

CHAPTER 3

EASTERN EUROPE AND THE CIS

3.1 Macroeconomic policy

In 2002, the conduct of macroeconomic policy in eastern Europe and the CIS was influenced by several key factors. One was the increasing importance of domestic sources of growth. The external environment remained generally unfavourable due to the continuing weakness of the global economy and, especially, sluggish growth in western Europe. In contrast, domestic demand in most east European and CIS economies remained buoyant, fuelled by growing real incomes and steadily improving expectations about the future. It was mostly this impetus that enabled these economies to maintain their relatively fast pace of growth in 2002. The growing uncertainties surrounding developments abroad prompted an easing of macroeconomic policy, especially in some of the east European countries.

The move towards greater policy activism in eastern Europe was facilitated by the considerable progress already achieved in establishing macroeconomic stability and the growing confidence – both among policy makers and among investors – that this would be maintained. Inflationary expectations in the EU acceding and candidate countries have been strongly anchored at low levels by the anticipated accession to EMU. But also in the non-acceding east European countries and in most of the CIS economies, cautious macroeconomic policies have contributed to the general lowering of inflationary expectations. In addition, imported inflation in 2002 was low due to falling commodity prices and the general moderation of international prices for manufactured goods.

Although some of these economies have a greater room for policy manoeuvre than was the case several years ago, it is still rather limited and should be used with great caution. The most severe constraints are the widespread and chronically large current account deficits. In the presence of exchange rate risk (which will remain for some time even in the acceding countries) and given the volatility of short-term capital flows, maintaining the stability of the external balance remains an issue of the highest priority for macroeconomic management. In this regard, the easing of macroeconomic policy, and especially the loosening of the fiscal stance, may carry some balance of payments risks. The recent emergence of large fiscal imbalances in some of the leading reformers of central Europe – which has compromised their otherwise good macroeconomic performance – is another major source of

concern. As discussed below, the emerging fiscal gaps in some countries, if unchecked, could prove an obstacle to future EMU accession and increase the risks to the sustainability of the long-term fiscal balance in these countries. Given these constraints, it is difficult to define the admissible limits to policy activism; however, a more conservative assessment of the emerging risks is probably needed when policy makers are considering the scope for active demand management.

(i) Monetary conditions and policy responses

In general the macroeconomic environment facing the monetary authorities in 2002 was relatively favourable in eastern Europe and the CIS as there were no major external shocks requiring immediate policy responses. The economies in the region were not directly affected by contagion from the financial crises in Latin America and capital flows to eastern Europe and the CIS were generally less volatile than in other emerging markets. In most countries disinflation continued and in some cases (Croatia, the Czech Republic, Latvia, Lithuania, Poland, Armenia and Ukraine, among others) the annual rates of inflation were even below the targets for the year.

At present there is a clear dividing line between the monetary goals in the EU acceding and candidate countries, on the one hand, and the non-acceding countries, on the other. The main strategic goal for the former is to prepare for a smooth accession to the EMU. Formally, three of the four Maastricht criteria for participation in the EMU (price stability relative to the three best performing EU member states, exchange rate stability in terms of adherence to ERM-2, and interest rate convergence on the three best performing member states in terms of price stability) are directly related to monetary policy. Thus, the central banks in all the acceding countries are actively engaged in elaborating their strategies for EMU accession.

As the date for entry into the EU is now set for May 2004 for eight east European countries (2007 is envisaged for Bulgaria and Romania), under the present regulations, the accession to EMU can take place at the earliest in late 2006, that is, after two years of participation in ERM-2 and assuming that the new member joins ERM-2 immediately after EU accession (although there is no requirement to do so). The timing of EMU accession is at present a central theme of most monetary policy

debates in the acceding countries but opinions diverge. A number of different and sometimes conflicting issues (such as the speed of nominal and real convergence as well as the cost of different accession options) have to be taken into account when considering the timing of EMU accession.⁷³ The optimal time to enter may not be the same for all countries, and this is probably one explanation of why there are also substantial differences in the declared intentions of the acceding countries.⁷⁴ Nevertheless, none of the eight acceding east European economies has so far set a target date for entry beyond the end of the current decade. This may turn out to be an overly ambitious objective given the serious challenges arising from the need to reconcile the goals of nominal and real convergence⁷⁵ and from some emerging problems related to the achievement of a sustainable general government fiscal position (discussed in section 3.1(ii)).

