

CHAPTER 1

THE ECONOMIC SITUATION IN THE ECE REGION AND SELECTED POLICY ISSUES

1.1 The ECE economies in 2002

(i) Western Europe and North America

Global economic developments were disappointing in 2002. Hopes for the beginning of a sustained recovery from the recession of 2001 were frustrated. The consensus of forecasters is now for a recovery to start in the second half of 2003 and to gain further momentum in 2004. The short-run outlook for the world economy, however, remains dominated by significant downside risks (see below). Large margins of spare capacity in the global economy and the fact that inflation has fallen to very low rates in the industrialized countries have, moreover, raised concerns, at least in some countries, about the risks of deflation. Global economic activity in early 2002 received some support from the bottoming out of the sharp decline in the ICT industry and related activities, which had been an important driving force behind the cyclical upswing in the second half of the 1990s. But the upturn in ICT did not survive the second half of the year. Oil prices rose markedly towards the end of 2002, largely reflecting mounting geopolitical tensions.

The dynamics and sustainability of world output growth continued to be strongly dependent on economic developments in the United States. Economic activity in Japan and western Europe, both potential engines of growth for the world economy, remained disappointingly sluggish, partly because of self-imposed constraints on more growth-supporting macroeconomic policies. In contrast, growth in eastern Europe and the CIS remained quite resilient to the deteriorating international economic environment (table 1.1.1).

The long economic boom in the United States petered out into a mild recession in 2001. But the fact that the downturn was short and mild also meant that the severe imbalances accumulated during the boom years were not corrected. These restrained growth in 2002 and are likely to continue to do so in 2003. In fact, the possibility of a disorderly unwinding of these imbalances remains a major downside risk for the outlook.

It is important to recall the special features which distinguish the present business cycle from previous postwar cycles. Typically, the boom phase reflects the rapid growth of demand in excess of trend output growth, which leads to inflationary overheating and, subsequently,

to a tightening of monetary policy that aims to bring actual output in line with potential output, often with a consequential recession. But the cyclical developments in the 1990s are more the reflection of the interaction of both supply and demand side elements, in which major roles were played by technological innovations (ICT), a credit boom and “irrational exuberance”, the combination of which led to massive overinvestment and a stock market bubble. At the same time there was an accumulation of high levels of debt in the private sector, and a rising current account deficit that led to a surge in foreign debt. All this took place in the presence of relatively benign inflationary pressures.¹

This confluence of factors, especially the emergence of large margins of excess capacity combined with the accumulation of considerable financial imbalances, implies that a rapid and sustained rebound of the United States economy from the mild recession of 2001 was bound to be unlikely, even without taking into account the weak state of the rest of the world economy. But such a rebound was not in any case very desirable, as a renewed upswing led by the United States would only postpone the necessary correction of the existing financial imbalances with the concomitant risk of a disruptive outflow of foreign capital and a more severe cyclical downturn later on.² Moreover, it became clear in 2002 that the responsiveness of business investment to reductions in interest rates is reduced, given the focus on debt consolidation and the need to work off excess capacities.

Economic growth in the industrialized countries in 2002 was also restrained by the impact of weakening consumer and business confidence on private sector spending. This reflected not only the increasing likelihood

¹ These developments are reminiscent of the Austrian theory of business cycles. S. Oppers, *The Austrian Theory of Business Cycles: Old Lessons for Modern Economic Policy?*, IMF Working Paper WP/02/2 (Washington, D.C.), January 2002. Looking only at the major macroeconomic variables – output and productivity growth, inflation, unemployment, government budget deficits – the economic performance of the United States in the 1990s, especially in the second half, was quite successful. A. Blinder and J. Yellen, *The Fabulous Decade: Macroeconomic Lessons from the 1990s* (New York, The Century Foundation Press, 2001).

² UNECE, *Economic Survey of Europe, 2002 No. 2*, p. 36; BIS, *71st Annual Report* (Basel), 11 June 2001, p. 144.

TABLE 1.1.1
Annual changes in real GDP in the ECE region, 1999-2003
(Percentage change over previous year)

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|------------------------------------|------|------|------|------|------|
| ECE region..... | 3.3 | 4.0 | 1.2 | 2.0 | 2.4 |
| Western Europe..... | 2.4 | 3.6 | 1.2 | 1.0 | 1.7 |
| European Union..... | 2.8 | 3.4 | 1.6 | 0.9 | 1.6 |
| Euro area..... | 2.8 | 3.5 | 1.5 | 0.8 | 1.4 |
| North America..... | 4.2 | 3.8 | 0.4 | 2.4 | 2.5 |
| United States..... | 4.1 | 3.8 | 0.3 | 2.3 | 2.5 |
| Eastern Europe..... | 1.5 | 3.9 | 3.0 | 3.0 | 3.9 |
| CIS..... | 4.5 | 8.2 | 6.0 | 4.8 | 4.4 |
| Russian Federation..... | 5.4 | 9.0 | 5.0 | 4.3 | 4.0 |
| <i>Memorandum items:</i> | | | | | |
| Europe (east and west)..... | 2.3 | 3.6 | 1.4 | 1.2 | 1.9 |
| Europe (east and west) and CIS ... | 2.6 | 4.2 | 2.0 | 1.7 | 2.3 |

Source: UNECE Statistical Database; European Commission, *European Economy*, No. 5 (Brussels), 2002; *OECD Economic Outlook*, No. 72 (Paris), December 2002; direct communications from national statistical offices to UNECE secretariat.

Note: The regional aggregates are computed by summing over all countries the constant prices series rescaled to the price level of the common base year 2000 and converted into dollars using the GDP purchasing power parity of the year 2000.

of a military conflict in Iraq, but also the general deterioration in the short-run economic outlook and its adverse implications for sales and profits, as well as for employment. This also contributed to the continuing slide in international share prices, which was accentuated by the uncertainty, caused by financial and accounting scandals, about the underlying strength of the corporate sector. Defaults on international corporate debt rose to record levels in 2002. Lower share prices, in turn, had a negative impact on household wealth and raised the financing costs of companies, both of which helped to weaken private sector spending on consumer and capital goods. The “flight to safety” of international investors led to a surge in demand for government bonds, with long-term yields falling to very low levels.

As a result of the recent failures of corporate governance in the United States and, to a lesser extent, in western Europe, corporate governance reform is firmly on the policy agenda in the ECE region (chapter 4). In 2002, reforms were initiated in the United States aimed at improving the quality of the auditing process, strengthening oversight by boards of directors, enhancing the transparency of financial markets and dealing with conflicts of interest in the financial services industry. Within the European Union, reforms are still at a preparatory stage but appear to be going in a similar direction.³ Both within the EU and between the EU and the United States, there is a need for further measures to prevent differences in corporate governance from distorting or impeding cross-border economic activity.

Despite this background, real GDP in the United States rose by 2.4 per cent in 2002, up from 0.3 per cent in 2001. But this robust performance for the year as a whole masks a slowdown to near stagnation in the final quarter. Private consumption was the mainstay of economic growth in 2002 but household spending was greatly influenced by temporary factors such as the generous financing schemes for the purchase of motorcars. Government spending also continued to be an important support to domestic activity. In contrast, business capital spending fell for the second consecutive year and the deterioration in real net exports was an important drag on the overall rate of economic growth. The underlying economic weakness combined with the expansionary stance of fiscal policy and a very accommodative monetary policy led to a considerable deterioration in the general government financial balance and a further rise in the already large current account deficit. In the foreign exchange markets, the dollar depreciated, a tendency which gathered momentum in early 2003. On a trade-weighted basis, the dollar in January 2003 was about 8 per cent lower than 12 months earlier.

In western Europe, economic growth was quite sluggish in 2002, real GDP rising on average by about 1 per cent (table 1.1.2). In the euro area, the annual rate of growth was even lower at about 0.8 per cent. This reflected in the main a combination of weak private consumption and investment. Cyclical factors were largely responsible for the overshooting of the fiscal targets established in the stability programmes of the individual member states of the euro area but, overall, the stance of fiscal policy was broadly neutral in 2002. There was renewed controversy about the Stability and Growth Pact and the target for achieving balanced budgets was postponed from 2004 to 2006. There have also been proposals by the Commission for amending the interpretation of the Pact (chapter 2.2). Despite deteriorating growth prospects, monetary policy was on hold for most of 2002; it was only in December 2002 that the ECB lowered its key interest rate, the first reduction since 6 November 2001.

