterly <sup>b</sup>	15-74
Lithuania .....	1994	Quarterly <sup>b</sup>	15-74
Poland .....	1992	Quarterly	15 and over
Romania .....	1996	Quarterly	15 and over
Serbia and Montenegro ....	1994	Annually	15 and over
Slovakia .....	1993	Quarterly	15 and over
Slovenia .....	1993	Quarterly <sup>c</sup>	15 and over
The former Yugoslav Republic of Macedonia ...	1996	Annually	15 and over
<b>CIS</b>			
Georgia .....	1998	Quarterly <sup>d</sup>	15 and over
Kazakhstan .....	2001	Quarterly	15 and over
Kyrgyzstan .....	2002	Quarterly <sup>e</sup>	15 and over
Moldova .....	1998	Quarterly	15 and over
Russian Federation .....	1992	Quarterly <sup>f</sup>	15-72
Ukraine .....	1996	Quarterly <sup>f</sup>	15-70

*Source:* National statistics and direct communications from national statistical offices to UNECE secretariat.

<sup>a</sup> Until 2000 semi-annually.

<sup>b</sup> Until 2002 semi-annually.

<sup>c</sup> Until 1997 annually.

<sup>d</sup> The results of the survey are not published regularly due to financial constraints.

<sup>e</sup> The first pilot LFS was conducted in November 2002.

<sup>f</sup> Until 1999 annually.

that in all three countries unemployment probably increased in 2003 to rates of 30 per cent or more of the labour force. The acuteness of the unemployment problem is illustrated by the fact that the number registered as unemployed is close to or even larger in some cases than the officially reported number of persons employed.<sup>142</sup> These high rates of unemployment are 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.

<sup>142</sup> The officially reported number of persons employed in Bosnia and Herzegovina in September 2003 (382,000) was only slightly higher than the number of jobless persons (302,000) registered by the Labour Office. The situation seems to be even worse in The former Yugoslav Republic of Macedonia where in the same period the corresponding figures were 275,000 and 390,000 persons, respectively. (LFS data give 316,000 unemployed and 545,000 employed in April 2003.) Apart from indicating the acuteness of the unemployment problem, these numbers also suggest a large-scale informal economy in these countries. The high levels of registered unemployment in some countries of the former SFR of Yugoslavia may exaggerate the actual levels of unemployment. UNECE, *Economic Survey of Europe, 2003 No. 1*, p. 75, and box 3.4.1 in this section.

### 3.5 Foreign trade and payments

#### (i) Current account developments

##### *Deficits prevail but generally remain under control*

The current account balance in most east European countries remained in deficit in 2003 (table 3.5.1); however, recent developments suggest that, in terms of their external financial positions, several of these economies may be approaching a post-transition phase. Thus, some of the more advanced economies (especially the EU acceding countries) seem to be reaching a point where access to financial capital is no longer a constraint on their development. In addition, the deficits in most of the acceding countries seem to be stabilizing, surpluses on the balances of services and transfers largely offsetting deficits on net factor incomes.<sup>143</sup>

In 2003 there were some exceptions to this general pattern. Thus, Estonia is heading towards a record deficit of over 14 per cent of GDP due to a large rise in imports related not only to high levels of investment but also to rising private consumption. Similar concerns exist about the sustainability of current account deficits in Bosnia and Herzegovina, Latvia, Serbia and Montenegro and probably Bulgaria (whose deficit rose rapidly in the second half of the year).

Another problem that has emerged only recently is the sharp fall in the FDI inflow to some east European countries. In 2002 the FDI inflows into eastern Europe were larger than the region's aggregate current account deficit, but in 2003 they covered only half of it. An increase in workers' remittances from abroad helped to alleviate the pressure on short-term borrowing to finance these deficits.

These various changes may indicate a turning point in the development of some of these economies, especially the acceding countries, after a decade and a half of economic transformation. The deepening of economic integration with the more developed EU economies and the emergence of new factors (both in the real economy and in the financial sphere) may be leading to a gradual reversal in the net balance of FDI, while the trade deficits should decline and the rising balances of net factor incomes and transfers continue to offset one another. The functioning of this mechanism at the macroeconomic level is described in box 3.5.1.

In the early stages of economic transformation, the scarcity of capital was one of the main constraints on growth because the transition to a market economy implied the virtual write-off of a large part of the existing capital stock. In the later stages of transition, additional capital was needed for the upgrading of human capital.

<sup>143</sup> Reporting the deficits in dollars introduces a bias in periods of increased volatility of the dollar exchange rate (as was the case in 2003, when the dollar deficits are likely to have been overstated). Expressing the deficit as a proportion of GDP eliminates this bias.

TABLE 3.5.1  
Current account balances of eastern Europe, 2001-2003  
(Million dollars, per cent)

	Million dollars				Per cent of GDP				Net FDI/current account <sup>a</sup> (per cent)		
	2001	2002	Jan.-Sep.		2001	2002	Jan.-Sep.		2002	Jan.-Sep.	
			2002	2003			2002	2003		2002	2003
<b>Eastern Europe</b> .....	-21 751	-25 913	-16 394	-19 259	-4.7	-5.0	-4.5	-4.4	92	113	53
Albania .....	-218	-407	-286	-258	-5.1	-8.4	-7.9	-5.8	33	33	42
Bosnia and Herzegovina .....	-1 305	-1 729	-1 098	-1 402	-27.9	-31.9	-27.5	-28.3	17	16	15
Bulgaria .....	-842	-713	-78	-833	-6.2	-4.6	-0.7	-5.9	123	811	109
Croatia .....	-725	-1 908	-869	-523	-3.7	-8.5	-5.3	-2.5	31	31	218
Czech Republic .....	-3 273	-4 415	-3 179	-3 662	-5.4	-6.0	-6.3	-5.9	204	251	106
Estonia .....	-339	-799	-525	-898	-6.0	-12.3	-11.0	-14.6	19	20	58
Hungary <sup>b</sup> .....	-1 754	-2 655	-1 369	-3 883	-3.4	-4.1	-3.0	-6.5	22	35	-
Latvia .....	-732	-647	-409	-650	-9.6	-7.7	-6.8	-9.0	58	83	34
Lithuania .....	-574	-734	-390	-755	-4.8	-5.3	-3.9	-5.9	97	138	13
Poland .....	-7 166	-6 700	-4 887	-2 964	-3.9	-3.5	-3.6	-2.0	57	51	74
Romania .....	-2 223	-1 525	-948	-1 831	-5.5	-3.3	-3.1	-4.8	74	85	58
Serbia and Montenegro <sup>c</sup> .....	-648	-1 731	-1 265	-1 391	-5.7	-11.0	-10.9	-9.6	27	25	63
Slovakia .....	-1 746	-1 939	-1 211	-73	-8.4	-8.0	-6.9	-0.3	207	278	650
Slovenia .....	37	314	321	65	0.2	1.4	2.0	0.3	-	-	-
The former Yugoslav Republic of Macedonia .....	-244	-325	-201	-203	-7.1	-8.8	-7.4	-6.0	24	32	17
<i>Memorandum items:</i>											
<b>EU acceding countries</b> .....	-15 546	-17 576	-11 648	-12 818	-4.3	-4.4	-4.1	-3.8	115	139	45
<b>Baltic states</b> .....	-1 644	-2 180	-1 324	-2 302	-6.5	-7.6	-6.4	-8.8	57	74	37
<b>Central Europe</b> .....	-13 902	-15 396	-10 324	-10 516	-4.1	-4.1	-3.9	-3.3	123	147	47
<b>South-east Europe</b> .....	-6 205	-8 337	-4 746	-6 441	-6.4	-7.4	-5.9	-6.4	43	50	67

Source: UNECE secretariat calculations, based on national balance of payments statistics; Hungarian National Bank, *Quarterly Report on Inflation* (Budapest), November 2003, pp. 51-53.

<sup>a</sup> This ratio is calculated only when net FDI is positive and the current account balance is negative.

<sup>b</sup> Excludes reinvested profits (a net outflow); otherwise the Hungarian current account deficit in per cent of GDP would be approximately -5.8 per cent in 2001, -6.1 per cent in 2002 and -8.6 per cent in 2003 (according to the estimates of the Hungarian National Bank).

<sup>c</sup> For 2003, excluding Montenegro.

Raising capital abroad and channelling it to meet such investment needs was definitely beneficial for the transition economies.<sup>144</sup> After 1995, this instrument of economic restructuring was actively used by most east European economies, their trade and current account balances being generally negative (appendix table B.16). The general policy of running current account deficits in eastern Europe can thus be viewed as a positive, strategic approach to their development. Subject to some caveats (box 3.5.1), large deficits often indicate that a country is undergoing successful restructuring and that investors are assessing positively its future growth potential. Consequently, for most of the transition period, current account deficits in eastern Europe were largely financed by net FDI inflows.

More recent developments, such as the recent financial turmoil in Hungary (see box 3.1.1), point to the need for more caution regarding the future. In Hungary's case, the root of the problem can be traced to the growth

of government spending before and after the 2002 elections (the government deficit reaching 9.2 per cent of GDP in 2002). The lesson from this experience is that large and poorly targeted stimulation of demand can have destabilizing side effects even in the most advanced of the east European economies. Poland's unbalanced growth path prior to the slowdown in 2001 also demonstrates the dangers of an external disequilibrium arising from an inconsistent policy mix.<sup>145</sup> The policy adjustment in 2001 helped to reduce the current account deficit (table 3.5.1) but at the expense of a considerable economic slowdown. While Poland does not seem to be facing balance of payments constraints at present, the projected increase in the budget deficit in 2004 is not without risks.<sup>146</sup>

Policy makers in eastern Europe also need to take into account the potential risks associated with twin deficits,

<sup>144</sup> According to growth theory, obtaining access to additional savings (and thus investment) shifts upwards an economy's long-term steady state growth rate; such an economy will enjoy a larger capital stock, a faster rate of growth and a higher, final level of output than would otherwise be possible. G. Mankiw, D. Romer and D. Weil, "A contribution to the empirics of economic growth", *Quarterly Journal of Economics*, Vol. 107, No. 2, 1992, pp. 407-437.

<sup>145</sup> UNECE, *Economic Survey of Europe, 2002 No. 1*, pp. 63-69.

<sup>146</sup> Another example is the Czech financial crisis in 1997, which was rooted in an unbalanced growth path supported by easy access to credit from the state banks (UNECE, *Economic Survey of Europe, 1998 No. 1*, pp. 75-82). The surfacing of huge accumulated contingent fiscal liabilities at that time remain a large burden on the Czech public finances (this phase of the Czech fiscal reform is due to be closed in 2006).

## BOX 3.5.1

**The balance of payments and the domestic economy**

The current account of the balance of payments of an open economy reflects the sources and uses of national income as they relate to the exports and imports of goods and services, and to international transfers of income related to factors (capital and labour) or consumer spending. This leads to the so-called fundamental macroeconomic identities of an open economy:

$(X-M) \equiv I_f$ , i.e. the current account is equal to the consolidated capital and financial accounts of the balance of payments, and

$(X-M) \equiv S + (T-G) - I$ , i.e. the current account is the difference between residents' savings (private and public) and their investments.