The monetary policy agenda in the non-acceding countries has been dominated by the need to sustain the recent achievements in macroeconomic and financial stabilization. There has also been considerable progress in the actual conduct of monetary policy which is now much more coherent and consistent than was the case in the early years of the transition. The rapid rate of disinflation in recent years is the clearest indication of the progress made in this area: most of these countries now have inflation rates in low, single digits and even in the few countries with double-digit inflation, the general trend in 2001-2002 has been downwards. Another sign of maturity in the conduct of monetary policy, both in eastern Europe and the CIS, is the fact that in 2002 – unlike in previous years – there were no major changes in exchange rate regimes.

For the first time since the start of economic transformation more than a decade ago, many east European and CIS currencies appreciated in nominal terms against the dollar in 2002 (chart 3.1.1). This was mainly due to the general weakening of the dollar in the

international currency markets⁷⁶ but significantly, since most of these countries adhere to floating exchange rate regimes, it also reflected, *inter alia*, the strength of their economies and their progress in achieving macroeconomic and financial stability. The general stance of monetary policy (discussed below) as well as some additional factors, also contributed to such appreciation. Thus, in some east European countries (notably the Czech Republic, Hungary, Poland, Slovakia and in 2002 also Slovenia and Yugoslavia) there has recently been a surge in foreign capital inflows and these have put an upward pressure on their currencies.⁷⁷ The large current account surpluses in CIS countries such as Russia and Ukraine have had a similar effect.⁷⁸

In addition, some east European economies appear to be subject to additional pressure on their currencies due to the Balassa-Samuelson effect.⁷⁹ In particular, when the exchange rate regime allows for some nominal flexibility of the currency and when the domestic inflation rate is low, the Balassa-Samuelson effect puts upward pressure on the foreign exchange market, forcing a real appreciation through a nominal appreciation of the currency. The emergence of nominal exchange rate appreciation caused by the Balassa-Samuelson effect is a relatively new phenomenon in eastern Europe; it only surfaced when inflation rates in the region fell to low single digits, at which point they became comparable to the size of this effect.⁸⁰

⁷⁶ In those cases when the exchange rate is fixed against the euro (such as Bosnia and Herzegovina, Bulgaria, Estonia, and Lithuania since 2002) the nominal exchange rate appreciation merely reflects the weakening of the dollar against the euro. For this reason only Bulgaria is shown in chart 3.1.1. In October 2001 Hungary abandoned the crawling peg and pegged the forint to the euro; however, the forint is allowed to fluctuate within a ± 15 per cent band (which has been in operation since May 2001).

⁷⁷ Some of the acceding countries can expect short-term capital flows to increase further in the run-up to EMU as they will be attracted by a convergence play promising high returns and low risk premia.

⁷⁸ In the case of Ukraine it should be added that the central bank has been using the exchange rate as a nominal anchor in its effort to achieve price stability.

⁷⁹ The Balassa-Samuelson effect refers to the fact that in a fast-growing catching-up economy the prices of non-tradeable goods (with a large weight in the CPI) tend to rise faster than the prices of tradeable goods and, consequently, faster than the prices of non-tradeables in comparison with a more mature economy growing at a lower rate. One consequence, if catching up is a long-term phenomenon, is that there will be a trend appreciation of the real exchange rate (CPI deflated) in the catching-up economy relative to the more mature economy. There have been a number of recent empirical studies confirming the presence of the Balassa-Samuelson effect in eastern Europe. UNECE, "Economic transformation ...", op. cit; M. Kovács (ed), *On the Estimated Size of the Balassa-Samuelson Effect in Five Central and East European Countries*, National Bank of Hungary Working Papers 2002/5 (Budapest); July 2002; B. Égert, "Investigating the Balassa-Samuelson hypothesis in the transition", *Economics of Transition*, Vol 10, No. 2, 2002, pp. 273-309; D. Mihajek, "The Balassa-Samuelson effect in central Europe: a disaggregated analysis", paper presented at the 8th Dubrovnik Economic Conference (Dubrovnik), 27-29 June 2002 (mimeo).