(ii) Eastern Europe and the CIS

Despite some slowing down of activity in eastern Europe and the CIS in 2002, rates of economic growth in these regions remained generally higher than those in western Europe. The slowdown was more pronounced in some of the CIS countries, particularly in the two largest economies, Russia and Ukraine, which pulled down the rate of growth of GDP for the region as a whole. Nevertheless, aggregate GDP in the CIS grew by 4.8 per cent in 2002 due to the still significant momentum from the previous year of rapid growth and a continuing boom in some of the Caucasian and central Asian countries (table 1.1.3 and chart 1.1.1).⁴ The growth of aggregate

³ European Commission, *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe* (Brussels), 4 November 2002 [europa.eu.int/comm/internal_market/en/company/company/modem/consult/report_en.pdf].

⁴ Throughout this *Survey* the grouping of the east European and CIS economies into regions and subregions is simply geographical. On the composition of these regions and subregions see the note to table 1.1.3.

TABLE 1.1.2
**Changes in real GDP in the developed market economies,
 2001-2003**
(Percentage change over previous year)

| | 2001 | 2002 | 2003 |
|---|------|------|------|
| France..... | 1.8 | 1.0 | 1.6 |
| Germany | 0.6 | 0.2 | 0.8 |
| Italy | 1.8 | 0.4 | 1.3 |
| Austria..... | 0.7 | 0.7 | 1.3 |
| Belgium | 0.8 | 0.7 | 1.4 |
| Finland | 0.7 | 1.4 | 2.6 |
| Greece | 4.1 | 3.5 | 3.6 |
| Ireland | 5.7 | 3.3 | 3.9 |
| Luxembourg | 1.0 | 0.1 | 2.0 |
| Netherlands | 1.3 | 0.2 | 1.0 |
| Portugal | 1.7 | 0.7 | 1.4 |
| Spain | 2.7 | 1.9 | 2.3 |
| Euro area | 1.5 | 0.8 | 1.4 |
| United Kingdom..... | 2.0 | 1.6 | 2.4 |
| Denmark | 1.0 | 1.7 | 1.8 |
| Sweden | 0.8 | 1.6 | 2.1 |
| European Union | 1.6 | 0.9 | 1.6 |
| Cyprus | 4.1 | 1.8 | 3.5 |
| Iceland..... | 1.5 | -0.6 | 1.5 |
| Israel | -0.9 | -1.0 | 1.0 |
| Malta | -0.8 | 2.5 | 3.4 |
| Norway..... | 1.4 | 2.1 | 1.5 |
| Switzerland..... | 0.9 | -0.2 | 1.0 |
| Turkey | -7.4 | 3.7 | 3.6 |
| Western Europe | 1.2 | 1.0 | 1.7 |
| Canada..... | 1.5 | 3.3 | 3.1 |
| United States | 0.3 | 2.3 | 2.5 |
| North America | 0.4 | 2.4 | 2.5 |
| Japan | 0.3 | -0.7 | 0.4 |
| Total above | 0.7 | 1.4 | 1.9 |
| <i>Memorandum items:</i> | | | |
| 4 major west European economies | 1.4 | 0.7 | 1.5 |
| Western Europe and North America | 0.8 | 1.7 | 2.1 |

Source: Eurostat; OECD national accounts; national statistics; European Commission, *European Economy*, No. 5 (Brussels), 2002; *OECD Economic Outlook*, No. 72 (Paris), December 2002; Consensus Economics, *Consensus Forecasts*, January 2003; *The Economist*, 25 January 2003.

Note: All aggregates exclude Israel. Data for 2002 are preliminary estimates. Data for 2003 are forecasts.

GDP in eastern Europe was considerably lower (3 per cent) and was basically unchanged from the previous year. Growth patterns varied in different parts of the region: central Europe continued to be the slowest growing subregion (weighed down by the sluggish Polish economy), while south-eastern Europe and, especially, the Baltic states performed considerably better than the average.

These outcomes are largely a reflection of the general development of the global economy. Some central European countries, where strong growth in previous years had been largely export led, were badly affected by the weakness of their most important west European markets. In turn, the commodity exporting CIS

countries were hit by the weaker growth of external demand and, during much of 2001 and 2002, by weak world market prices. In addition, some CIS countries were hurt by the slowdown in the Russian economy, which was no longer the strong engine of growth for its neighbours that it had been in the previous two years.

Despite the unfavourable external environment, economic activity in eastern Europe and the CIS nevertheless remained fairly buoyant in 2002 and the area as a whole was still among the fastest growing regions in the world. Among other things, this reflected an important change that had emerged already in 2001 but which became dominant in 2002, namely, a shift from external to domestic sources of growth. Although the available data still prevent a detailed assessment of the year as a whole, the preliminary statistics for some of the major east European and CIS economies point to the enduring strength of domestic demand as the main factor that prevented a further weakening of output growth in this part of the ECE region.

Such a pattern of growth, however, is a mixed blessing for the east European and CIS economies. On the one hand, the resilience of domestic demand is a sign of confidence in the future prospects of these economies on the part of both consumers and investors. This also reflects the considerable progress that some of these countries have made in their market reforms as evidenced by the invitation to eight east European countries to join the European Union in 2004. But also in some of the CIS economies, which are generally lagging behind eastern Europe in systemic reforms (chapter 5), several years of strong growth have contributed to rising incomes and levels of welfare of the population, which, in turn, have reinforced domestic support for economic activity.

On the other hand, reliance on domestic demand as the main engine of growth is unlikely to be sustainable since most of the region consists of small, open economies. With few exceptions, most east European and CIS economies are characterized by chronic and large current account deficits, accompanied in some cases by fiscal imbalances (the twin deficit problem); an excessive shift towards domestically-driven growth is clearly not an appropriate strategy for keeping these deficits in check. Moreover, with privatization nearing completion, privatization-related FDI (which has been among the principal sources of financing of current account deficits in recent years) is set to end in the not too distant future. Another related source of concern is the recent shift towards active demand management in some central European economies, which has contributed to their rising fiscal deficits (chapter 3.1(ii)).

Obviously, the policy response to the existing macroeconomic imbalances should depend on their underlying causes. In countries where there is a large structural fiscal deficit, a major change in policy is called for. Long-term fiscal sustainability in the central European

TABLE 1.1.3
Annual changes in real GDP in eastern Europe and the CIS, 1999-2003
(Per cent)