Thus, external disequilibria (both real and monetary) are closely tied to internal disequilibria concerning growth, employment or prices. The expenditure of a country's residents on consumption, investment, government services and imports (on domestic absorption,  $A$ ) can only exceed the national product,  $Y$ , if the difference is financed by the rest of the world:  $A + (X-M) \equiv Y$ . Such additional resources ( $I_f$ ) are equal to the absolute value of the current account deficit ( $X-M$ ), which is negative in this case. In other words, if the private and public savings of a country are insufficient to finance the required investments for restructuring, then foreign funds must be mobilized for this purpose. However, not all countries and their economic agents consider this the most appropriate policy.

The short-term and long-term costs and benefits associated with current account deficits may diverge significantly. All such deficits lead to an accumulation of debt that has to be serviced (and eventually repaid), including the debt created by foreign direct investment. Thus, the worldwide average implicit real rate of interest on FDI is estimated to be around 16 per cent per annum.<sup>1</sup> However, even more caution is needed if the borrowed foreign funds are not used to increase the stock of physical and human capital and to raise competitiveness, but instead are used to finance imports for consumption or are otherwise used inefficiently. The elasticity of imports with respect to aggregate domestic demand in immature economies is often significantly above unity and the income elasticity of domestic production for import replacements is usually less than unity. During the period of transition, diverging magnitude in the gap between these elasticities was very wide in the east European economies as well. Under such conditions, economic growth that is driven by the expansion of domestic demand will tend to generate an unsustainable current account deficit. The danger is even greater if there is also a parallel fiscal deficit, which is used to finance an unstructured public sector or provide soft budget constraints to various beneficiaries. Such "public dissaving" can lead quickly to the accumulation of foreign public indebtedness, a crowding out of private investment and even to an excessive increase in private savings, which reduces consumption (due to the "Ricardian equivalence" effect). It also tends to generate inflationary pressure weakening the exchange rate. Unless checked, such unsustainable policies may lead to a full-blown financial crisis.

<sup>1</sup> D. Woodward, *The Next Crisis? Direct and Equity Investment in Developing Countries* (London, Zed Books, 2001).

especially given the recent deterioration in the public financial balances in some of these countries (table 3.1.1).<sup>147</sup> Large current account deficits may become more problematic if FDI inflows dwindle (as already has happened in Hungary) or if the deficit on net investment income deepens. In addition, with privatization coming to an end in most of eastern Europe, the financing of large budget spending will become much more difficult to cover from tax revenues alone.

#### ***Increasing importance of reinvested earnings and transfers***

Another issue that has recently entered the public policy debates in eastern Europe concerns the flow of earnings to non-resident direct investors. Reinvested earnings are recorded twice: first as debits in the income balance of the current account, similarly like dividends or repatriated profits; and, secondly, as a countervailing

credit in the financial account where it is entered as an inflow of FDI. With the growth in the FDI stock, reinvested earnings begin to play a much more visible role in the balance of payments and at some point they may well start to dominate the total FDI inflow. As a result, the current account balance of such countries will be more exposed to decisions by foreign direct investors: to their dividend and investment policies or whether they repatriate or reinvest their profits in the host country.

Foreign direct investors in Hungary, for example, are currently reinvesting a little more than 50 per cent of their local profits, the rest being repatriated.<sup>148</sup> Similarly, reinvested earnings in the Czech Republic were \$2.7 billion in 2002 and \$3.4 billion as an estimate for 2003.

<sup>147</sup> As discussed in box 3.5.1, one of the main ingredients of a twin deficit crisis is the failure to channel the additionally mobilized resources into productive investments and/or into the growth-enhancing public investment.

<sup>148</sup> Until now, the Hungarian balance of payments statistics, contrary to the internationally accepted standard, omits reinvested profits (see also box 3.1.1). If an adjustment is made to include them, the Hungarian current account deficit would increase from 4.1 to 6.1 per cent in 2002 and from 6.4 to 8.6 per cent in 2003, respectively. Estimates published in Hungarian National Bank, *Quarterly Report on Inflation* (Budapest), November 2003, pp. 51-53.

When large current account deficits merely reflect large amounts of reinvested earnings by foreign direct investors, the deficits need not be a source of policy concern. On the contrary, they indicate not only that the local FDI ventures are highly profitable but also that investors consider them as worth expanding. In addition, there is no need to finance such “debts” through the foreign exchange market.<sup>149</sup>

Among the accession countries only Estonia had a current account deficit in 2003 above 10 per cent of GDP (for the second consecutive year), and which is financed mainly through short-term borrowing abroad by the commercial banks. Although confidence in the currency board, backed by Estonia’s credit rating of A1, remains high at the beginning of 2004, the economy nevertheless remains exposed to the risk of a sudden reversal of these flows, which in turn could cause a squeeze on the foreign exchange market.

EU enlargement will have important implications for the balance of current transfers of the acceding countries both as regards official and private transfers. Total official EU transfers to the eight acceding east European countries in the period 2004-2006 was set at the Copenhagen meeting in December 2002 at €39.9 billion (at 1999 prices).<sup>150</sup> The sum set aside for 2004 is €10.2 billion. After deducting the membership contributions of the eight countries, estimated for the three years at €14 billion, the net enlargement transfers for 2004-2006 could be as high as €26 billion.<sup>151</sup> The envisaged gross transfers amount to 3.6 per cent of the combined GDP of the acceding countries, ranging from 2.2 per cent for Slovenia to 7.1 per cent for Lithuania.<sup>152</sup> The planned allocations from the structural and cohesion funds are approximately 1.9 per cent of the countries’ GDP.<sup>153</sup> However, the planned budget figures represent mainly the EU commitment of funds, which is conditioned by various criteria and domestic co-financing. The effective financing in absolute amounts may thus turn out to be less generous than those implied by limits to the declared commitments. The overall impact of net EU transfers on the current account

balances of the new members is therefore difficult to estimate.<sup>154</sup>

As for private transfers, it can be expected that EU enlargement will raise substantially the importance of workers’ remittances to their home countries. Latvia and Slovenia were the only EU acceding and candidate countries where net private transfers in 2002 were more (by a small margin) than \$100 per capita. The amounts for the other countries were even lower: \$35 in Slovakia, around \$44 in Hungary and Lithuania, and \$55 in Bulgaria, the Czech Republic, Poland and Romania. For comparison, workers’ remittances to Portugal in 2002 were \$286 per capita.

Net private transfers have recently been growing rapidly in some of the acceding countries: thus in the Czech Republic, Estonia and Latvia the surplus more than doubled in a year. This growth could accelerate after May 2004 when the employment of their nationals in some EU countries or in some professions will become legal. However, according to most estimates, EU enlargement is not expected to result in high rates of labour migration from the new EU members, even when the enlarged EU labour market is fully deregulated after 2010.<sup>155</sup>

The south-east European countries have traditionally received larger net private transfers than the central European economies. Thus, in Albania, Croatia, Serbia and Montenegro and The former Yugoslav Republic of Macedonia, net private transfers in 2002 were between \$168 and \$238 per capita. Net current transfers to the 15 east European countries in 2003 are estimated at \$13 billion, of which \$7 billion accrued to the seven south-east European economies. For these economies, net private transfers are a major source of financing for their current account deficit. Thus in 2002, the surplus on transfers covered 39 per cent of their total merchandise trade deficit.

## (ii) International trade

### *East European export growth accelerates further in the second half of the year...*

In the third quarter of 2003, the volume of east European exports expanded at an estimated year-on-year rate of about 10 per cent, bringing the aggregate export

<sup>149</sup> J. Brada and V. Tomšík, *Reinvested Earnings Bias, The “Five Per cent” Rule and the Interpretation of the Balance of Payments – With an Application to Transition Economies*, University of Michigan, William Davidson Institute, Working Paper, No. 543, February 2003, available at [eres.bus.umich.edu/docs/workpap-dav/wp543.pdf].

<sup>150</sup> European Commission, *The Adjustment of the Financial Perspective for Enlargement*, COM(2003) 70 final (Brussels), 11 February 2003 [europa.eu.int/comm/budget/pdf/financialfrwk/enlarg/COM\_2003\_0070\_F\_E\_N\_ACTE.pdf].

<sup>151</sup> The cost of this to the population of the current 15 EU members amounts to approximately a maximum €26 per capita per annum.

<sup>152</sup> These numbers refer to the upper limit of the planned gross transfers.

<sup>153</sup> This is close to what the four poorest “cohesion” EU countries were receiving during the 1994-1999 period (some 2.2 per cent of their aggregate GDP).

<sup>154</sup> It could vary from zero up to 4 per cent of GDP in 2005, with an estimated average of 1.6 per cent for the whole group of acceding countries.

<sup>155</sup> As estimated by Boeri and Brücker, and later updated in a report for the European Commission, such migration in the first few years can be expected to add a mere 0.2 per cent a year to the labour supply in the current 15 EU members, subject to a declining trend. Labour mobility in the new EU member countries is expected to be even lower than it is among the old EU members. T. Boeri and H. Brücker, “Eastern enlargement and EU labour markets”, *World Economics*, Vol. 2, No. 1, 2001, pp. 49-68 and H. Brücker et al., *Potential Migration from Central and Eastern Europe into the EU 15 – An Update*, Report for the European Commission, DIW (Berlin), March, 2003.

TABLE 3.5.2

**Trade performance and external balances of eastern Europe, 2001-2003**  
(Rates of change and shares, per cent)

	Merchandise exports (growth rates)			Merchandise imports (growth rates)			Trade balance (per cent of GDP)		
	2001	2002	2003 Jan.-Sep.	2001	2002	2003 Jan.-Sep.	2001	2002	2003 Jan.-Sep.
<b>Eastern Europe</b> .....	10.8	13.7	27.6	9.0	12.0	26.3	-9.8	-9.2	-9.0
Albania .....	17.6	8.2	38.6	24.3	13.1	25.5	-23.7	-23.9	-22.6
Bosnia and Herzegovina .....	11.5	-2.5	43.8	7.5	12.0	24.1	-36.6	-39.4	-34.7
Bulgaria .....	6.0	11.2	32.2	11.6	8.8	39.4	-15.8	-14.2	-15.1
Croatia .....	5.3	5.0	24.8	16.0	17.1	31.8	-22.9	-25.9	-27.4
Czech Republic .....	15.0	15.0	26.4	13.3	11.7	25.2	-5.0	-3.2	-2.0
Estonia .....	4.1	3.5	31.1	0.8	11.4	35.5	-17.6	-20.9	-23.2
Hungary .....	8.6	12.6	19.4	5.0	11.7	25.6	-6.1	-5.0	-6.7
Latvia .....	7.3	13.9	25.9	10.0	15.2	30.5	-19.6	-21.0	-22.7
Lithuania .....	20.3	20.4	36.9	16.4	22.3	26.9	-14.9	-16.3	-13.3
Poland .....	14.0	13.6	27.1	2.7	9.6	21.1	-7.7	-7.5	-7.2
Romania .....	9.8	21.8	28.7	19.1	14.8	32.5	-10.4	-8.7	-10.4
Serbia and Montenegro .....	10.4	19.5	11.8	30.3	30.7	5.9	-25.7	-25.8	-20.4
Slovakia .....	6.7	14.4	52.0	16.0	12.6	37.4	-9.5	-8.3	-1.2
Slovenia .....	6.0	11.9	21.9	0.3	7.7	25.9	-4.6	-2.6	-3.5
The former Yugoslav Republic of Macedonia .....	0.3	-12.5	20.2	0.4	-19.1	16.7	-22.4	-14.5	-19.3
<i>Memorandum items:</i>									
<b>EU acceding countries</b> .....	11.4	13.7	27.6	7.1	11.4	25.6	-7.6	-6.9	-6.4
<b>Baltic states</b> .....	11.7	13.4	32.8	9.7	17.2	30.3	-16.9	-18.7	-18.2
<b>Central Europe</b> .....	11.4	13.7	27.1	6.8	10.8	25.2	-6.9	-6.0	-5.4
<b>South-east Europe</b> .....	7.8	13.8	27.6	16.6	14.2	28.7	-17.7	-17.5	-18.0

*Source:* UNECE secretariat calculations, based on national statistics and direct communications from national statistical offices.