⁸⁰ Most empirical studies estimate the Balassa-Samuelson effect to be of the order of 1-2 percentage points of price differential (accordingly, of real appreciation) per annum. For this effect to exert pressure on the nominal exchange rate, inflation has to be of a comparable magnitude; otherwise the real exchange rate appreciates with the inflation differential.

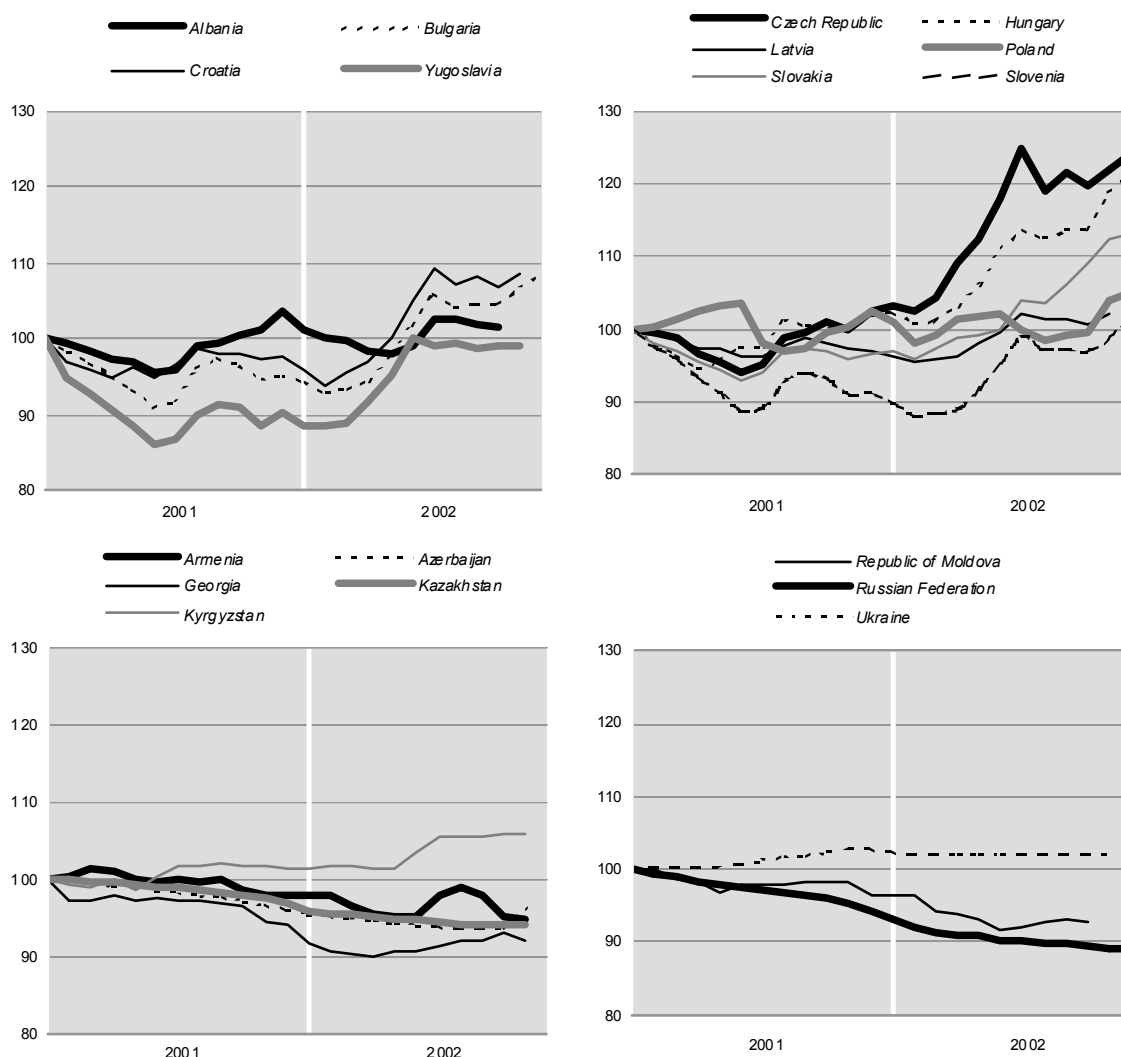
⁷³ UNECE, "Alternative policies for approaching EMU accession by central and east European countries", *Economic Survey of Europe, 2002 No. 1*, chap. 5, pp. 181-193; T. Padoa-Schioppa, "Trajectories towards the euro and the role of ERM-2", speech given at the East-West Conference, *Structural Challenges and the Search for an Adequate Policy Mix in the EU and in Central and Eastern Europe*, organized by the Austrian National Bank (Vienna), 3-5 November 2002 (www2.oenb.at/tagung/ostwest2002/index.htm).