| | 1999 | 2000 | 2001 | 2002 | | 2003 |
|--|-------|------|------|------------------------|------------------------|-------------------|
| | | | | Jan.-Sep. ^a | Full year ^b | official forecast |
| Eastern Europe | 1.5 | 3.9 | 3.0 | 2.8 | 3.0 | 3.9 |
| Albania..... | 7.3 | 7.8 | 6.5 | .. | 4.5 | 6 |
| Bosnia and Herzegovina..... | 10.6 | 4.5 | 2.3 | .. | 4 | 4 |
| Bulgaria..... | 2.3 | 5.4 | 4.0 | 4.4 | 4.2 | 4.8 |
| Croatia..... | -0.9 | 2.9 | 3.8 | 5.0 | 4.6 | 4.2 |
| Czech Republic..... | 0.5 | 3.3 | 3.3 | 2.4 | 2.5 | 3.3 |
| Estonia..... | -0.6 | 7.1 | 5.0 | 5.7 | 5.7 | 5 |
| Hungary..... | 4.2 | 5.2 | 3.8 | 3.2 | 3.2 | 3.7-4.0 |
| Latvia..... | 2.8 | 6.8 | 7.7 | 5.4 | 5.7 | 5.6 |
| Lithuania..... | -3.9 | 3.8 | 5.9 | 6.1 | 5.9 | 4.9 |
| Poland..... | 4.1 | 4.0 | 1.0 | 0.9 | 1.3 | 3.0-3.5 |
| Romania..... | -1.2 | 1.8 | 5.3 | 4.6 | 4.7 | 5.2 |
| Slovakia..... | 1.3 | 2.2 | 3.3 | 4.1 | 4 | 3.7-4.1 |
| Slovenia..... | 5.2 | 4.6 | 3.0 | 2.9 | 3.2 | 3.4 |
| The former Yugoslav Republic of Macedonia..... | 4.3 | 4.5 | -4.5 | -0.6 | 0.3 | 2-3 |
| Yugoslavia ^c | -17.7 | 6.4 | 5.1 | .. | 4 | 5 |
| CIS | 4.5 | 8.2 | 6.0 | 4.5 | 4.8 | 4.4 |
| Armenia..... | 3.3 | 5.9 | 9.6 | 11.0 | 12.9 | 6 |
| Azerbaijan..... | 7.4 | 11.1 | 9.9 | 9.8 | 10.6 | 7.5 |
| Belarus..... | 3.4 | 5.8 | 4.7 | 4.6 | 4.7 | 6-6.5 |
| Georgia..... | 3.0 | 1.9 | 4.7 | 1.9 | 5.4 | 4.5 |
| Kazakhstan..... | 2.7 | 9.8 | 13.5 | 9.3 | 9.5 | 6 |
| Kyrgyzstan..... | 3.7 | 5.4 | 5.3 | -3.0 | -0.5 | 5-6 |
| Republic of Moldova ^d | -3.4 | 2.1 | 6.1 | 5.9 | 7.2 | 5 |
| Russian Federation..... | 5.4 | 9.0 | 5.0 | 4.1 | 4.3 | 3.5-4.4 |
| Tajikistan..... | 3.7 | 8.3 | 10.2 | 8.9 | 9.1 | 7.4 |
| Turkmenistan ^e | 17.0 | 17.6 | 20.5 | .. | 21.2 | 16 |
| Ukraine..... | -0.2 | 5.9 | 9.1 | 4.3 | 4.1 | 4 |
| Uzbekistan..... | 4.4 | 4.0 | 4.5 | 3.0 | 4.2 | 5.3 |
| Total above | 3.3 | 6.5 | 4.8 | 3.8 | 4.1 | 4.2 |
| <i>Memorandum items:</i> | | | | | | |
| Baltic states (BS-3) | -1.2 | 5.5 | 6.3 | 5.8 | 5.8 | 5.1 |
| Central Europe (CE-5) | 3.2 | 3.9 | 2.2 | 2.0 | 2.2 | 3.4 |
| South-east Europe (SEE-7) | -2.0 | 3.4 | 4.5 | 4.2 | 4.4 | 4.9 |
| CIS without Russian Federation (CIS-11) | 2.7 | 6.6 | 8.4 | 5.6 | 5.9 | 5.3 |
| Caucasian CIS countries (CCIS-3) | 5.0 | 6.9 | 8.1 | 7.6 | 9.5 | 6.3 |
| Central Asian CIS countries (CACIS-5) | 5.0 | 7.6 | 9.3 | 6.6 | 7.2 | 5.8 |
| Three European CIS countries (ECIS-3) | 0.8 | 5.7 | 7.7 | 4.4 | 4.4 | 4.7 |

Source: National statistics, CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat; reports by official forecasting agencies.

Note: Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Aggregates are UNECE secretariat calculations, using PPPs obtained from the 1996 European Comparison Programme. Aggregates shown are: eastern Europe (the 15 countries below that line), CIS (the 12 member countries of the Commonwealth of Independent States). Sub-aggregates: Baltic states (BS-3): Estonia, Latvia, Lithuania; central Europe (CE-5): Czech Republic, Hungary, Poland, Slovakia, Slovenia; south-east Europe (SEE-7): Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia, Yugoslavia; Caucasian CIS countries (CCIS-3): Armenia, Azerbaijan, Georgia; central Asian CIS countries (CACIS-5): Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan; three European CIS countries (ECIS-3): Belarus, Republic of Moldova, Ukraine.

^a Over the same period of 2001.

^b Preliminary estimates.

^c Excluding Kosovo and Metohia.

^d Excluding Transnistria.

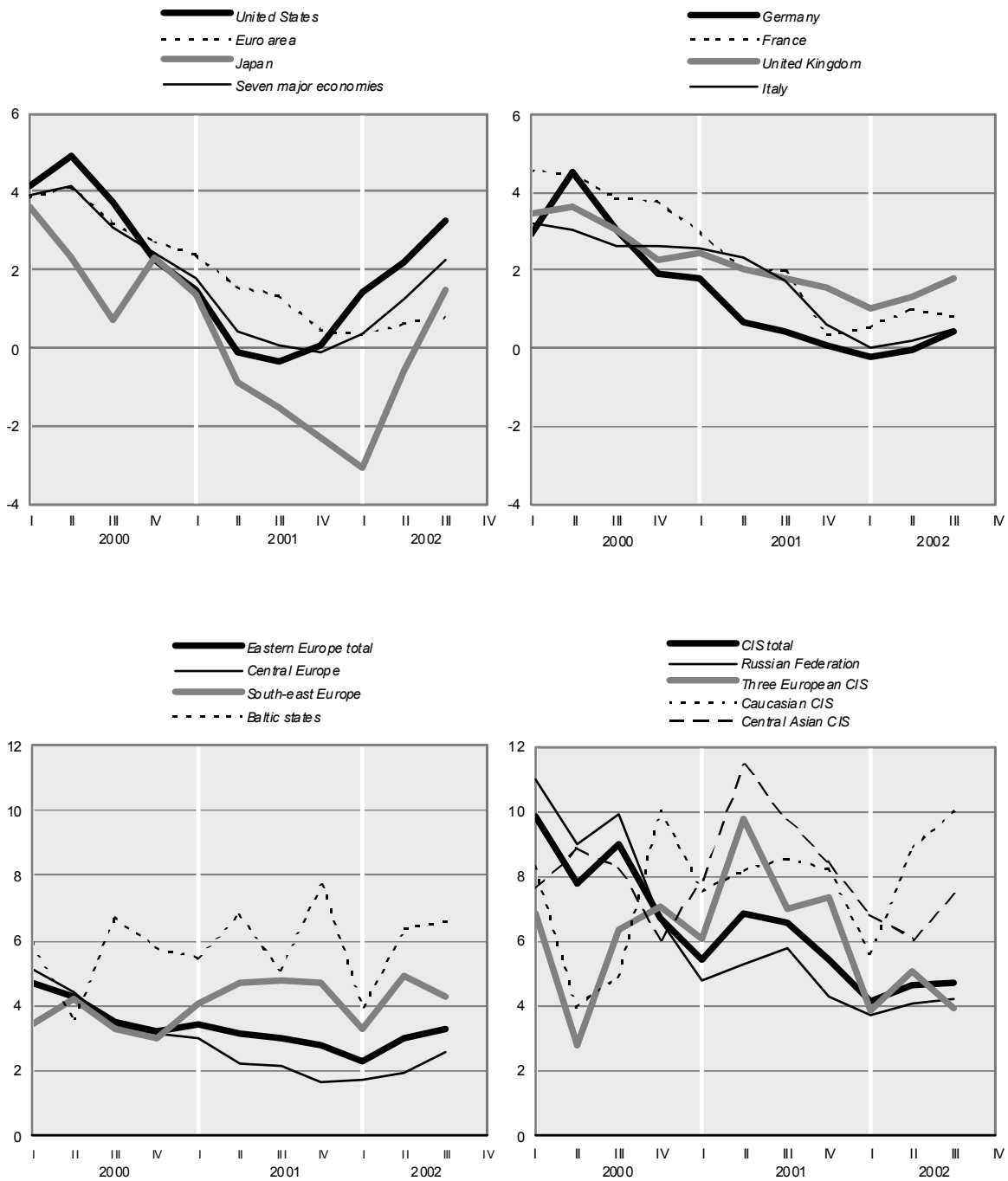
^e Figures for Turkmenistan should be treated with caution. In particular, the deflation procedures that are used to compute officially reported growth rates are not well documented and the reliability of these figures is questionable.

economies requires the acceleration of key structural reforms, particularly of the social security and tax systems. At the same time, greater prudence in demand management in such cases is also needed in the short run, as the room for manoeuvre is rather limited. Nevertheless, when the underlying structural fiscal deficit

is small and manageable (indicating that fiscal restraint has been pursued over the medium term), governments have more room to support domestic demand in the short run.

Although net exports did not generally make a positive contribution to GDP growth in 2002, one of the surprising developments during the year was the strength

CHART 1.1.1
Quarterly changes in real GDP in the ECE economies, 2000QI-2002QIII
 (Percentage change over the same period of previous year)



Source: National statistics; Eurostat, New CronosDatabase.

Note: Data for developed market economies are seasonally adjusted. Seven major economies: Canada, France, Germany, Italy, Japan, United Kingdom and United States. On the composition of regional sub-aggregates in eastern Europe and the CIS, see the note to table 1.1.3

of east European exports in the face of the persistent weakness of economic activity in western Europe: on average they grew faster than both western import demand and total world exports (chapter 3.5(ii)). Moreover, this was the second consecutive year of such relative strength, a consequence of which was a large

increase in the east European share of west European markets despite the weakness of import demand.