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

volume for the first nine months to 9 per cent above its 2002 level.<sup>156</sup> In current dollars the region's exports grew by 28 per cent in January-September (table 3.5.2), largely reflecting the substantial depreciation of the dollar; in current euros – in which more than 70 per cent of the region's exports are traded – the increase was much more moderate, about 6 per cent. The dollar unit values of exports increased by 17-18 per cent on average and the terms of trade of the region as a whole improved slightly.

Except for a few economies (Croatia and Latvia among them), the growth of export volume picked up in the third quarter, reversing the slowdown that started at the end of 2002 (chart 3.5.1). East European exporters were helped by the gradual recovery of west European demand; they also were successful in increasing exports to the more dynamic intraregional markets and to other developed economies during this period (tables 3.5.3 and 3.5.4). Moreover, in the course of 2003 there was a pronounced improvement of the competitive position of several east European exporters in their major markets.

This was particularly true of Poland, where the zloty had depreciated considerably in real effective terms since the end of 2001 and the fall of unit labour costs in industry accelerated (tables 3.3.2 and 3.5.4 and chart 3.1.2). Price and cost competitiveness also improved in the Czech Republic and Latvia, but in Bulgaria and Lithuania, where the decline in unit labour costs was quite significant in January-September 2003, the pegging of their currencies to the euro to some extent worsened their export price competitiveness in dollar-denominated markets (such as the CIS and developing countries). Due to their still relatively high exposure to these markets, the price-based real effective exchange rates of the lev and the litas appreciated perceptibly in 2002-2003 (chart 3.1.2).

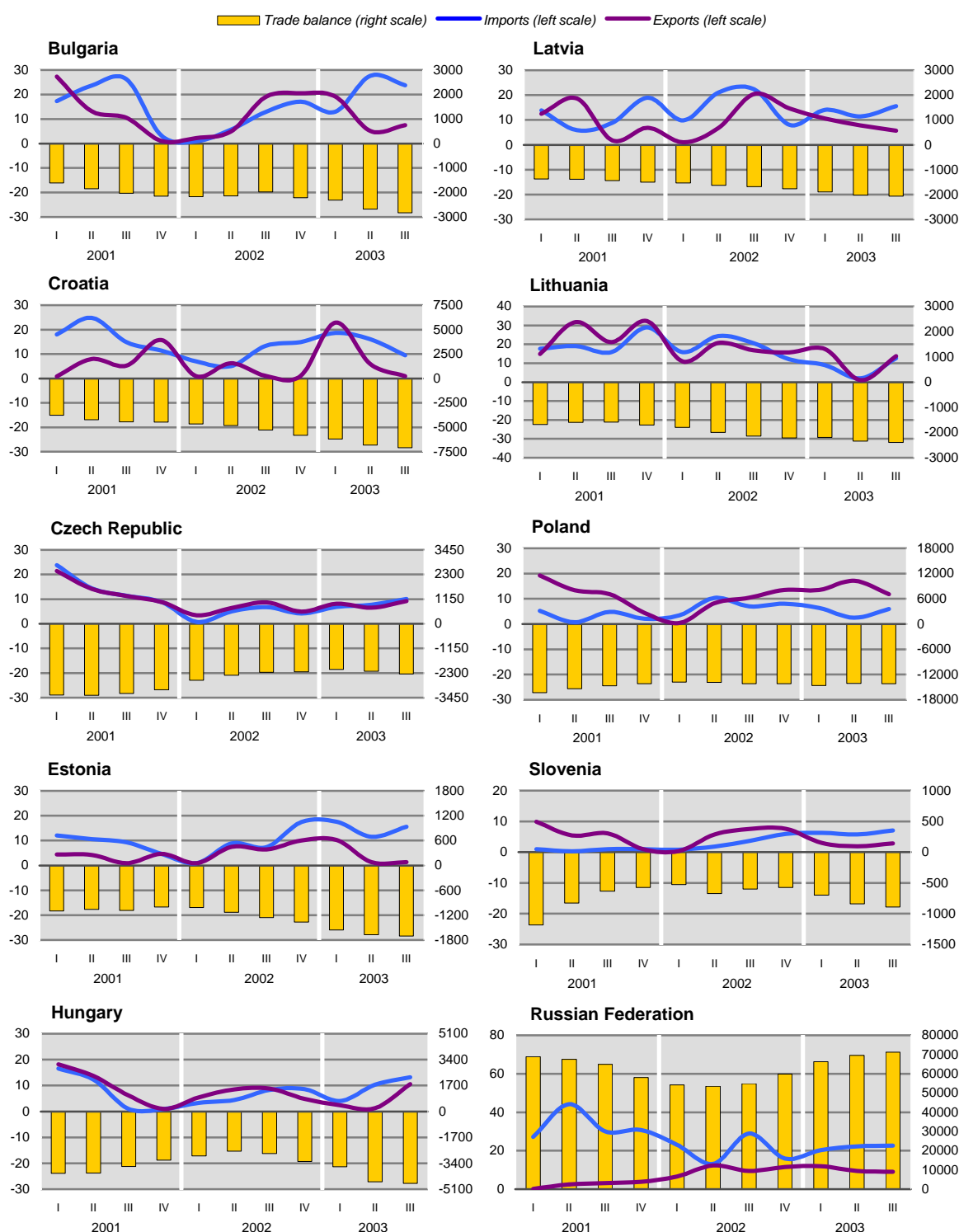
In Hungary, the strong appreciation of the forint in real effective terms in 2001-2002 had forced the exporting sector to accept a serious squeeze on profit margins in order to maintain export price competitiveness, prompting some multinational companies to relocate part of their production to Asia in 2002 and early 2003 due to the considerable rise in Hungarian unit labour costs.<sup>157</sup> This

<sup>156</sup> The analysis below is based on customs data for merchandise trade, which differ (noticeably in some cases) from the balance of payments statistics of trade in goods. Estimates of aggregate volume growth are based on data for the 11 east European economies presented in table 3.5.4.

<sup>157</sup> The biggest impact was the relocation to China of Microsoft's Xbox game console production in June 2002; IBM closed its hard disk production facility in Hungary and several smaller foreign subcontractors, not only in the electronics sector, but also in clothing and footwear, followed suit. The decline of exports of "other manufactured goods" depicted in chart 3.5.2 reflects these developments.

CHART 3.5.1

Merchandise trade flows and balances in selected east European countries and Russia, 2001QI- 2003QIII  
 (Trade balance in million dollars, percentage change of export and import volumes over same quarter of the previous year)



Source: UNECE secretariat calculations, based on national statistics.

Note: Merchandise trade balances at the end of the quarter cumulated over 12 months. Volume changes as reported by countries or estimated from changes in average export and import prices (unit values) and trade values.

development was reversed to some extent in 2003: the Hungarian forint depreciated in the second and third quarters, year-on-year, in real effective terms, and the rise

of unit labour costs has been arrested. The currencies of Estonia, Slovakia, Slovenia, and the majority of south-east European countries, in contrast, appreciated in real



TABLE 3.5.3

**Foreign trade of eastern Europe by direction, 2001-2003**  
(Value in billion dollars, growth rates in per cent)<sup>a</sup>

Country or country group <sup>b</sup>	Exports				Imports			
	Value 2002	Growth rates			Value 2002	Growth rates		
		2001	2002	2003 <sup>c</sup>		2001	2002	2003 <sup>c</sup>
<b>Baltic states, to and from:</b>								
World .....	11.2	11.8	13.4	32.8	16.6	9.7	17.2	30.3
Eastern Europe and CIS .....	3.3	23.4	8.4	27.1	5.4	9.4	12.6	39.2
CIS .....	1.5	40.9	15.2	16.6	3.0	4.5	6.7	40.4
Baltic states .....	1.4	10.0	8.3	37.0	1.1	15.7	26.0	35.4
Central and south-east Europe .....	0.4	24.0	-9.5	31.9	1.2	19.0	17.1	40.0
Developed market economies .....	7.3	5.1	14.6	37.5	9.7	5.6	18.9	26.0
European Union .....	6.4	4.7	11.5	25.1	8.4	5.5	18.4	24.5
Developing economies .....	0.6	49.2	31.9	4.6	1.5	49.8	24.2	26.4
<b>Central Europe, to and from:</b>								
World .....	138.6	11.4	13.7	27.1	161.0	6.8	10.8	25.2
Eastern Europe and CIS .....	29.0	17.6	14.1	31.4	31.6	5.3	5.6	29.9
CIS .....	6.2	30.3	14.3	25.7	13.5	0.2	-0.2	28.8
Baltic states .....	1.6	8.9	20.9	36.6	0.4	-13.0	-10.6	43.7
Central and south-east Europe .....	21.2	15.0	13.6	32.6	17.8	10.6	11.0	30.5
Developed market economies .....	103.4	10.5	13.3	27.0	109.1	6.1	8.9	23.0
European Union .....	95.2	10.9	13.3	25.8	95.4	6.9	9.6	23.3
Developing economies .....	6.2	0.3	18.3	10.5	20.2	15.8	33.7	30.0
<b>South-east Europe, to and from:</b>								
World .....	29.0	7.8	13.8	27.6	48.7	16.6	14.2	28.7
Eastern Europe and CIS .....	5.5	-1.1	5.8	32.1	13.0	8.4	9.6	32.3
CIS .....	0.6	-3.9	-23.6	17.9	5.4	7.5	1.0	27.5
Baltic states .....	0.0	22.2	4.0	35.4	0.0	-18.7	36.8	79.9
Central and south-east Europe .....	4.8	-0.7	11.2	34.4	7.6	9.2	16.8	35.6
Developed market economies .....	19.3	13.3	13.6	29.0	29.3	19.7	13.8	30.6
European Union .....	17.3	13.5	14.3	29.5	26.3	20.7	15.4	31.2
Developing economies .....	4.2	-2.8	27.4	23.7	6.5	22.1	27.2	40.7
<b>Eastern Europe, to and from:</b>								
World .....	178.8	10.8	13.7	27.6	226.3	9.0	12.0	26.3
Eastern Europe and CIS .....	37.8	14.7	12.3	31.1	50.0	6.5	7.4	31.5
CIS .....	8.2	27.1	10.4	23.4	22.0	2.5	1.0	30.2
Baltic states .....	3.0	9.6	14.4	36.8	1.5	4.6	14.7	37.9
Central and south-east Europe .....	26.5	11.9	12.7	32.9	26.6	10.5	12.8	32.2
Developed market economies .....	130.0	10.6	13.4	27.9	148.0	8.4	10.4	24.5
European Union .....	118.8	10.9	13.3	26.3	130.1	9.2	11.3	24.8
Developing economies .....	11.0	0.8	22.3	14.8	28.2	18.9	31.6	31.9

**Source:** National statistics and direct communications from national statistical offices to UNECE secretariat.

<sup>a</sup> Growth rates are calculated on values expressed in dollars.