⁷⁴ Thus, for example, Hungary and Poland reportedly are aiming at the earliest possible EMU accession date, while the authorities in the Czech Republic are apparently contemplating a longer preparatory period. Czech National Bank, "The Czech Republic and the euro – draft accession strategy", *Press Release*, 27 December 2002 (www.cnb.cz/en/index.php); A. Csajbók and Á. Csémely (eds.), *Adopting the Euro in Hungary: Expected Costs, Benefits and Timing*, Hungarian National Bank Occasional Paper, No. 24 (english.mnb.hu/dokumentumok/opaper24.pdf); statement by the joint Finance ministry and central bank committee in Poland, as reported by *Reuters News*, 8 October 2002.

⁷⁵ UNECE, "Economic transformation and real exchange rates in the 2000s: the Balassa-Samuelson connection", *Economic Survey of Europe, 2001 No. 1*, chap. 6, pp. 227-239.

CHART 3.1.1

Nominal exchange rates against the dollar in selected east European and CIS economies, 2001-2002
(Indices, January 2001=100)



Source: UNECE secretariat calculations, based on national statistics.

Note: An increase in the index denotes a nominal appreciation and vice versa.

As a result of the combined effect of these factors, the tendency towards nominal appreciation in 2002 was especially pronounced in several countries: thus the currencies of Croatia, the Czech Republic, Hungary and Slovakia,⁸¹ appreciated nominally against the euro as well. In some cases central banks intervened to weaken their currencies,⁸² but the effect of these interventions was short-lived.

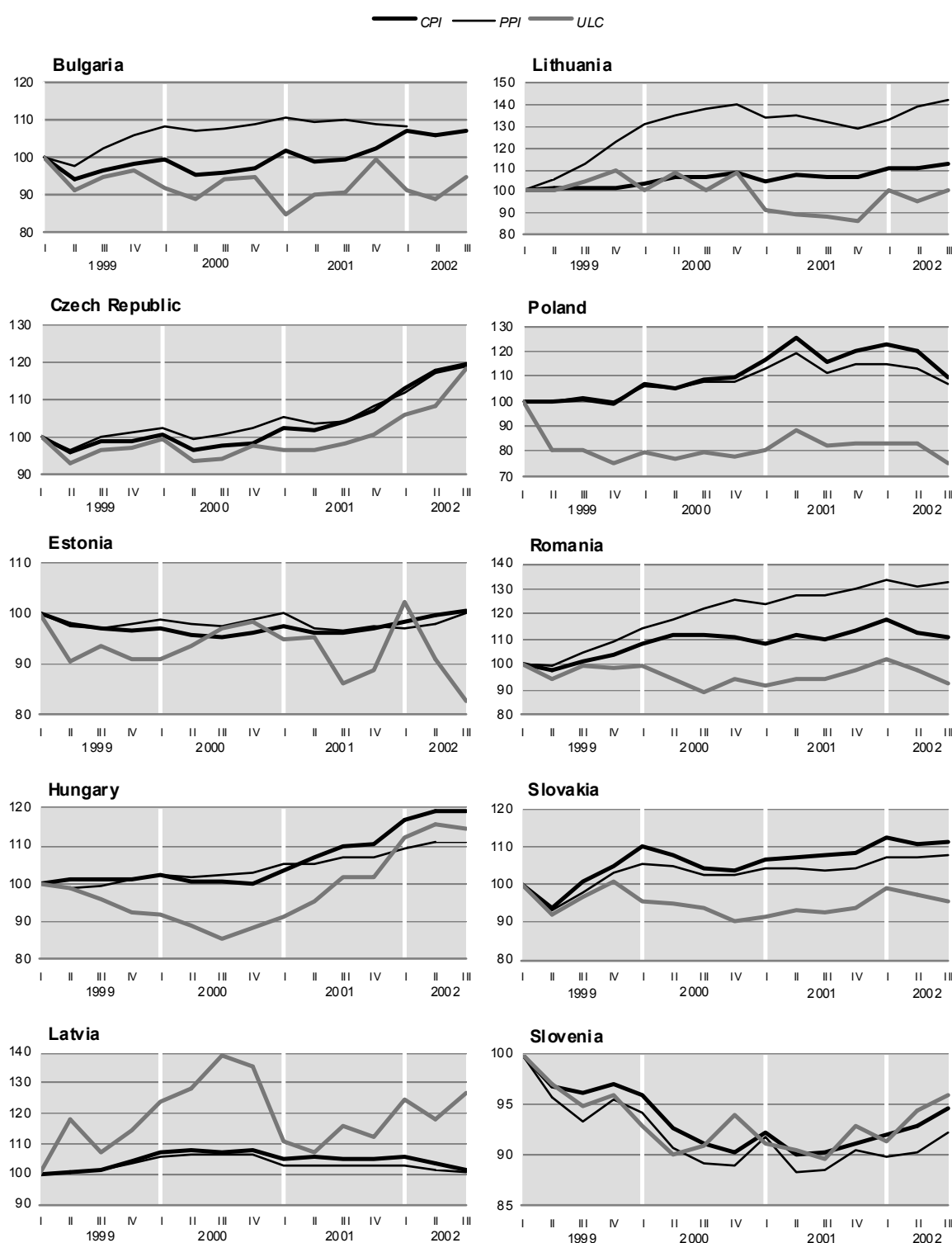
⁸¹ In the final months of the year, in Poland and Azerbaijan as well.