It is still too early to draw any definite conclusions about the nature of this east European export expansion because the evidence about the underlying factors is still incomplete. However, several factors are likely to have

contributed to this outcome. First, since the start of economic transformation more than a decade ago, a number of east European economies have had massive inflows of FDI, a large part of which have been undertaken by large, export-oriented multinational companies. Thus, this has been a period which has seen a considerable expansion of new production and export capacities, a process that is still underway. These new capacities exploit the comparative advantages of these economies in low-cost labour (particularly, low-cost skilled labour) as well as their proximity to the major markets of western Europe. The increased exploitation of such comparative advantage can allow the rapid growth of particular export products even when aggregate external demand is generally weak or stagnant. This fundamental competitive edge appears to have been one of the factors that allowed east European exporters to continue to gain export market share in 2002 despite the weakness of western demand and, in some cases, some deterioration in their cost competitiveness (as measured by the real effective exchange rate – chapter 3.1(i)).

In a period of global economic slowdown – as was the case in 2001 and 2002 – the importance of eastern Europe's comparative advantage may have been amplified by the general squeeze on profit margins, which has made multinational companies even more sensitive to their production costs. Faced with the need to trim their global costs in response to the slump in global demand, multinationals will tend to accelerate the relocation of part of their global production volumes to lower cost countries. As the east European economies are still competitive in this regard vis-à-vis their western counterparts, they may have benefited from such intra-company relocation of production in this period. Some evidence in support of this conjecture is provided in chapter 3.5(ii).⁵ At the same time eastern Europe itself is under pressure from countries offering even more competitive conditions for cost-saving or located nearer to other major markets, as suggested by the recent relocation of some production lines from eastern Europe to destinations in south-east Asia.

Overall, the rising market shares of east European exporters are a medium-term development reflecting transition-related changes in the international division of labour. Due to the nature of their underlying comparative advantage and the existing differences in labour costs, the east European economies are likely to gain further market shares in west European and global markets in the short to medium run. In the longer run, however, comparative advantage is not static and as development and income levels in eastern Europe start to catch up with those in the

industrialized countries new sources of international competitiveness will have to be developed via the accumulation of physical and human capital.

The macroeconomic environment in 2002 was generally supportive of disinflation in eastern Europe and the CIS, and most of these economies made further progress towards price stability or lower rates of inflation. Nowadays inflation in the majority of these countries, while generally higher than that in the more developed market economies, mostly reflects transition-specific developments and cannot be attributed to loose macroeconomic policy. Thus in 2002, the main sources of inflationary pressures in the region were the rising prices of services which, as discussed in chapter 3.3, can be regarded as a normal feature of the development process in these economies as well as increases in some administered prices. During most of the year the prices of tradeable goods, however, tended to offset these domestic inflationary pressures: imported inflation was almost non-existent due to weak world market prices for basic commodities and manufactures (and, in some east European economies, appreciating exchange rates), while good harvests in many countries eased the domestic price of food.

Labour markets in most of eastern Europe and the CIS continue to suffer from chronic structural imbalances. While there were some positive developments in 2002 they were confined to just a few countries: unemployment, as measured by labour force surveys, declined in the three largest CIS economies (Kazakhstan, Russia and Ukraine) as well as in all the Baltic states. At the same time, unemployment remains worryingly high in south-east Europe and has continued to increase in other countries, in some cases (such as Poland) to record levels.

Against the overall trends in domestic and external demand in 2002, as well as changes in the terms of trade, the aggregate current account balances of eastern Europe and the CIS deteriorated although there were considerable differences among countries. While in several east European countries (Croatia, the Czech Republic, Estonia, Hungary and Yugoslavia, among others) there was a substantial widening of their current account deficits, in others there were improvements (Bulgaria, Romania and Slovenia). Within the CIS, Russia's current account surplus shrank but was still much larger than had been expected at the beginning of the year. The situation with financing also varied: in general, east European countries had few problems in financing their current account deficits (even when they increased); but some CIS countries continued to face balance of payments constraints due to their limited access to external finance.

Despite the generally unfavourable external environment, net capital flows into eastern Europe generally rose in 2002, largely due to changes in international investors' perception of relative risk in

⁵ Another favourable factor for east European exports in this period has been a shift in the composition of overall import demand in the developed market economies: while demand for investment goods (which is not an area of specialization for east European exporters) shrank considerably, personal consumption, and hence demand for imports of consumer goods, in which eastern Europe is mainly specialized, remained relatively strong in some countries.

emerging markets. The upturn reflects changes in two main flows: larger volumes of FDI, and a surge in short-term capital flows which, in net terms, changed direction from 2001. As noted earlier, however, privatization, which has been a major attraction for FDI in eastern Europe in recent years and an important source of financing of current account deficits, is nearing its end in most of these countries. The elimination of this convenient source of financing implies the need for alternatives or for an adjustment in the external balances of some countries.

(iii) The EU's eastern enlargement: challenges and opportunities

The year 2002 started and ended with two important economic and political events for the ECE region: the launching of the euro in January and the Copenhagen European Council held in December. The latter will be remembered for the successful conclusion of negotiations with 10 candidates for EU accession. This group comprises eight central European and Baltic countries: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia as well as Cyprus and Malta. All 10 countries are expected to attain full membership of the European Union in 2004. In addition, Bulgaria and Romania are also quite advanced in their accession negotiations and the Copenhagen summit endorsed their goal of becoming full EU members in 2007.

The successful completion of the accession negotiations by eight former centrally planned economies is an important confirmation of their considerable progress in implementing market-oriented economic reforms, a process which has been underway in the eastern part of the ECE region for more than a decade. It is now generally accepted that in view of the degree of systemic transformation already achieved in the most advanced reformers – the countries of central Europe and the Baltic region – the period of their transition from plan to market is coming to an end. Accession to the European Union will formally confirm its successful completion.

The importance of the goal of EU membership (reinforced on both sides by a strong political commitment) for the successful economic and political transformation in eastern Europe cannot be overestimated. A targeted agenda for EU membership has been both a key benchmark for progress and an important catalyst of market reforms in these countries. It is reasonable to assume that the same will hold for those east European economies that are not part of the current round of enlargement but have realistic prospects for future membership.

The Copenhagen summit was an important milestone in the process of the EU's eastern enlargement. Apart from formally endorsing the accession of 10 new member states in 2004 it also addressed some related

institutional issues such as voting in the EU Council and representation in the European Parliament after enlargement. At the same time, a number of key policy issues related to enlargement still remain open and need to be resolved for the process to be completed successfully.

Important policy challenges thus face both the current EU member states and the accession countries. On the part of the EU, these are mainly related to the continuation of reforms in the institutional framework and the decision-making process in the European Union, which were initiated by the Treaty of Nice adopted at the Intergovernmental Council in December 2000. These reforms are aimed at establishing more efficient and transparent institutional arrangements and effective decision-making mechanisms for a Union consisting of 25 or more member states. In this regard, the institutional decisions taken at the Copenhagen summit are subject to further development. The debate on the European Convention (the "Constitution for Europe") and the future of the European Union, which is scheduled to continue until 2004 (when the next intergovernmental conference is planned), is expected to produce proposals for resolving some of the outstanding issues.

However, there are also a number of very sensitive policy matters (such as the future of the Common Agricultural Policy and the future of regional policy and cohesion funds in an enlarged Union) that must also be dealt with before enlargement but where reforms are still in an initial phase. The steps taken so far are only tentative and there is still no consensus among the member states about the ultimate objective of these reforms. Policy discussion on other important issues such as the decision-making process in the European Central Bank (ECB) of an enlarged EMU is also advancing.⁶

The policy challenges facing the east European accession countries are no less daunting. Although the accession negotiations were successfully completed with all chapters formally closed, it is difficult to assert that the accession countries are ready to fully comply with and implement the EU's *acquis communautaire*. Due to existing institutional weaknesses, the enforcement of legislative and regulatory norms in the accession countries still lags considerably behind that in the current members and also varies considerably between countries. All the acceding countries have yet to experience the full competitive pressure of the EU market when the remaining few but important non-tariff, local market barriers are lifted. The challenges to macroeconomic policy in the run-up to EMU accession are also formidable. As shown by recent research, the simultaneous pursuit of the goals of monetary and real

⁶ The Governing Council of the ECB has approved a proposal on the future adjustment of its voting modalities. European Central Bank, *Press Release* (Frankfurt am Main), 20 December 2002.

convergence may create domestic policy conflicts.⁷ In addition, the emergence of large fiscal imbalances in some central European countries is worrisome as, in the absence of an adequate policy response, these may well become a serious stumbling block on the way to the euro zone (chapter 3.1(ii)). All indications are that the east European accession countries will need a sufficiently long preparatory period before they can achieve a smooth accession to the EMU. A goal of rapid entry into the EMU (for the sake of “outperforming the others”) might require an unwarranted and excessive tightening of macroeconomic policy over a rather lengthy period, which, in turn, would imply an unnecessary sacrifice of economic growth and social welfare.