<sup>b</sup> For country groups see table 3.2.1.

<sup>c</sup> January-September 2003 over same period of 2002.

effective terms in January-September 2003. If in Estonia and Slovenia the ongoing appreciation seems to have dampened the growth of exports,<sup>158</sup> in Slovakia the impact is not yet visible.

In Slovakia, as well as in many other east European countries, capacities and competitiveness in the exporting sectors have been enhanced considerably in recent years by inflows of FDI, while close integration with the

production networks of multinational companies has helped to smooth the impact of faltering demand on western markets in the past two years.<sup>159</sup> In fact,

<sup>158</sup> The damaging effect of the appreciation of the Estonian kroon is best seen in the poor performance of exports related to foreign subcontracting activities: those of textiles and textile articles were 4.5 per cent down in euro terms in January-November 2003, year-on-year, and those of machinery and electrical equipment and their parts were virtually stagnant. These two groups account for about three quarters of exports after inward processing, which in turn makes up about 30 per cent of total Estonian exports (special reporting system).

<sup>159</sup> However, in the case of Estonia the reliance on subcontracting and its overexposure to a single foreign investor in the manufacturing (exporting) sector – at the beginning of 2001, mobile communication equipment and its components produced by a subsidiary of the Finnish multinational company Elcoteq accounted for about a quarter of Estonia's total export revenues – proved to be rather risky: in mid-2001, Elcoteq, faced with plummeting demand for mobile phones, closed one of its Estonian production plants and reduced production in the second for more than a year (production was partly relocated to a Chinese subsidiary). In the last quarter of 2002 the company restarted its production in Estonia, but only at reduced capacity. The swings in Estonia's export volume growth depicted in chart 3.5.1 clearly reflect the impact of these Elcoteq decisions. In fact, even after five consecutive quarters of growth, Estonia's export volume in January-September 2003 was still some 15-16 per cent below its 2000 level.

TABLE 3.5.4

**Factors affecting the foreign trade performance of selected east European countries, 2002-2003**  
(Changes in per cent against same period of the previous year, shares in per cent)

	Demand conditions						Price competitiveness				Outcomes					
	Domestic demand <sup>c</sup>		Partner's demand <sup>a</sup>				Real effective exchange rate <sup>d</sup>		Export unit values <sup>e</sup>		Export volume growth by markets <sup>b</sup>				Share in extra-EU imports <sup>f</sup>	
			Western market economies		East European and CIS economies						Western market economies		East European and CIS economies			
	2002	2003	2002	2003	2002	2003	2002	2003 <sup>g</sup>	2002	2003 <sup>g</sup>	2002	2003 <sup>g</sup>	2002	2003 <sup>g</sup>	2002	2003 <sup>g</sup>
Bulgaria .....	5.0	7.6	1.8	3.3	7.6	11.3	-3.5	0.4	0.1	19.7	12.9	11.7	-9.0	9.6	0.37	0.36
Croatia .....	5.5	6.4	0.7	1.8	4.8	6.1	3.0	1.5	4.6	17.3	-4.8	12.4	10.1	4.6	0.25	0.26
Czech Republic .....	3.2	3.9	0.1	2.1	5.9	11.6	9.1	-3.8	8.9	17.3	5.1	8.3	3.5	7.5	2.79	3.02
Estonia .....	10.3	8.1	0.5	2.0	8.4	12.7	-0.3	5.5	4.9	25.8	-2.6	5.8	10.8	13.5	0.30	0.31
Hungary .....	8.4	5.8	0.0	2.2	6.8	10.8	16.8	-2.2	6.3	14.0	7.1	1.6	5.0	18.0	2.56	2.59
Latvia .....	7.1	8.1	0.9	2.0	10.6	11.0	9.5	-8.1	4.3	16.6	11.8	10.0	7.5	5.6	0.20	0.21
Lithuania .....	6.1	8.0	1.6	2.1	7.6	14.1	11.5	-1.4	3.3	24.4	22.0	17.6	1.8	-0.6	0.28	0.30
Poland .....	1.0	1.3	0.2	2.1	8.0	11.7	-6.8	-15.7	4.9	11.4	7.8	12.3	13.5	17.8	2.86	3.11
Romania .....	4.0	6.6	1.3	2.4	6.1	11.9	-3.5	-0.1	3.7	..	18.1	..	-3.2	..	1.06	1.12
Slovakia .....	3.5	-0.2	0.2	2.1	5.1	8.7	2.9	8.1	4.8	33.5	9.6	16.9	3.0	4.3	0.98	1.23
Slovenia .....	1.4	3.6	0.3	2.1	6.6	9.6	4.9	5.9	6.1	18.8	2.1	2.1	12.2	4.0	0.69	0.75

*Source:* UNECE secretariat computations, based on national statistics. Figures for 2003 are estimates, based on January-September data unless otherwise noted.

<sup>a</sup> Aggregation of the import volume growth rates of individual western and transition countries, respectively, weighted by their share in the exports of each transition country in 2002. The import data refer to goods and services on a national accounts basis, except for a few CIS countries for which, in the absence of real import data, GDP growth rates were used as a proxy. Western market economies include western Europe, North America, Turkey and Japan; data for 2003 are based on national forecasts.

<sup>b</sup> For Hungary and Poland as reported by national statistics, for the rest of the countries calculated on the basis of changes of average export unit values and export values by partners. For Slovakia, estimates are based on average changes in unit values for HS 2-digit commodity groups and the actual commodity structure of exports to western and eastern partners in 2002.

<sup>c</sup> Growth of final domestic demand in exporting country (consumption + gross fixed capital investment). Data for 2003 refer to January-June for Latvia and Romania.

<sup>d</sup> Deflated by unit labour costs. Calculated on the basis of quarterly indices as in chart 3.1.1.

<sup>e</sup> Changes in dollar unit values calculated from reported changes in export unit values in national currencies and respective exchange rates.

<sup>f</sup> Computations based on EU import data as reported by Eurostat (Intra- and extra-EU trade, CD-ROM No. 12, 2003).

<sup>g</sup> January-September.

supported by their geographical proximity and still competitive labour costs, some east European countries have markedly increased their share of west European markets in 2002-2003, particularly in the EU (table 3.5.4). According to Eurostat data, EU imports (in current euros) from eastern Europe rose nearly 8 per cent in January-September 2003, year-on-year, following average annual increases of 10 per cent in 2001 and 2002, while total extra-EU imports remained virtually unchanged (in 2003) or even declined (in 2001-2002).<sup>160</sup>

#### *...but performance varies across countries*

The strongest export growth in the first nine months of 2003 was in Slovakia (tables 3.5.2-3.5.4).<sup>161</sup> Slovak export growth was backed by very strong sales to the EU, which rose 50 per cent in dollar value and about 17 per cent in volume,<sup>162</sup> and by large increases to CIS countries,

particularly to Russia (up 70 per cent in dollar value). According to European Union data, purchases from Slovakia were among the fastest-growing extra-EU imports in January-September 2003 (27 per cent year-on-year increase in euros). This increase was mainly due to an increase in the production capacities of VW Slovakia. Thus, the strengthened position of Slovakia on EU markets is very narrowly based both geographically and in commodity terms: in January-September 2003, three quarters of EU imports from Slovakia went to Austria and Germany, road vehicles and their components and parts accounting for nearly 40 per cent of Slovakia's exports to the EU.<sup>163</sup> In the same period, Slovak exports of road vehicles to Russia increased nearly tenfold in current dollars. (A more detailed account of export growth by major commodity groups in several east European countries is presented in chart 3.5.2.)

Exports to the EU from Poland also increased rapidly, and those to Poland's major EU market – Germany – were

<sup>160</sup> Eurostat, Euroindicators, *News Release*, No. 150/2003, 19 December 2003 and Eurostat, Comext, *Intra- and Extra-EU Trade*, CD-ROM No. 12, 2003.

<sup>161</sup> On 29 January 2004, Slovakia's Customs Directorate announced the forthcoming revision of export data for September-December 2003 due to some irregularities in customs declarations processing.

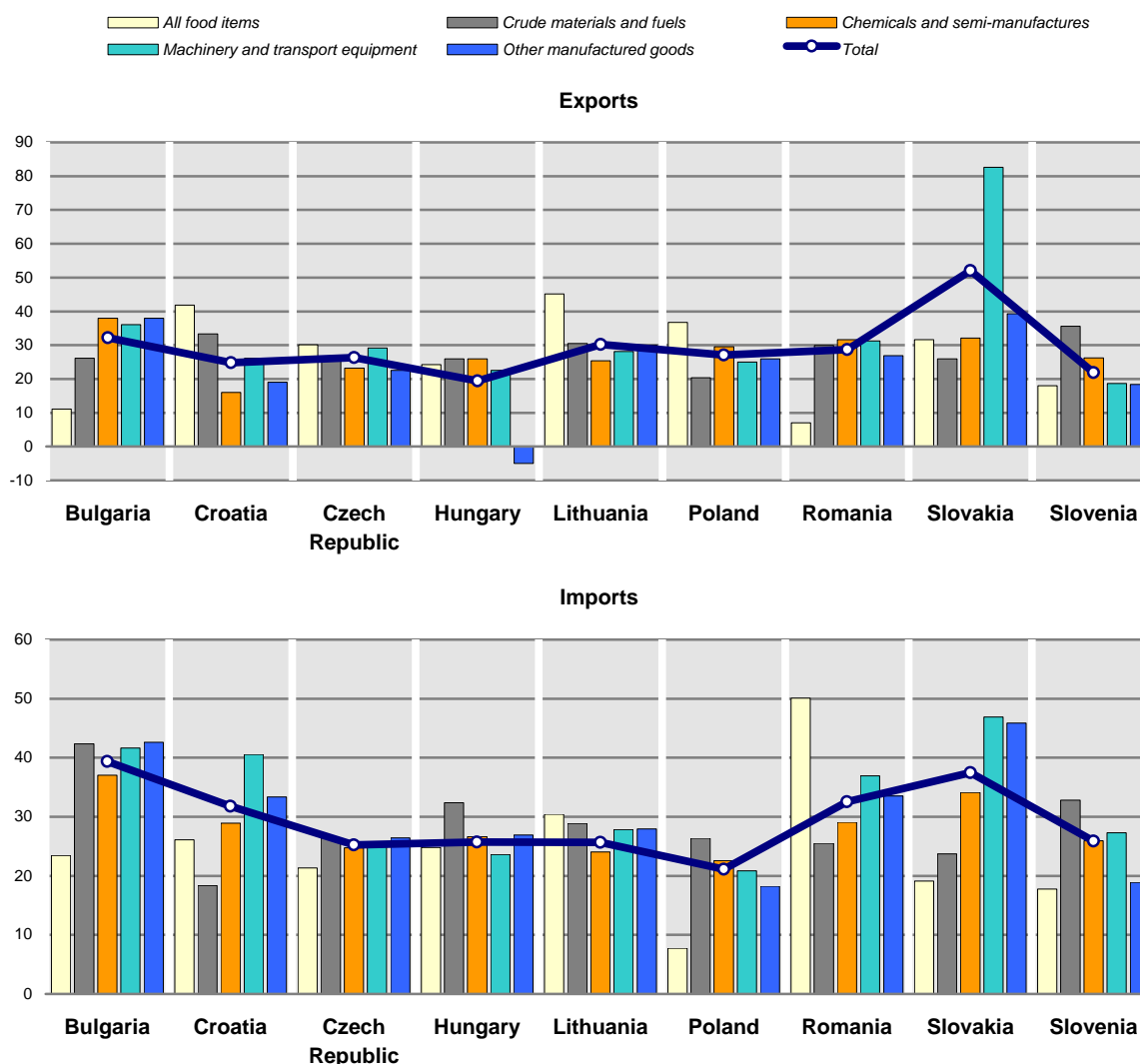
<sup>162</sup> Estimated export dollar unit values for the Slovak goods sold on the EU markets increased some 33-35 per cent in January-September