⁸² During the second quarter of 2002, the Croatian National Bank purchased €316.9 million, the equivalent of some 11 per cent of M1. Croatian National Bank, *Quarterly Report*, No. 75 (Zagreb), October 2002. Interventions were also reported throughout the year in the Czech Republic and Slovakia. The Bank of Slovenia intervened actively against the tolar on the foreign exchange market to counter the impact of large capital inflows. The absence of a nominal appreciation in this case, however, can be explained by the relatively high inflation rate in the country, which helped to absorb the real appreciation of the currency.

In 2002 the Balassa-Samuelson effect was probably mitigated by the general slowing down of economic growth in the region although a positive productivity differential vis-à-vis western Europe and most of the other developed market economies remained. In addition, inflation in eastern Europe and the CIS was dampened by the very low rates of imported inflation, which in some cases were probably negative. As a result, CPI-deflated real exchange rates diverged: in some countries such as Bulgaria, the Czech Republic, Estonia, Lithuania, Hungary, Slovakia and Slovenia trend appreciation continued, but in others, such as Latvia, Poland and Romania, it was reversed (chart 3.1.2).⁸³ The large real appreciation of the PPI-deflated real

⁸³ In Poland, this reversal is probably associated with the marked weakening of output as a result of which the Balassa-Samuelson effect probably changed direction.

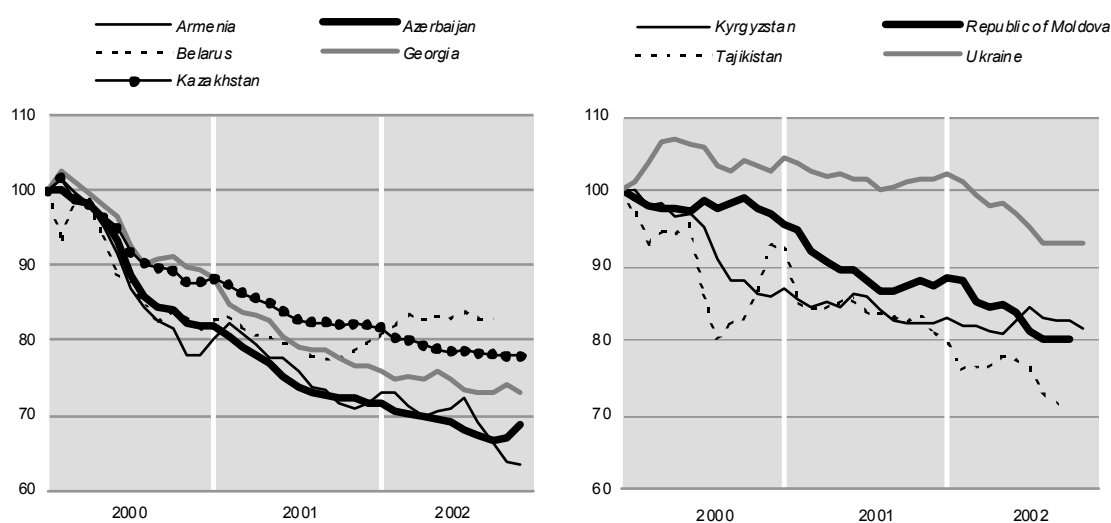
CHART 3.1.2
Real effective exchange rates in selected east European countries, 1999-2002
(Indices, first quarter 1999=100)