The process of eastern enlargement of the European Union will also have significant economic and political implications for the whole ECE area. In terms of its economic potential after 2004, the Union of 25 member states will become the largest fully integrated market in the world. The deepening of economic integration within this vast economic space is expected to make every member country better off in the long run.

But EU enlargement is also expected to have a positive impact on economic development in the non-acceding countries of the ECE region (chapter 6). The economic ties between the enlarged EU and these areas are likely to be intensified by widening and strengthening the existing forms of economic cooperation now embodied in the Stabilization and Association Agreements (with countries in south-eastern Europe) and the Partnership and Cooperation Agreements (with CIS countries). This process will not only lead to the further liberalization of trade between the EU and the non-acceding countries⁸ but will also foster trade liberalization between the non-acceding countries themselves. Such a tendency was already observed among the current accession countries during the 1990s, when they were only “associated” with the EU. Eventually, new free trade zones could emerge in the ECE region, which could include most, if not all, of the ECE member states.

The deepening of economic cooperation, however, can be expected to go beyond the conventional liberalization of foreign trade. Already there appears to be a growing demand both on the part of the EU and on the part of some of the non-acceding countries, in particular Russia, for extending existing economic ties to other more mature forms of economic integration such as legislative, regulatory and institutional harmonization covering standards, technical regulations, transport, customs procedures, public procurement, competition

policy, investment regimes, intellectual property rights, etc. Such regulatory convergence is likely to contribute to the acceleration of systemic reforms and economic transformation in the non-acceding countries. Accession to the WTO – which has been achieved by some countries and is on the policy agenda of others – should have a similar effect in fostering multilateral and bilateral economic ties.

The EU has launched a policy discussion of the prospects for closer economic cooperation between the enlarged EU and its new neighbours within the so-called “New Neighbours” or “Wider Europe” initiative. In a recent speech the President of the European Commission outlined the objective of creating “a common market embracing the EU and its partners [which] would offer a single market, free trade, open investment regime, approximation of legislation, interconnection of networks and the use of the euro as a reserve and reference currency in ... bilateral transactions.” The new forms of economic partnership would be based on “shared principles and values” and would also imply close cooperation in other areas such as the environment, transport, research, education and culture. Currently the “Wider Europe” initiative is only at the conceptual stage and not much can be said about the prospects for its operationalization. But by providing the institutional framework for greater regulatory and legislative harmonization and further trade liberalization, it is expected to boost regional trade and investment, thus laying the ground for higher rates of economic growth and better living standards throughout the whole ECE region.

1.2 The prospects for 2003

(i) Western Europe and North America

Uncertainty surrounding the short-term economic outlook is amplified by the increasing possibility of a war with Iraq. This has already contributed to the weakening of consumer and business confidence and has fostered a wait-and-see attitude with regard to big spending items. The available baseline forecasts, which assume that there will be no military conflict, however, suggest only a moderate strengthening of growth in the global economy in the course of 2003. The cyclical recovery is seen as likely to gather momentum in 2004.

The United States are again seen as leading the global recovery, given the prolonged weakness of domestic demand in western Europe and Japan. Expectations are for a limited cyclical upturn in the United States in the first half of 2003, which should

⁷ UNECE, “Alternative policies for approaching EMU accession by central and east European countries”, *Economic Survey of Europe, 2002 No. 1*, chap. 5, pp. 181-193.

⁸ Some non-acceding countries, however, are concerned at the possibility of increases in EU contingent protection after enlargement.

⁹ R. Prodi, “A Wider Europe – a proximity policy as the key to stability,” speech given at the Sixth ECSA-World Conference, *Peace, Security and Stability International Dialogue and the Role of the EU* (Brussels), 5-6 December 2002, SPEECH/02/619 [europa.eu.int/comm/external_relations/news/prodi/sp02_619.htm].

gather momentum in the second half of the year. The associated strengthening of domestic demand in the United States would then stimulate—directly or indirectly via changes in real net exports—economic activity in the rest of the world, including eastern and western Europe and the CIS.

One of the key assumptions behind this benign outlook is that oil prices will average around \$24-\$26 per barrel in 2003, broadly unchanged from 2002.¹⁰ This compares with an actual level of about \$31 in January 2003. Also, little change is expected for non-oil commodity prices in 2003 as compared with 2002. Other key assumptions are a return to stability in the financial markets, especially equity markets. In the foreign exchange markets, the dollar is assumed to trade close to parity against the euro and at some 120 yen in 2003.

Forecasts of economic growth in the United States in 2003 have been relatively stable since the late summer of 2002, real GDP being expected to increase by about 2.5 per cent (table 1.1.2). As already mentioned, this outcome is based on the assumption of a faster rate of economic expansion in the second half of the year, driven by strengthening private consumption and a recovery of business fixed investment. Changes in inventories are also forecast to support economic activity. The growth of consumer demand, however, will be restrained by the need of households to increase savings in the face of their high debt servicing burdens, the considerable loss of financial wealth stemming from the plunge in share prices and concerns about the problems facing pension funds. The scope for higher business capital spending will also be circumscribed by the need to reduce corporate debt. Exports should be supported by the gains in price competitiveness stemming from the depreciation of the dollar in 2002 and the expected upturn of economic activity in other regions of the world. Changes in real net exports are expected to be less of a drag on economic growth in 2003 than in 2002. The current account deficit is forecast to reach some 5¼ per cent of GDP, reflecting, *inter alia*, the differential strength of domestic demand in the United States and the rest of the world.

Monetary policy in the United States will continue to be expansionary, and given the continued economic sluggishness in the early months of 2003, a further lowering of interest rates can be expected. Pending adoption of the new tax package, the fiscal stimulus is likely to be more moderate in 2003, reflecting also the restraints on state and local government expenditure. In the event of war, increased military spending will tend to stimulate economic activity, although the likely order of magnitude involved is uncertain. This would also have to be set against the negative impact of military conflict on consumer and business confidence and spending (see below) and, more generally, on the global economy.

In western Europe, forecasts of economic growth in 2003 have been generally lowered since the autumn of 2002. Real GDP in the euro area is now forecast to increase by somewhat less than 1.5 per cent in 2003, up from 0.8 per cent in 2002 (table 1.1.2). In the late summer of 2002, the forecasts were still for an annual increase of real GDP by 2¼ per cent in 2003, which was already down from nearly 3 per cent expected in the spring of 2002.¹¹ The modest growth rate for 2003 is pulled down by the continued sluggishness of the German economy, where real GDP is forecast to increase by less than 1 per cent for the third consecutive year. But growth will also be weak in France and Italy and many of the smaller economies.

The basis for this moderate strengthening of growth in 2003 is a stimulus to export demand—originating in the United States—which is seen as triggering a virtuous circle of rising activity, increasing confidence and higher levels of spending by businesses and households. In this scenario, exports are the most dynamic component of final demand, reflecting a stronger cyclical momentum in the global economy in the second half of the year. But the overall stimulus to economic activity is still relatively modest, as is reflected in the modest acceleration expected in the growth of total domestic demand. This increase of domestic demand, moreover, is accompanied by rising imports, while export growth is likely to be restrained by the appreciation of the euro. Changes in real net exports are therefore likely to be broadly neutral in their impact on overall economic activity in 2003. Output growth will remain below trend, leading to a further increase in the output gap. Against this background, inflation is expected to fall below the 2 per cent ceiling of the ECB's target range in 2003 but unemployment can be expected to increase.