2003, year-on-year. Such a sharp rise was mainly due to the sales of a new higher class car model (VW Touareg) that VW Slovakia introduced in 2003; the company produced some 50,000 VW Touaregs in 2003 (a quarter of the total number of cars produced) and foresees a 50 per cent expansion in 2004.

<sup>163</sup> Eurostat, Comext, op. cit.

CHART 3.5.2

Growth of exports and imports by major commodity groups in selected east European countries, January-September 2003<sup>a</sup>  
(Per cent)



Source: National statistics.

Note: Foreign trade growth is measured in current dollars. Commodity groups are Sections of the United Nations Standard International Trade Classification (SITC, Rev.3): all food items (0+1+4); crude materials and mineral fuels (2+3); chemical products and semi-manufactures (5+6); machinery and transport equipment (7); other manufactured goods (8).

<sup>a</sup> Over January-September 2002.

up 11 per cent in volume in January-September 2003 despite sluggish import demand in the latter. Polish exports to its east European partners also rose by nearly 25 per cent. Volumes increased in almost all major commodity groups to both western and eastern markets.<sup>164</sup> There was also a strong and broadly-based expansion of Czech exports to all major partners in the first nine months of 2003 and a further acceleration in the months that followed, although exports under foreign subcontracting fared relatively poorly. Slovene and Hungarian exporters also expanded sales to their eastern

neighbours – the CIS (up nearly 25 per cent in volume terms in Hungary), CEFTA and some south-east European countries; exports to the EU, however, practically stagnated in Slovenia and increased less than 2 per cent in Hungary, year-on-year, in volume.<sup>165</sup>

In the Baltic states, there was a deceleration of export growth in the first half of 2003 followed by an upturn in the following months in Lithuania and probably

<sup>164</sup> The two exceptions were falls of 5 per cent in Polish exports of fuels (SITC 3) to the EU and 10 per cent falls in exports of beverages and tobacco (SITC 2) to east European partners.

<sup>165</sup> In the case of Hungary, the low growth rate largely reflects a base-period effect. Since the high-base effect had diminished by the third quarter, the growth of exports to the EU for the year as a whole is expected to be higher. In fact, the year-on-year average monthly growth rates of exports to the EU were above 5 per cent in volume in the third quarter of 2003 and had accelerated to 12 per cent in October.

also in Estonia. The cause of the poor Lithuanian export performance on eastern markets (table 3.5.4) was a nearly 30 per cent fall in exports of refined petroleum products to the CIS and a 12-15 per cent decline in volume of exports of passenger cars to Russia, whereas exports of other major commodities were selling well on both eastern and western markets (chart 3.5.2).<sup>166</sup> Although Estonia's exports under foreign subcontracting declined in January-September 2003 (affecting mainly exports to western markets), as already mentioned, the country's direct exports (i.e. excluding those related to inward and outward processing) were slowly gaining momentum in the course of the year and increased by some 8-10 per cent in volume, with machinery and electrical equipment increasing most. Since Estonia's trade with the CIS and eastern Europe is dominated by direct exports, the latter benefited from the strong demand in those markets (table 3.5.4 and sections 3.2 and 4.2). Latvia's exports to western markets, which are dominated by timber and timber products (nearly 50 per cent of exports to the EU) and textile articles under foreign subcontracting, also grew strongly.

Among the south-east European countries, Bulgarian and Romanian exports grew rapidly in January-September 2003. Exports of both countries rely extensively on outward processing trade (OPT) with western Europe (mainly textiles and clothing, but also some electrical machinery), and those continued to grow thanks to still relatively low labour costs. Traditional exports of foods and agricultural products, however, declined in volume in both countries, due to poor harvests and restrictions on grain exports.<sup>167</sup> In Croatia, the 7-8 per cent volume growth of exports in January-September 2003 mainly reflected a low base period in the first part of the year; in the third quarter, exports declined in volume, but seemed to be recovering momentum in the months that followed. Serbia and Montenegro was the only country where, after a short-lived boom in the first quarter, exports declined in volume in the first nine months of the year. Exports from other south-east European countries – Albania, Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia – were

rising, despite the fact that there was a continuing struggle to restore the industrial infrastructure of these economies (section 3.2).

### *Import demand remains strong*

In the first nine months of 2003, east European imports were supported by the generally strong growth of domestic demand, but it was also driven by exporter's requirements for inputs and capital goods and, in a few countries, by the strong appreciation of domestic currencies (table 3.5.4 and section 3.2). In aggregate, imports grew more or less in line with exports in volume but lagged slightly behind in value; and similar to exports, import growth accelerated during the third quarter, mainly under the influence of stronger import demand in Poland.

However, the growth of imports varied from country to country. The aggregate figures hide the deceleration of import growth in Croatia and Romania from the second quarter of 2003 and the more recent downturn in Bulgaria, which coincided with a slowdown in export growth in all three countries. In Croatia, a slowdown in domestic consumption growth was an important factor behind the subdued import growth in the second half of the year (chart 3.5.1 and table 3.2.2). A slower growth of imports was also perceptible in other south-east European countries where it was weaker than that of exports in 2003.

Boosted by buoyant private consumption Hungarian imports of food products and manufactured consumer goods grew vigorously in the first nine months of 2003, while those of machinery and equipment were affected by a subdued investment activity (chart 3.5.2 and table 3.2.2).<sup>168</sup> Imports, backed by strong domestic demand, also outpaced exports in Latvia and Slovenia while Czech import volumes moved more or less in parallel with exports. However, the dynamics of commodity flows in Czech imports and exports differed; thus, in comparison with exports, imports of manufactured consumer goods grew more rapidly boosted by booming private consumption, while those of machinery and equipment lagged behind.

Similarly to Slovenia, Estonia's high levels of investment in the renovation of the transport infrastructure and various other projects boosted imports of machinery and transport equipment, particularly in the first quarter.<sup>169</sup> The persistent strength of private consumption in Estonia, backed by increased wages and household borrowing, led to a considerable upsurge in

<sup>166</sup> The swings in the volumes and destinations of Lithuania's exports of refined petroleum products (which are actually re-exports after processing) largely depend on the Russian crude oil providers who are the major stake-holders in the Mazeikiiai refinery. Thus, for instance, after their decision to redirect most of Mazeikiiai refinery petroleum exports through Switzerland, Lithuanian exports of refined petroleum to the EU fell nearly twentyfold in January-September 2003, year-on-year, according to the customs data, from €472.5 million to €25 million, with quite a detrimental effect on the overall exports to the EU. At the same time, Switzerland became the most important single export partner, accounting for 11.5 per cent of total Lithuanian exports. Refined petroleum products accounted for 18.5 per cent of Lithuania's total exports in 2002. Cutbacks in passenger car exports to Russia (predominantly re-exports of second-hand vehicles) was due mainly to Russia's protectionist measures imposed in 2003 (new car registering rules and high fees for second-hand vehicles among them).

<sup>167</sup> In 2003, Bulgarian grain exporters were first subject to a state export duty and then, later in the year, to a complete ban on grain exports following the bad harvest. Bulgaria was a net importer of grain in 2003.

<sup>168</sup> According to preliminary figures released by the local car importers association (MGE), sales of new passenger cars are estimated to have risen by 21 per cent in 2003. World Markets Research Centre, *Daily Analysis*, 13 January 2004, reported in Dow Jones Reuters Business Interactive (Factiva).

<sup>169</sup> According to the Bank of Estonia, more than a quarter of capital goods imported in January-March 2003 consisted of untypical, one-off purchases: railway engines, freight cars and a passenger boat.

passenger car imports and other manufactured consumer goods (furniture, clothing, etc.). Imports for inward processing, however, were virtually stagnant in January-September 2003 (mainly reflecting a sharp deceleration in imports of components and parts for mobile communication equipment).

In the first three quarters of 2003, private consumption was relatively subdued in Poland and Slovakia and this had a strong impact on imports of food, beverages and tobacco in both countries and also imports of durable consumer goods in Poland (a fall of 2 per cent in volume).<sup>170</sup> In total, Polish imports grew by 5 per cent in volume compared with 14 per cent for exports. In Slovakia, the growth in total imports reflected a large increase in inputs for the car industry, which are included in “machinery and equipment” as well as in “other manufactured goods” in chart 3.5.2. By the third quarter, however, imports were gathering momentum in Lithuania and Poland, spurred by increased investment (chart 3.5.1 and section 3.2). Capital goods imports are expected to have increased in Slovakia by the end of the year due to the start of a large FDI project.

#### *Merchandise trade deficits continue to widen*

In those economies with rapidly growing imports there was a considerable widening of merchandise trade deficits, both in value terms and in relation to GDP (Estonia and Hungary among them), while in the other east European countries deficit-to-GDP ratios generally improved. Only in Slovakia was the deficit markedly smaller than a year earlier thanks mainly to its rising surplus in trade with the developed market economies. In fact, the aggregate east European deficit in trade with western Europe narrowed markedly from \$6.4 billion in January-September 2002 to \$5.8 billion a year later.