Monetary policy in the euro area shifted to a more accommodative stance in early December 2002, but the real appreciation of the euro has effectively led to a tightening of monetary conditions, offsetting the impulse from lower real interest rates. The appreciation of the euro, moreover, will tend to reduce imported inflationary pressures and this, in combination with the expected sluggishness of economic activity in early 2003, should enable the ECB to reduce interest rates again. Fiscal policy is faced with deteriorating total and structural government financial balances and the constraints on active policies imposed by the Stability and Growth Pact. On average, fiscal policy will not be supporting economic activity in the euro area in 2003, given, *inter alia*, the significant budgetary consolidation required in Germany to lower its budget deficit to below the 3 per cent threshold.

Outside the euro area, real GDP in the United Kingdom is forecast to grow by some 2.4 per cent in 2003, up from 1.6 per cent in 2002. There are major

¹⁰ See e.g. *OECD Economic Outlook*, No. 72 (Paris), December 2002; European Commission, *European Economy*, No. 5 (Brussels), 2002.

¹¹ European Commission, *European Economy*, No. 2 (Brussels), 2002.

uncertainties, however, related to the future developments of house prices and the related strength of private consumption expenditures. Low interest rates will continue to support domestic demand. The orientation of fiscal policy will be broadly neutral in 2003, following two years of strong support to economic activity.

In aggregate, real GDP in western Europe is expected to increase by some 1¾ per cent in 2003, up from 1 per cent in 2002. This is not an inspiring prospect and one which will contribute very little to correcting the major imbalances in the global economy.

(ii) Eastern Europe and the CIS

The considerable uncertainties surrounding the outlook for the global and west European economies, and not least the potential shock waves from a possible war in Iraq, cast a long shadow on the short-term outlook for eastern Europe and the CIS. The downside risks to the prospects for recovery in the world's major economies are compounded by the expected direct and indirect consequences of an eventual major military conflict and its possible repercussions on emerging markets. At the same time, it must be acknowledged that the east European and CIS economies demonstrated surprising resilience to the global slowdown in 2001 and 2002, thanks to the strong growth of their domestic demand and, in several cases, their unexpectedly good export performance. On balance, however, the downside risks, which have been escalating steadily since the final months of 2002 and the beginning of 2003, are not fully acknowledged in the official forecasts for the year (table 1.1.3), some of which were formulated last autumn in the context of preparing the 2003 budgets.

Although governments in some countries have recently lowered their forecasts (particularly in Hungary and Slovenia), the official outlook for most countries in eastern Europe and the CIS remains fairly optimistic about growth prospects in 2003. These forecasts imply aggregate real GDP growth in eastern Europe of close to 4 per cent in 2003 and in the CIS by almost 4½ per cent. It should be borne in mind, however, that growth in both these regions will be shaped to a considerable degree by the strength of output in the two largest regional economies – Poland and Russia, respectively.

In the course of 2002, recovery was slowly gaining momentum in Poland, especially in the second half of the year when there was a notable acceleration in the growth of both industrial output and GDP. This development prompted the government to raise its forecast for GDP growth in 2003 from 3.1 to 3.5 per cent. This, however, is considered by many independent analysts (as well as by the Polish National Bank) as too optimistic: most private forecasters envisage GDP growth in the range of 2 to 3 per cent. GDP growth is expected to remain relatively moderate in 2003 (between 3 and 4 per cent) in

all other central European countries (the Czech Republic, Hungary, Slovakia and Slovenia).¹²

The widening fiscal imbalances in some central European economies also pose a risk to their future growth. Obviously, the present fiscal policy stance in these countries is not sustainable and governments may soon be faced with the need to curb these imbalances (this process already started in Poland in 2002). Moreover, as discussed below, the countries acceding to the EU will need to make additional fiscal adjustment in order to comply with the EU's fiscal rules. The required fiscal tightening will inevitably restrain domestic demand and hence economic activity and growth in these countries.

Strong growth (with GDP growing by some 5-5½ per cent) is expected to continue in 2003 in the three Baltic states, the fastest growing region of eastern Europe for the last three years. Compared with the central European economies, these countries are less affected by structural fiscal imbalances, which leaves their governments more room to support economic activity in the short run, if such is needed.

According to official forecasts, moderate to strong growth is expected to continue in all the south-east European economies in 2003, with GDP increasing in most cases by some 4 to 5 per cent (and even more in Albania). However, the economic situation in individual countries differs considerably. After several years of steady recovery underpinned by prudent policies, the Bulgarian economy seems set to continue on its present course in 2003. Since 2001, the Romanian economy has broadly followed a similar path but the sustainability of high GDP growth in 2003 is questionable. While GDP growth in Croatia was relatively robust in 2002, its economy is plagued by a chronic twin deficit problem that has not been adequately addressed by policy so far; this may reduce the scope for policy to react to any eventual deterioration in the external environment. The major economic reforms which are still underway in Yugoslavia are likely to continue to have a dampening effect on its economic performance, which raises doubts as to the government's GDP growth forecast for 2003. A moderate recovery is expected to continue in Bosnia and Herzegovina, while in Albania the attempt to return to higher rates of growth in 2003 may prove to be difficult. The post-conflict recovery in The former Yugoslav Republic of Macedonia has proceeded more slowly than expected and only a modest recovery in GDP (by some 2-3 per cent) is projected for 2003.

¹² The official forecast for GDP growth in the Czech Republic in table 1.1.3 reflects a recent upward revision, which was prompted by a change in the quarterly national accounts for 2002. In January 2003 the Czech Statistical Office revealed a miscalculation in the previously reported foreign trade figures for the first three quarters of 2002; this also led to a major revision in the national accounts statistics, which showed that GDP growth in 2002 had been stronger than previously estimated.

Russia's budget for 2003 was based on a set of macroeconomic projections whereby, under different assumptions about the external environment (in the first place, the price of crude oil) the rate of GDP growth was expected to be in a range of between 3.5 and 4.4 per cent. The most recent forecasts by private analysts are even more optimistic, suggesting GDP growth of between 4 and 5 per cent. However, recent developments do not point in the same direction. Thus, while world oil prices surged to a two-year high in the early months of 2003 (a development which will benefit both Russian exporters and the economy at large), the significant weakening of the dollar (in which oil is priced) against other major currencies is likely to be detrimental. While the policy of moderate real exchange rate appreciation¹³ has facilitated Russia's recent disinflation, it is also likely to have contributed to the slowdown in industrial output in the last quarter of 2002.¹⁴ These somewhat conflicting trends indicate the uncertainties that surround the short-term outlook for the Russian economy.

Ukraine's recovery also lost some momentum in 2002 and GDP growth is expected to remain moderate (at some 4 per cent) in 2003. Apart from the weakening demand for Ukrainian exports in both Russia and western markets, this reflects a continued tightening of monetary policy with the central bank focusing its efforts on achieving a fast rate of disinflation. Some moderation in GDP growth is also expected in Kazakhstan but, according to official forecasts, GDP should nevertheless grow by some 6 per cent in 2003, underpinned not only by the strength of the oil-related industries but also by a continuing recovery in other sectors of the economy. Moderate to high rates of GDP growth are expected elsewhere in the CIS in 2003, with official forecasts ranging between 4 and 7 per cent (table 1.1.3).

(iii) Risks and uncertainties

The short-term economic outlook for the ECE region and the global economy at large remains subject to major downside risks. These are related to the factors mentioned earlier, which have been present for quite some time but which have not lost their importance. But in addition there is now the more acute risk of a military conflict in Iraq. It is impossible to estimate with any great accuracy the economic consequences of a war in Iraq, although some idea can be provided by more or less plausible scenarios.¹⁵ These scenarios differ with regard

to the duration of the conflict (ranging from a short intervention to a more protracted conflict), the total damage caused to Iraq, and the possible extension of the conflict and instability beyond that country.

The military and non-military budgetary costs for the United States (and possibly other countries) are therefore highly uncertain, as is the broader economic impact on the oil markets and the global economy. The latter will depend not only on what happens to the price of oil but also on the impact of (higher) defense spending and how the outbreak of war will affect consumer and business confidence. There is also the more long-term concern about the effect of a possible oil price shock on productivity growth in the net oil importing countries.

Consumer confidence in western Europe fell in January 2003 to its lowest level since the end of 1996, while in the United States, it reached its lowest level since the end of 1993. In the international equity markets, prices fell to six-year lows in late January 2003. These developments, however, reflect not only the threat of war in Iraq but also the bleak outlook for jobs and profits. The open question, however, is to what extent confidence and the equity markets will continue to decline in the event of the actual outbreak of military conflict. In any case, the already low levels of confidence and share prices do not bode well for private sector spending in 2003.

Oil prices in the final months of 2002 already incorporated a "war premium" of some \$5 per barrel and rose above \$31 per barrel in January 2003. If maintained at that level throughout 2003, this would be tantamount to a considerable "oil tax", which would increase inflation and dampen the growth of real incomes and the global demand for goods and services. Simulations suggest that a temporary (one-year) increase in oil prices by \$10 per barrel would, on average, reduce total economy output by a quarter of a percentage point in the industrialized countries and raise inflation by half a percentage point.¹⁶ Given the weakness of the present conjuncture, however, the effect of such an increase on output might be much larger.

Needless to say, a sustained rise in oil prices to much higher levels could push the western economies into recession. The precise circumstances in which this might happen is, of course, a matter of speculation. It could occur in the event of a conflict that is more protracted than expected, especially if combined, for example, with disruption (or threats of disruption) to oil supplies and further adverse shocks to consumer and business confidence.

The conflict could, however, be short and be followed by a sharp fall in oil prices, thereby boosting business and consumer confidence as well as real

¹³ According to a statement by Deputy Prime Minister and Finance Minister Alexei Kudrin, Russia will continue to pursue this policy in 2003. *Interfax News Agency, Today's News*, 30 January 2003.

¹⁴ According to the latest preliminary estimates, GDP growth is likely to have accelerated in the fourth quarter of 2002, mostly driven by the fast recovery in the services sector, while industrial output slowed down considerably.

¹⁵ W. Nordhaus, "The economic consequences of a war with Iraq", *War with Iraq. Cost, Consequences and Alternatives*, American Academy of Arts and Sciences Occasional Paper, 2002, chap. 3 [www.amacad.org].

¹⁶ *OECD Economic Outlook*, op. cit., pp. 46-47.

disposable incomes.¹⁷ But the adjustment problems associated with the considerable global financial imbalances mentioned above would still be present. It is therefore not clear that a swift resolution of the Iraq crisis would actually lead to a sustained recovery of economic activity in the United States and the global economy at large.

A major challenge remains the gradual reduction of the United States huge current account deficit and, associated with that, a gradual depreciation of the dollar. Although the dollar was weakening significantly and in an orderly fashion in 2002 and early 2003, there is still a risk of a more abrupt adjustment in international capital flows and exchange rates. This might reflect increased concerns on the part of international investors about the persistence of large external imbalances and the associated accumulation of foreign debt in combination with the re-emergence of much larger government budget deficits ("the twin deficit" problem).

Any accelerated depreciation of the dollar would raise imported inflation and would eventually force a tightening of monetary policy in the United States. An unexpectedly rapid and sustained depreciation of the dollar (against the euro and the yen) would, moreover, act as brake on economic growth in the euro area, Japan and other Asian economies. Such an outcome would be likely to trigger a coordinated intervention by the major central banks.

Another downside risk is that the pace of balance sheet adjustments by private households and the corporate sector in the United States could be more rapid than assumed, which would depress domestic demand growth.¹⁸

In a similar vein, a further sharp fall in equity prices (reflecting, for example, waning confidence in the recovery) would also tend to dampen business and household spending. In addition, there is the risk of a reversal of the boom in prices for residential real estate in the United States, which, if it were to occur, would amplify the loss of wealth already incurred by the plunge in share prices. (There is a similar risk for the United Kingdom.)

In a context of low inflation and sluggish economic activity, a collapse of equity prices, large margins of excess capacity and interest rates already at low levels, many commentators have expressed worries about the risk of sliding into a deflationary spiral, especially if central banks continue to aim at keeping inflation at

excessively low levels.¹⁹ The reason is that since official nominal interest rates cannot be reduced below zero,²⁰ the room for manoeuvre of monetary policy in a severe cyclical downturn may be quickly exhausted. The upshot is that in a context of low inflation and marked falls in economic activity, there is a case for a more active macroeconomic policy.

In the 1990s, economic forecasters and financial markets did not anticipate the sustained deflationary slump in Japan.²¹ One lesson from the Japanese experience is that when interest rates and inflation rates are already close to zero, monetary policy should pay special attention to the downside risks of economic forecasts, especially the possibility of deflation. In Germany, where inflation was about 1 per cent in 2002 and economic activity was stagnating at a low level, there appears to be the potential for a deflationary development.²²

The case of Japan also illustrates the point that once an economy has entered a deflationary process, it may be very costly and difficult to reverse.²³ Compared with that situation, the costs of a temporary, excessive monetary loosening would have been more limited and more easily corrected.²⁴ In Japan, the degree of monetary loosening proved inadequate and, with hindsight, a precautionary further loosening of monetary policy in the first half of the 1990s would have been justified. In a similar vein, model simulations suggest that a timely and moderate

¹⁹ More precisely, at levels below 2 per cent. IMF, *World Economic Outlook* (Washington, D.C.), April 2002, chap. II, pp. 85-103. For a more general assessment of the risks of deflation related to the recent episode of rapid credit expansion, excessive debt accumulation, overinvestment and speculative financial market bubbles see P. Warburton, *Debt and Delusion* (London, Penguin Books, 2000).

²⁰ Negative nominal interest rates are not in fact impossible, as is often assumed. A negative rate simply implies that the borrower is paid to borrow or, alternatively, is required to pay back less than was lent. This was effectively the situation for a while in the 1970s when, in an attempt to check the appreciation of the Swiss franc, Swiss banks were required to charge foreign customers for making deposits in banks in Switzerland. More recently, foreign banks in Japan, have been able to charge the large numbers of Japanese wanting to deposit their money with them, rather than Japanese banks whose solvency might be doubtful. In late January 2003, the overnight call rate on funds traded between foreign banks in Japan fell at one point to minus 0.1 per cent. This is perhaps a special case in that it reflected the institutional arrangement in Japan whereby the banks are required either to lend their surplus funds or place them with the Bank of Japan. Since the central bank has recently been reducing the volume of deposits it is prepared to accept, the foreign banks are forced to lend even at negative rates of interest. See "Japan's interest rates fall below zero", *Financial Times*, 25/26 January 2003.

²¹ A. Ahearn et al., *Preventing Deflation: Lessons from Japan's Experience in the 1990s*, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 729 (Washington, D.C.), June 2002.

²² DIW, "Grundlinien der Wirtschaftsentwicklung 2003/2004", *Wochenbericht 1-2/2003* (Berlin), 9 January 2003.

²³ Falling prices encourage consumers to postpone spending in the expectation of still lower prices. Deflation also increases the real burden of debt.

²⁴ A. Ahearn et al., *op. cit.*, p. 5.

¹⁷ A sustained sharp fall in oil prices would, of course, dampen economic growth and weaken government financial balances in the oil exporting countries, including Russia.

¹⁸ For an early warning about the unsustainability of the United States domestic and external imbalances see W. Godley and A. Izurieta, *As the Implosion Begins...? Prospects and Policies for the U.S. Economy: A Strategic View*, Jerome Levy Economics Institute, July 2001 [www.LEVY.org].

additional fiscal loosening might have been sufficient to maintain economic activity. Moreover, combining a monetary loosening with a fiscal stimulus is likely to have been even more effective and therefore desirable, "as it would have reduced the need to rely too heavily on each instrument individually, and thus would have moderated some of the drawbacks associated with pushing either instrument too far."²⁵

The general lesson is that when inflation and interest rates have fallen close to zero, active policies should not be held back by fears of an excessive stimulus, which can be reversed later through the tightening of policies. Conversely, providing too little stimulus runs the risk that the economy will slide into a deflationary spiral where conventional monetary policy instruments can no longer stabilize the economy. Although there exist a variety of unconventional measures for dealing with this situation, there is no experience with their implementation or knowledge of the likely effectiveness of these instruments.²⁶

Although the possibility of deflation still appears to be remote in most industrialized countries, the risk has probably increased and should not be ignored. Any prospect of deflationary tendencies can certainly be countered by the timely creation of a conducive environment for a sustained economic recovery.

(iv) Achieving a sustained cyclical recovery

The European Union's economic performance was relatively good in the second half of the 1990s, with annual growth rates of real GDP falling within a range of 2.5 to 3.3 per cent from 1997 to 2000 accompanied by strong employment gains and moderate inflation. But economic growth faltered in 2001 and was even more sluggish in 2002. If such a performance were to continue, the European Union would not even come close to the ambitious strategic goals agreed upon at the Lisbon European Council in March 2000, namely, to become "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion"²⁷ by the end of the first decade of this new millennium. The crucial issue now is to lay the foundations for a sustained and robust rate of growth over the medium term.