Except for Poland and Hungary, the terms of trade improved or remained unchanged across the region, partly as a result of somewhat lower prices for imports of intermediate and manufactured goods originating from outside western Europe (an effect of the weak dollar).<sup>171</sup> On the export side, however, the increased competitive pressures in international markets for manufactured goods generally inhibited price increases which followed closely those in western Europe (except in the case of Slovakia, see footnote earlier in this section). Since world market prices of major international commodities (excluding cereals, foods, beverages and tobacco) rose more than the average dollar prices of manufactured

goods exported by European countries, the terms of trade of several south-east European countries as well as Latvia and Lithuania, which rely more on commodity exports, improved more noticeably.<sup>172</sup>

#### **(iii) External financing and FDI**

##### *The composition of foreign financing is changing*

In January-September 2003, net financial flows to eastern Europe amounted to \$27 billion, somewhat less than during the same period of 2002 (table 3.5.5). Probably the record level of net financial flows in 2002 will be difficult to match in the near future as privatization in the region (an important attraction for foreign investment) has already passed its peak.<sup>173</sup> It is therefore not unreasonable to expect that the present rate of net external financing (on average, between 6-7 per cent of GDP) will tend to stabilize or even decline. The rates of domestic saving are generally high in the majority of these countries and their reliance on large financial injections from abroad is likely to diminish in the future. What is more important now is the quality and composition of foreign capital inflows: the proper match between external and domestic resources and the type of spillovers generated by foreign capital in the domestic markets.

In 2003 there was a notable shift in the direction of FDI in different east European subregions. While FDI flows to the south-east European countries increased significantly, the net balance of FDI in acceding countries decreased sharply as a result of rising outflows and a decline of inflows to all the central European economies in the first three quarters of the year (tables 3.5.6 and 3.5.9). Other financial flows to eastern Europe were rather volatile (not only in 2003 but also in previous years). For example, in 2002-2003 the absorption of short-term funds increased in most of the acceding countries, especially in the Czech Republic, Estonia, Hungary and Poland, whereas the demand for long-term funds and portfolio investments was more pronounced in countries with smaller FDI inflows (such as the south-east European economies). With a net contribution of \$4.9 billion in the first nine months of 2003, long-term and portfolio investments were the most important source of external financing in south-east Europe. In virtually all 15 countries, effective financial flows (net of changes in reserves) exceeded the absolute value of current account

<sup>170</sup> Interestingly, this did not affect imports of passenger cars, which increased year-on-year by some 29 per cent in current dollar value in January-September 2003. New passenger car registrations soared in Poland in anticipation of price increases in 2004 in the aftermath of EU accession.

<sup>171</sup> Imports from dollar-dominated markets account for a third of total imports in the Baltic countries and for more than a quarter in central and south-east European countries; the commodity composition of these imports is generally dominated by intermediate goods, lower value added manufactures, raw materials and fuels.

<sup>172</sup> In 2003, world raw material prices were on average some 14.5 per cent above their 2002 level; prices for industrial and agricultural raw materials rose by 17 and 21 per cent, respectively, and those for beverages and tobacco and food by 4 and 8 per cent (direct communication from Hamburg Institute of Economic Research (HWWA), see also chap. 2.1). In the first nine months of 2003, average export unit values for European manufactured goods were some 10.7 per cent above their dollar level of a year earlier. United Nations, *Monthly Bulletin of Statistics*, December 2003.

<sup>173</sup> Between 1992 and 2002 the net financial inflows effectively absorbed by the economies (i.e. excluding the additions to official reserves) increased more than tenfold to \$41.5 billion in 2002.

TABLE 3.5.5  
Net financial flows into eastern Europe, 2001-2003  
(Million dollars, per cent)

	Capital and financial account flows <sup>a</sup>						Change in official reserves <sup>b</sup>		Change in reserves/GDP <sup>b</sup>	
	Million dollars				Capital flows/GDP		(million dollars)		(per cent)	
	2001	2002	Jan.-Sep.		2002	2003	2002	2003	2002	2003
			2002	2003						
<b>Eastern Europe</b> .....	29 537	41 349	29 641	27 099	8.0	6.1	15 436	7 840	3.0	1.8
Albania .....	363	435	322	336	9.0	7.6	29	79	0.6	1.8
Bosnia and Herzegovina .....	2 067	1 620	969	1 449	29.9	29.3	-109	47	-2.0	0.9
Bulgaria .....	1 117	1 299	413	1 428	8.4	10.1	586	595	3.8	4.2
Croatia .....	2 038	2 605	1 541	1 265	11.6	6.0	697	742	3.1	3.5
Czech Republic .....	5 038	11 043	9 528	4 025	15.0	6.5	6 627	364	9.0	0.6
Estonia .....	292	854	550	960	13.1	15.6	55	62	0.8	1.0
Hungary <sup>c</sup> .....	1 658	872	-168	5 131	1.3	8.5	-1 784	1 249	-2.7	2.1
Latvia .....	1 037	649	414	741	7.7	10.2	2	92	0.0	1.3
Lithuania .....	899	1 157	681	981	8.4	7.6	423	226	3.1	1.8
Poland .....	6 728	7 339	5 947	4 401	3.9	2.9	639	1 437	0.3	1.0
Romania .....	3 707	3 327	2 365	3 076	7.3	8.1	1 802	1 245	3.9	3.3
Serbia and Montenegro <sup>d</sup> .....	1 139	2 842	2 171	2 459	18.1	16.9	1 111	1 068	7.1	7.4
Slovakia .....	1 890	5 585	3 988	331	23.1	1.4	3 646	258	15.1	1.1
Slovenia .....	1 245	1 529	766	265	7.0	1.3	1 842	330	8.4	1.6
The former Yugoslav Republic of Macedonia .....	321	195	152	250	5.3	7.4	-131	46	-3.5	1.4
<i>Memorandum items:</i>										
<b>EU acceding countries</b> .....	18 785	29 027	21 708	16 836	7.2	4.9	11 451	4 018	2.8	1.2
<b>Baltic states</b> .....	2 227	2 660	1 645	2 683	9.3	10.2	480	380	1.7	1.4
<b>Central Europe</b> .....	16 558	26 367	20 062	14 154	7.1	4.5	10 971	3 638	2.9	1.2
<b>South-east Europe</b> .....	10 752	12 322	7 933	10 263	10.9	10.2	3 985	3 822	3.5	3.8

Source: UNECE secretariat calculations, based on national balance of payments statistics; IMF, *Balance of Payments Statistics* (Washington, D.C.) and IMF country studies.

<sup>a</sup> Includes errors and omissions; excludes changes in official reserves.

<sup>b</sup> A negative sign indicates a decrease in reserves.

<sup>c</sup> Excludes reinvested profits (net inflow).

<sup>d</sup> For 2003, excluding Montenegro.

TABLE 3.5.6  
Net financial flows by type of capital into eastern Europe, 2000-2003  
(Billion dollars)

	EU acceding countries <sup>a</sup>				South-east European countries <sup>b</sup>			
	2000	2001	2002	Jan.-Sep. 2003	2000	2001	2002	Jan.-Sep. 2003
Capital and financial account <sup>c</sup> .....	19.2	14.3	27.4	16.4	6.7	9.3	13.1	10.6
Capital and financial account <sup>d</sup> .....	22.0	18.8	29.0	16.8	6.8	10.8	12.3	10.3
<i>of which:</i>								
FDI .....	17.3	17.4	20.2	5.8	3.6	4.3	3.6	4.3
Portfolio investment .....	1.7	3.3	1.3	0.8	0.6	1.2	-	1.4
Medium-, long-term funds .....	2.5	-1.6	0.4	1.9	2.9	2.5	4.7	3.5
Short-term funds .....	-2.7	-5.1	5.1	7.9	-1.0	0.6	3.8	0.7
Errors and omissions .....	2.8	4.4	1.6	0.4	0.1	1.5	-0.8	-0.4
Capital account .....	0.4	0.3	0.3	-	0.5	0.6	0.8	0.5
Short-term investment <sup>e</sup> .....	1.8	2.6	8.1	9.1	-0.3	3.3	3.1	1.8

Source: UNECE secretariat estimates, based on national balance of payments statistics.

<sup>a</sup> Includes Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

<sup>b</sup> Includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia and Montenegro and The former Yugoslav Republic of Macedonia.

<sup>c</sup> Excluding errors and omissions and the change in official reserves.

<sup>d</sup> Including errors and omissions, but excluding the change in official reserves.

<sup>e</sup> Includes portfolio investments, short-term funds and errors and omissions.

TABLE 3.5.7  
Selected external financial indicators for eastern Europe, 2001 and 2003  
(Million dollars, per cent)

	Gross debt, national data		Gross debt/exports		Gross debt/GDP		Official reserves				Net debt relative to	
	(million dollars)		(per cent) <sup>a</sup>		(per cent)		Million dollars		Months of imports <sup>a</sup>		gross debt (per cent)	
	2001	2003 <sup>b</sup>	2001	2003 <sup>b</sup>	2001	2003 <sup>b</sup>	2001	2003 <sup>b</sup>	2001	2003 <sup>b</sup>	2001	2003 <sup>b</sup>
<b>Eastern Europe</b> .....	212 605	292 536	106	102	46	47	79 922	121 096	4.0	4.3	62	59
Albania <sup>c</sup> .....	1 199	1 300*	120	87*	28	22*	740	949	5.0	4.4	38	27*
Bosnia and Herzegovina <sup>c</sup> ...	2 600	2 700*	137	110*	56	39*	1 221	1 510	3.3	2.9	53	44*
Bulgaria .....	10 616	12 381	135	109	78	62	3 291	5 503	4.3	4.7	69	56
Croatia .....	11 317	19 973	113	132	58	68	4 703	7 058	4.8	4.4	58	65
Czech Republic .....	22 374	28 389	52	47	37	30	14 341	25 556	3.7	4.6	36	10
Estonia .....	3 279	5 936	63	84	59	69	820	1 174	1.7	1.6	75	80
Hungary .....	32 683	49 313	82	94	63	56	10 727	12 778	3.1	2.6	67	74
Latvia .....	5 570	8 415	151	164	73	83	1 149	1 396	3.1	2.5	79	83
Lithuania .....	5 268	7 220	84	73	44	39	1 618	2 823	2.7	3.0	69	61
Poland .....	71 900	93 266	195	188	39	45	25 648	31 595	6.1	6.0	64	66
Romania .....	12 327	18 580	89	84	31	33	5 442	8 785	3.8	4.0	56	53
Serbia and Montenegro <sup>d</sup> ....	11 740	13 314	420	340	103	66	1 005	3 222	2.3	4.5	91	76
Slovakia .....	11 043	15 386	71	57	53	47	4 141	10 023	2.9	4.4	63	35
Slovenia .....	9 182	14 632	78	87	47	52	4 330	7 876	4.4	5.6	53	46
The former Yugoslav Republic of Macedonia .....	1 507	1 731	104	97	44	37	745	849	4.4	3.7	51	51
<i>Memorandum items:</i>												
<b>EU acceding countries</b> .....	161 299	222 557	100	98	45	46	62 774	93 221	4.1	4.3	61	58
<b>Baltic states</b> .....	14 117	21 571	93	98	56	58	3 587	5 393	2.5	2.4	75	75
<b>Central Europe</b> .....	147 182	200 987	100	98	44	45	59 188	87 828	4.2	4.5	60	56
<b>South-east Europe</b> .....	51 306	69 979	132	120	53	49	17 147	27 875	4.0	4.2	67	60

Source: National statistics; IMF, *International Financial Statistics* (Washington, D.C.) and IMF country studies; UNECE secretariat estimates.

<sup>a</sup> Exports of merchandise and services, and factor income receipts. Total imports of merchandise and services, and factor income payments, respectively.

<sup>b</sup> Gross debt at end September 2003.

<sup>c</sup> Public sector debt only.

<sup>d</sup> For 2003, excluding Montenegro.

deficits, continuing a trend already established in previous years. These economies (especially those joining the EU) are now generally considered to be attractive by international investors, and this is reflected in their relatively favourable ratings of creditworthiness.<sup>174</sup> Purchases of foreign exchange by national banks in eastern Europe (mostly the result of intervention to ease pressures on exchange rates) amounted to 1.8 per cent of GDP (table 3.5.5).

#### *The influx of short-term capital may prompt a policy response*

The large inflows of foreign funds, rising indebtedness and the state of monetary reserves (table 3.5.7) are having a significant effect on the conduct of monetary policy in the east European countries, of which only Poland now has a freely floating exchange rate regime. Exchange rate management under less flexible adjustment regimes carries certain risks, especially in an environment of large budget deficits. A large influx of foreign capital generally exerts upward pressure on the

exchange rate; in addition, it can trigger a monetary expansion, which may lead to overheating and higher inflation. The result may be a further deterioration in the trade balance and even larger inflows of foreign capital, which are unlikely to be sustainable. Sterilization of the monetary inflow is a costly policy option and may be counterproductive, especially if it enlarges interest rate differentials. Overall, with fully liberalized capital flows, appreciating equilibrium real exchange rates (related to their relatively fast growth) and with still significant interest rate differentials, the acceding east European economies are particularly exposed to international financial pressures. Besides, such flows may not only be very high but also on a net basis may be highly volatile (tables 3.5.5 through 3.5.8). Under such circumstances, the degree of policy freedom is rather limited as was clearly revealed in the recent exchange rate turmoil in Hungary (box 3.1.1). All these factors appear to have prompted the national banks in some of the acceding countries to reconsider their previous plans for early entry into the EMU.

Although most east European countries have been net debtors for at least a decade, their consolidated gross external debts (table 3.5.7) are still relatively small by international standards due to the high proportion of FDI

<sup>174</sup> Thus, 6 of the 15 countries were ranked in the first three deciles among more than 150 countries evaluated in *Institutional Investor: Country Credit Ranking* (New York), September 2003.

TABLE 3.5.8

**Inflows and stocks of foreign direct investment in eastern Europe, 2002-2003**  
(Million dollars, dollars, per cent)

	Inflows				Cumulative net inflows (stocks) <sup>a</sup>			
	Million dollars			Per cent/GDP <sup>b</sup>	Million dollars	Per cent/GDP <sup>b</sup>	Dollars per capita <sup>b</sup>	Per cent of eastern Europe average per capita
	2002	Jan.-Sep.2002	Jan.-Sep.2003	Jan.-Sep. 2003	Sep. 2003	Sep. 2003	Sep. 2003	
<b>Eastern Europe</b> .....	25 491	19 786	11 731	2.7	164 848	37.3	1 309	100
Albania .....	135	94	108	2.4	1 029	23.1	297	23
Bosnia and Herzegovina .....	293	178	206	4.2	1 014	20.5	236	18
Bulgaria .....	905	636	925	6.6	5 951	42.2	766	59
Croatia .....	1 124	785	1 180	5.6	8 765	41.8	1 973	151
Czech Republic .....	9 305	8 159	4 004	6.5	42 697	68.9	4 186	320
Estonia .....	285	217	640	10.4	3 817	61.9	2 809	215
Hungary <sup>c</sup> .....	858	662	-743	-1.2	24 856	41.3	2 447	187
Latvia .....	382	342	249	3.4	3 281	45.3	1 403	107
Lithuania .....	732	545	126	1.0	3 743	29.0	1 079	82
Poland .....	4 119	2 659	2 452	1.6	41 979	28.1	1 098	84
Romania .....	1 144	803	1 099	2.9	9 958	26.1	445	34
Serbia and Montenegro <sup>d</sup> .....	475	310	883	6.1	2 538	17.5	305	23
Slovakia .....	4 012	3 391	472	2.0	10 618	45.2	1 974	151
Slovenia .....	1 644	942	96	0.5	3 638	18.1	1 823	139
The former Yugoslav Republic of Macedonia .....	77	64	34	1.0	962	28.5	471	36
<i>Memorandum items:</i>								
<b>EU acceding countries</b> .....	21 338	16 916	7 295	2.1	134 630	39.4	1 841	141
<b>Baltic states</b> .....	1 399	1 104	1 015	3.9	10 841	41.2	1 513	116
<b>Central Europe</b> .....	19 939	15 812	6 280	2.0	123 789	39.3	1 877	143
<b>South-east Europe</b> .....	4 153	2 870	4 436	4.4	30 218	30.1	572	44

*Source:* National balance of payments statistics; IMF, *Balance of Payments Statistics* (Washington, D.C.) and IMF country studies; UNECE secretariat estimates; Hungarian National Bank, *Quarterly Report on Inflation* (Budapest), November 2003, pp. 51-53.

<sup>a</sup> Net of residents' investments abroad: Bulgaria, 1990-1994; Poland, 1990-1992; The former Yugoslav Republic of Macedonia, 1990-1998.

<sup>b</sup> National forecasts of the GDP for the third quarter of 2003 and the population for 2003 are used in the denominator.

<sup>c</sup> Excludes reinvested profits; otherwise the Hungarian FDI inflows in September 2003 would be higher by approximately \$1.65 billion and by \$2 billion in 2002 (according to the estimates of the Hungarian National Bank).

<sup>d</sup> For 2003, excluding Montenegro.

and other equity flows in their financial balance.<sup>175</sup> The gross external debt of all east European countries increased from 43 per cent of their aggregate GDP in 1995 to just 47 per cent in 2003. The levels of net indebtedness (gross debt less official reserves) have actually declined or remained unchanged during the last two years in all countries, except Croatia, thanks to the rapid growth of their official reserves.<sup>176</sup> The net positions of the eight acceding countries are generally balanced as between medium- and short-term maturities, thus reducing the risks of a liquidity crisis.

### *The flows of FDI change directions...*

Until 2002 the flow of FDI to eastern Europe was steadily increasing. However, in 2003 the total flow fell

by nearly 40 per cent, but this decline was concentrated on the EU acceding countries with the exception of Estonia (table 3.5.8). In contrast, the south-east European economies attracted increasing amounts of direct investment from abroad. The dispersion of the FDI stock in eastern Europe (as measured as a share of GDP or on a per capita basis) declined for the first time since 1993, which may be a sign that the previous asymmetrical distribution of FDI in the region is about to be corrected.

The fall in FDI going to central Europe (which followed four years of massive inflows – see appendix table B.17) could be a delayed effect of the large overall decline in global FDI in 2001 and 2002.<sup>177</sup> But it also

<sup>175</sup> The gross external debt of a country is defined as all the recorded liabilities of residents to non-residents after the deduction of direct investment equity capital (including reinvested earnings) and other equity securities. According to a widely accepted definition, a “moderately indebted country” is one with a gross debt of between 48 and 80 per cent of GDP.

<sup>176</sup> The total stock of official reserves in the eight acceding countries amounts to more than \$93 billion.

<sup>177</sup> In this period, the total world FDI fell by 53 per cent to \$651 billion in 2002. Only a slight recovery is expected in 2003, although the attraction of eastern Europe and the CIS as a destination for FDI remains high. UNCTAD, *World Investment Report, 2003, FDI Policies for Development: National and International Perspectives* (United Nations publication, Sales No. E.03.II.D.8). The slump in FDI reflected the global economic recession, a certain loss of trust in the “new economy”, and overinvestment in large enterprises. Boston Consulting Group, *The Path to Value Creation: Global Corporate Banking 2003*, November 2003, available among publication reports at [www.bcg.com].



TABLE 3.5.9

Outflows of foreign direct investment from eastern Europe,  
1990-2003<sup>a</sup>  
(Million dollars)

	Cumulative 1990- 2000 <sup>b</sup>	2001	2002	Jan.- Sep. 2003	Cumulative 1990- 2003 <sup>b</sup>
<b>Eastern Europe</b> .....	-3 925	-1 127	-1 703	-1 578	-8 333
Albania .....	2*	-	-	-	2
Bosnia and Herzegovina ..	-	-	-	-	-
Bulgaria .....	18*	-10	-29	-15	-36
Croatia .....	-390	-155	-533	-42	-1 119
Czech Republic .....	-705	-165	-276	-122	-1 268
Estonia .....	-342*	-200	-132	-117	-791
Hungary <sup>c</sup> .....	-1 857	-346	-265	-720	-3 187
Latvia .....	42*	-12	-8	-26	-5
Lithuania .....	-45*	-7	-18	-31	-100
Poland .....	-468	-67	-330	-248	-1 113
Romania .....	-21	17	-16	-41	-61
Serbia and Montenegro <sup>d</sup> ..	-	-	-	-	-
Slovakia .....	-3	-37	-5	-1	-45
Slovenia .....	-152	-145	-93	-215	-604
The former Yugoslav Republic of Macedonia ..	-	-1	-	-	-1
<i>Memorandum items:</i>					
<b>EU acceding countries</b> .....	-3 534	-979	-1 126	-1 479	-7 117
<b>Baltic states</b> .....	-348	-219	-157	-174	-899
<b>Central Europe</b> .....	-3 186	-759	-969	-1 305	-6 218
<b>South-east Europe</b> .....	-391	-148	-578	-99	-1 215

**Source:** National balance of payments statistics; IMF, *Balance of Payments Statistics* (Washington, D.C.) and IMF country studies; UNECE secretariat estimates.

<sup>a</sup> Outflows of FDI from the reporting countries. A negative sign indicates a net outflow of capital by national economic residents. A positive sign indicates a net repatriation of such capital.

<sup>b</sup> Totals include UNECE secretariat estimations for countries for which data were missing for 1990-1995: all of these had negligible FDI outflows.

<sup>c</sup> Excludes reinvested profits.

<sup>d</sup> For 2003, excluding Montenegro.

reflected a change in the structure of the FDI inflows: a large fall in the share of privatization related acquisitions (with privatization in central Europe attenuating) and the increasing importance of greenfield investments and investment from retained earnings.<sup>178</sup> The data for 2002-2003 also suggest that countries that have accumulated large FDI stocks might become important exporters of FDI (table 3.5.9).<sup>179</sup>

The attraction of obtaining capital and investors from abroad is part of the more complex macroeconomic mechanism outlined in box 3.5.1. It is also strongly influenced by various microeconomic, policy and

<sup>178</sup> Nevertheless, acquisitions still represented more than half of the inflows in 2002 and considerable assets (in banks, public utilities, energy infrastructure and other sectors) still remain in public hands in some of these countries.

<sup>179</sup> This provides a new and more robust evidence for the conjecture put forward in W. Andreff, "The new multinational corporations from transition countries", *Economic Systems*, Vol. 26, No. 4, 2002, pp. 371-379.

institutional factors.<sup>180</sup> The scale and quality of foreign capital absorption in eastern Europe is a reflection of their perceived growth potential, their endowment with natural resources, the state of infrastructure, the scope for external economies, the international competitiveness of labour, the stock of human capital, the effectiveness of their protection of property rights, the degree of sophistication of institutions of financial intermediation and, very importantly, their prospects of EU membership.