Hopes for a recovery in 2003 are pinned upon a cyclical upturn in the United States, which is being relied upon as an engine of global growth. But the large

domestic and external imbalances in the United States now constrain its ability to continue playing this role.²⁸ Indeed, what is required in the United States is a greater emphasis on the growth of net exports, which means essentially switching expenditures from imported to domestically produced goods, in order to reduce the huge external deficit to more sustainable levels. The mechanism for achieving this is improved price competitiveness, i.e. a depreciation of the dollar. This process got underway with the decline of the dollar that started in 2002 and has continued in early 2003.

The implication, of course, is that the expected cyclical impulse from the United States is likely to be smaller than is anticipated in current forecasts. This points to the need for a greater reliance on domestic sources of economic growth in both western Europe and Japan. This in turn would effectively help the adjustment process in the United States to advance more smoothly given the stronger import demand from the rest of the world.

Economic growth can be stimulated by reforms in capital, labour and product markets and there is certainly a need for more progress in these areas.²⁹ But in the current cyclical context there is also a need for economic activity to be supported by more expansionary economic policies. The stance of monetary policy in the euro area was further relaxed in late 2002, but in view of the deteriorating growth prospects this appears to have been "too little, too late". A further lowering of interest rates is now warranted, given the persistent weakness of growth in the three larger euro area economies, especially in Germany.

Economic developments in the euro area in 2002 have once again led to a conflict between the fiscal policy rules embodied in the Stability and Growth Pact (SGP) and the short-term stabilization needs of individual countries. A principal rationale for fiscal rules in the EMU is that they are designed to protect the ECB against pressures from high-debt countries for debt bailouts. Excessive levels of government borrowing are also seen as increasing the risk of interest rate spillovers to the other members of the EMU. Although these rationales are not uncontroversial, it goes without saying that long-term debt sustainability is a matter of considerable concern, especially in view of the growing fiscal pressures arising from population ageing. The need

²⁵ Ibid., p. 6.

²⁶ The Federal Reserve Board, *Deflation: Making Sure 'It' Doesn't Happen Here*, remarks by Governor Ben S. Bernanke before the National Economists Club (Washington, D.C.), 21 November 2002 [www.federalreserve.gov].

²⁷ Lisbon European Council, 23 and 24 March 2000, Presidency Conclusions [www.europarl.eu.int/summits].

²⁸ UNECE, *Economic Survey of Europe, 2002 No. 2*, p. 37.

²⁹ European Commission, Economic Policy Committee, *Annual Report on Structural Reforms 2002* (Brussels), 5 March 2002, ECFIN/EPC/117/02-EN. The empirical effects of product market liberalization on labour market performance, however, are difficult to gauge and probably not very large. G. Nicoletti et al., "European integration, liberalization and labor market performance", in G. Bertola, T. Boeri and G. Nicoletti (eds.), *Welfare and Employment in a United Europe* (Cambridge, MA, The MIT Press, 2001), pp. 147-235.

to ensure generational balance, i.e. an equitable intergenerational distribution of fiscal burdens and social welfare, constitutes an enormous policy challenge. The fiscal pressures differ considerably across countries but if not tackled in time they risk undermining the EMU.³⁰ But the looming generational imbalances also raise the wider issue of whether government debt-to-GDP ratios are always an appropriate measure of fiscal prudence or vulnerability.

The crux of the issue over quantitative fiscal rules, however, is not only that they always contain an element of arbitrariness but that they also may be too rigid in unexpectedly bad times when more flexibility is required. The recent proposals by the European Commission aim to alleviate some of the concerns about the procyclical bias of the Stability and Growth Pact by shifting the focus of medium-term fiscal consolidation to cyclically adjusted budget deficits and by giving greater importance to the government debt criterion in the budgetary surveillance process.³¹ At the same time, the deterioration of economic conditions in 2002 led to a postponement of the date for meeting the main fiscal targets (broadly balanced budgets) from 2004 to 2006. While going in the right direction, these new rules, however, do not apply to countries with significant budget deficits, which are required to reduce their structural deficits by 0.5 per cent of GDP a year from 2003, i.e. they will have to pursue a procyclical policy despite the worsening economic outlook, an approach that may well prove to be counterproductive.

An alternative solution would be to fix long-term targets only for government debt and to establish credible fiscal rules and mechanisms that force governments to pursue them without imposing quantitative budget deficit targets in the short run.³² This would allow the automatic stabilizers to be fully operational at all times and to provide scope for a discretionary stimulus when needed. It has also been proposed that countries be provided with some leeway for exceeding the current reference value for budget deficits, depending on the level of government debt. But, in any case, there is no easy way to reconcile short-term stabilization needs with long-term concerns about fiscal sustainability. There remains also the important

issue of public infrastructure investment, which for reasons of intergenerational equity is often financed by borrowing (the so-called golden rule). The requirement to achieve a close-to-balance government budget may adversely affect the extent to which the public sector capital stock is being rebuilt and enhanced, if these investment expenditures are not excluded from the calculation of government financial positions, with negative long-run consequences for economic growth.

The degrees of flexibility in fiscal policy within the SGP and the Code of Conduct (COC) also have significant implications for the acceding east European countries. Applying the current EU fiscal rules could have particularly harmful consequences for those economies that are approaching EU accession with a weak fiscal position in terms of the structural fiscal deficits and public debt. Some of the accession countries (in particular, most of the central European economies) seem to fall into this category, at least insofar as their current financial position is concerned. Although until now there have been no accurate estimates of their structural deficits, recent research suggests that these might be quite sizeable.³³

Their weak initial fiscal positions will be a double burden for the accession countries. They will require first of all an initial structural adjustment in the run-up to EMU accession in order to move closer to the reference fiscal deficit levels; given their starting position, this implies a risk of an excessive fiscal tightening in this period, with obviously negative consequences for economic growth. Second, even after such an adjustment, the EU's fiscal rules may be detrimental for growth in the accession countries due to the fact that their economies are still generally immature: compared with mature market economies, the east European countries are more susceptible to external disturbances and hence to higher volatility of aggregate output. Consequently, in a cyclical downturn they will be more likely to exceed the fiscal deficit reference level, a situation which would require a needlessly severe fiscal tightening (fiscal policy would in fact become procyclical).³⁴ And third, once they are members of the EU, the accession countries will also be committed to achieving the main fiscal target, that of fiscal balance, which in some cases may require a new round of fiscal adjustment. Moreover, the net fiscal effect of EU membership on the acceding countries is expected to be negative, at least in the short run – see chapter 3.1(ii). Thus, even if revised in accordance with current proposals

³⁰ N. Ferguson and L. Kotlikoff, "The degeneration of EMU", *Foreign Affairs*, March/April 2000, pp. 110-121; N. Ferguson, *The Cash Nexus* (London, Allen Lane, The Penguin Press, 2001), pp. 332-340.

³¹ Chap. 2.2.

³² It has even been suggested that independent fiscal policy committees be established (along the lines of independent central banks), which would have to ensure that the long-run targets for sustainable levels of debt are met, while deciding on the annual levels of budget deficits in a flexible manner, depending on macroeconomic conditions. C. Wyplosz, *Fiscal Policy: Institutions versus Rules*, CEPR Discussion Paper, No. 3238 (London), February 2002.

³³ A recent empirical study concludes that the large deficits in some accession countries in recent years are largely structural. F. Coricelli and V. Ercolani, *Cyclical and Structural Deficits on the Road to Accession: Fiscal Rules for an Enlarged European Union*, CEPR Discussion Paper, No. 3672 (London), December 2002.

³⁴ Ibid.

EU fiscal rules may still impose excessively harsh policy constraints on newly acceding EU members, effectively creating an impediment to their economic growth.

More generally, the pattern of growth that prevailed in eastern Europe in 2001 and 2002 – when it was predominantly driven by domestic demand – is no longer consistent with the weak fiscal position of some of these countries. This is not a sustainable model of long-run growth for catching-up economies, which as a rule rely

on export-led growth and fixed investment, a pattern that prevailed in eastern Europe during the second half of the 1990s. These considerations once again highlight the importance of achieving a sustained upswing in the EU's major economies, which would help to restore the balance of economic growth in the ECE region as a whole, with the larger economies resuming their leading role as engines of growth for the smaller and weaker east European economies.