During the period of economic transformation, eastern Europe became one of the world's principal destinations for FDI. In 2003 the average ratio of the FDI stock to GDP in eastern Europe (accumulated in less than 15 years) was 40 per cent higher than the global average. At the same time, it was still significantly lower than the values of FDI per capita in the less developed countries of the EU (for example, \$4,360 for Portugal or \$5,290 for Spain in 2002, against \$1,309 for the whole of eastern Europe).

#### ...and their composition is also changing

The FDI inflows to eastern Europe have also been changing in terms of their qualitative characteristics.<sup>181</sup> In central Europe and Estonia the production of components within multinational supply networks has been an important source of export growth since the mid-1990s.<sup>182</sup> Another new development is the widening of the linkages between local suppliers and the mother investment company, which has increased even more than the share of integrated products in their exports. The emerging clusters of supply and demand chains, based mainly in central Europe, have the potential to become (especially after EU enlargement) the nucleus of future industrial agglomerations (see box 3.5.2).

<sup>180</sup> N. Campos and Y. Kinoshita, *Why Does FDI Go Where it Goes? New Evidence from the Transition Economies*, IMF Working Paper No. 03/228 (Washington, D.C.), November 2003. The issue of incentives is discussed in M. Sass, *Competitiveness and Economic Policies Related to FDI*, Ministry of Finance, Working Paper, No. 3 (Budapest) September 2003.

<sup>181</sup> Thus, following a specialization pattern already apparent in the more advanced east European economies, foreign firms have expanded in sectors which require relatively more skilled labour and are based on high technologies, leaving unskilled labour intensive activities to domestic firms. A. Zemplerová, "The importance of foreign-owned enterprises in the catching-up process", paper presented at the East-West Conference 2003, *The Economic Potential of a Larger Europe. "Keys to Success"*, organized by the Austrian National Bank (Vienna), 2-4 November 2003.

<sup>182</sup> At present, between one third and one half of these countries' exports to the EU comprise components for the automotive, electronic, electrical, office equipment, information technology, and rubber and plastics industries. B. Kaminski and F. Ng, *Trade and Production Fragmentation: Central European Economies in European Union Networks of Production and Marketing*, World Bank Policy Research Working Paper, No. 2611 (Washington, D.C.), June 2001; G. Navaretti, J. Haaland and A. Venables, *Multinational Corporations and Global Production Networks: The Implications for Trade Policy*, Centre for Economic Policy Research (CEPR), Report for the European Commission (London), 2002.

## BOX 3.5.2

## The emerging automobile cluster in central Europe

Large strategic direct investments are able to overcome the limitations of small domestic markets and can generate the build-up of large clusters of suppliers around them. Hence, in terms of policy recommendations, small economies with enterprises of only local importance, should seek first to establish a strategic link to a “core” enterprise in order to be able to gradually develop an integrated local hub. The emergence of a cluster of industries, integrated by backward and forward linkages, is therefore conditional on the establishment of a leader (or group of leaders) whose size and dynamism can guarantee economies of scale.

The mushrooming of secondary greenfield firms and domestic services around the strategic enterprise can be illustrated by the development of the automobile industry in central Europe. Its inception was laid by the acquisition of Škoda by Volkswagen in 1991. The output of Škoda motor vehicles increased twofold between 1993 and 2002, reaching 446,000 units. It led, in turn, to a booming market for the Czech production of car components, so that employment in the entire automotive industry increased in the same period by 44 per cent, value added in constant prices by 187 per cent, real sales by 240 per cent and exports in nominal euros by 446 per cent. The dynamic growth of Škoda-Auto spilled over to the whole automobile industry, which grew at an average rate of 11.7 per cent (in real value added) in the same period. Thanks to the accompanying learning process, local suppliers of components and car related services became so competitive that since 2002 the Czech Republic has been attracting the largest number of investment projects in the automobile industry in Europe, overtaking traditional leaders such as the France and the United Kingdom.

Apart from the Czech Republic, the boom in automobile production is also present in Hungary, Poland and Slovakia, producing altogether over 1 million cars. Until recently, cross-border cooperation between automobile firms in the region was not intensive and dependence on the supply chains based in the current EU member states dominated both production and the trade. A dramatic change can be expected when three additional plants start operating in the region (consortium Toyota-Peugeot-Citroen in the Czech Republic and PSA and Hyundai in Slovakia, and the total production of cars in the region will reach almost 2.4 million cars a year by 2007. The new supply strategies are based on a greater use of locally produced components and on local business services and, after the abolition of existing economic barriers following EU enlargement, deeper intraregional integration of firms. The increasing complexity of cooperation and competition in the car industry in the Budapest-Prague-Warsaw triangle should create all advantages of industrial agglomeration: specialized suppliers, the pooling of specialized labour markets, knowledge spillovers, and strong leaders at the end of the supply chain generating both internal and external scale economies.<sup>1</sup> The experience of some central European countries (in particular, the Czech Republic) also indicates that national investment promotion agencies can play a key role not only in fostering the development of sophisticated transnational networks but also in increasing their positive technological spillovers and economy-wide social returns.

The comparative advantage in cheap labour does not appear to be any longer the main attraction of eastern Europe. Instead of economizing on variable costs such as wages, the strategic objective in modern industries is to seek out fixed cost reductions and external economies associated with the industrial cluster. Thus, a company that tried to enter the car industry in a location outside the above-mentioned triangle would be at an immediate disadvantage because it would be burdened with additional fixed and transaction costs that would most likely be much higher than any gains from lower wage costs.

<sup>1</sup> P. Krugman, “Increasing returns and economic geography”, *Journal of Political Economy*, Vol. 99, No. 3, 1991, pp. 483-499.

Human capital is gradually superseding unskilled labour as the primary source of comparative advantage in the east European economies mainly due to the changing pattern of specialization by foreign enterprises. Nevertheless, the role of competitive wage rates should not be underestimated. Labour costs in eastern Europe, both in terms of the absolute level of wage rates and in relative terms as a share of total costs (which, in aggregate, is illustrated by the share of total compensation of employees in GDP – table 3.5.10) are still low, if compared with the developed market economies.<sup>183</sup> However, in recent years nominal wages in some of the east European countries have tended to grow faster than productivity, a development

which can undermine the cost competitiveness of enterprises in the tradeable sector (appendix tables B.8 and B.10). In addition, there is the danger of wage spillovers from more productive foreign-controlled firms to less productive domestic enterprises. The problem arises from the dual nature of these economies, which is characterized by considerable productivity differentials; although absolute wages in domestic firms may be lower than those in foreign-controlled firms, relative to value added they could still be higher, thus reducing the returns to capital in the indigenous sector.<sup>184</sup> Hence, any pay rise that is not justified by productivity gains can weaken further the viability of domestic firms, while the foreign firms can absorb the same increase thanks to their productivity lead.

<sup>183</sup> In table 3.5.10 the difference to 100 per cent is an aggregate measure of the gross profit margin, or return on capital. Even though this margin on average is still higher in eastern Europe than in the EU, the average premium of 13.5 per cent is not large.

<sup>184</sup> A. Zemplerová, op. cit.

TABLE 3.5.10

Share of the total compensation of employees in GDP,  
1998 and 2002  
(Per cent of GDP)

	1998	2002
Bulgaria .....	38.8	34.5
Czech Republic .....	46.1	46.4
Estonia .....	51.0	48.0
Hungary .....	44.8	45.7
Latvia .....	48.5	42.9
Lithuania .....	42.9	39.6
Poland .....	45.2	43.6
Romania <sup>a</sup> .....	39.9	41.1*
Slovakia .....	43.7	41.9
Slovenia .....	49.7	52.7
Above (weighted average) .....	43.7	42.8
EU acceding countries .....	45.4	44.3
<b>EU</b> .....	50.4	51.2
<b>Euro zone</b> .....	49.3	49.7
Austria .....	52.5	51.2
Finland .....	48.1	48.9
Germany .....	53.5	53.6
Greece .....	33.2	33.2
Italy .....	40.6	41.2
Spain .....	49.9	49.8
Sweden .....	54.3	57.2
United Kingdom .....	54.1	55.7
<i>Memorandum item:</i>		
Turkey .....	25.5	26.7

Source: UNECE secretariat estimates, based on national statistics, 2003.

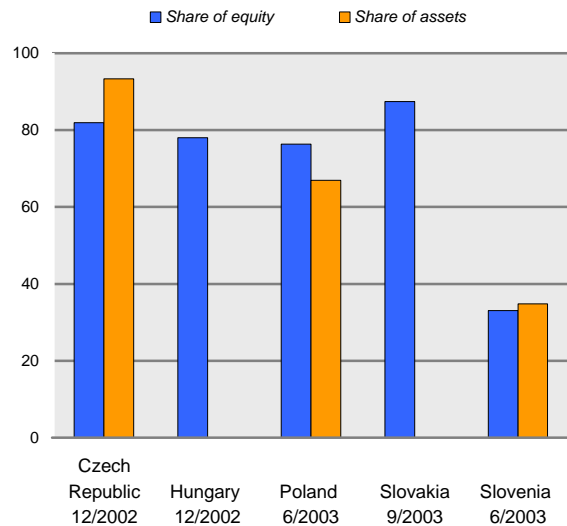
<sup>a</sup> The latest available data is for 2000 only.

Even though the service sector – real estate, financial intermediation, retail trade, telecommunications – has dominated the structure of FDI in nearly all the countries of eastern Europe (accounting for over 60 per cent of all FDI in central Europe and even more in the Baltic states), more recently a growing number of FDI projects have been concentrated in information networks, research and development and business support, and generally in high skill and knowledge-based activities.<sup>185</sup>

The penetration of foreign capital in the corporate banking sector in some east European countries is unprecedented (chart 3.5.3). Thus, while foreign ownership of the banking sector in four of the central European countries is now around 80 per cent, in the euro zone it is still of marginal importance.<sup>186</sup> Cross-border

CHART 3.5.3

Foreign ownership in the banking sector in central Europe,  
2002-2003  
(Per cent)



Source: National banks, January 2004.

takeovers have played a very important role in the restructuring of eastern Europe's banking sector: the new owners have injected new capital (to recapitalize troubled domestic banks) and managerial know-how, reorganized the banks' structures and operations, and introduced new banking products, all of which have produced significant efficiency gains.

<sup>185</sup> The recent investment by one of the world's largest logistics companies, DHL, which is relocating its ICT activities from Britain and Switzerland to the Czech Republic, is seen by many to be as significant as the Volkswagen investment in 1991 that initiated the fastest growing automobile cluster in Europe.

<sup>186</sup> In the EU, mergers and acquisitions have mainly occurred within the domestic banking sectors and the role of foreign penetration via the establishment of cross-border branches has been minimal. Only in Ireland and Luxembourg have the market shares of foreign banks exceeded 10 per cent. The United Kingdom is the only exception to the rule of domestic dominance: branches of EU banks alone held 23.7 per cent of the total value of balance sheets in the country in 2001. K. M  r  and M. Valentinyi, *The Role of Foreign Banks in Five Central and Eastern European Countries*, Hungarian National Bank, Working Paper 2003/10 (Budapest), November 2003.