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.

CHART 3.1.3
Real exchange rates against the Russian rouble ^a in selected CIS economies, 2000-2002
(Indices, January 2000=100)



Source: UNECE secretariat calculations, based on national statistics.

Note: An increase in the index denotes a real appreciation and vice versa.

^a CPI deflated.

exchange rates in Lithuania and Romania and, to a lesser extent, in Bulgaria after 1999, can be explained by the surge in the international prices of oil and oil products between 1999 and 2001: all three countries are major exporters of such products and the latter have a significant weight in their PPI indices.

Within the CIS, most currencies depreciated in real terms against the Russian rouble in 2002, a trend that has prevailed since 2000 (chart 3.1.3).⁸⁴ The main factor behind this development has been the strength of the rouble against the main international currencies, underpinned by a large current account surplus and the rapid growth in Russia's official reserves (tables 3.5.1 and 3.5.8). Among the exceptions to this pattern in 2002 were Belarus and partly Kyrgyzstan.⁸⁵

The central banks used various monetary instruments, but especially interest rates, to prevent an excessive nominal appreciation of their currencies during the course of 2002. Thus, the Czech National Bank

lowered its key official interest rates five times,⁸⁶ and during the second half of the year these were lower than those of the European Central Bank.⁸⁷ In Slovakia, after a long period with virtually no intervention in the money market, the central bank was more active in 2002. In November it cut its basic two-week repo rate by 150 basis points (to 6.5 per cent): this was the most radical move taken in the last six years and was prompted by the emerging pressures on the exchange rate. Similarly, in October, the Croatian National Bank cut its refinancing rate by 140 basis points (to 4.5 per cent), the first reduction in more than two years. In Hungary, the general trend was also towards a lowering of the central bank's interest rates,⁸⁸ although the changes were not always in the same direction: on two occasions (in May and July) the central bank raised its refinancing rates because of fears about the inflationary impact of rapid wage growth and of the loose stance of fiscal policy. Due to these concerns, monetary policy in Hungary was actually tightened in 2002, a stance that is reflected in the sharp rise in real interest rates (see below).⁸⁹

⁸⁴ Two countries, Turkmenistan and Uzbekistan, are not presented in this chart due to data problems and the nature of their exchange rate regimes. Turkmenistan does not publish any price statistics and maintains a non-convertible currency; the exchange rate is fixed but there is no free access to foreign exchange at this rate. The situation in Uzbekistan is similar, although not so acute. It still maintains a multiple exchange rate system; in 2002, as part of an IMF-supported reform programme, it was due to liberalize the foreign exchange market and establish a single market exchange rate. However, the implementation of the programme has encountered delays and currency convertibility has still not been introduced. It should be noted that the country so far has not published price statistics for 2002.

⁸⁵ In Ukraine the strength of the hryvnia against the rouble in 2000 and 2001 largely reflects the central bank policy of targeting nominal exchange rate stability.

⁸⁶ Over this period the key two-week repo rate was reduced from 4.5 to 2.75 per cent while the discount rate fell from 3.5 to 1.75 per cent.

⁸⁷ The latter also reduced its main refinancing rate to 2.75 per cent in December.

⁸⁸ Between the beginning and the end of the year the main two-week repo rate fell from 9.75 to 8.5 per cent.

⁸⁹ The monetary stance was eased in January 2003 when the central bank cut its refinancing rate by a further 200 basis points to 6.5 per cent. In January the central bank was also forced to intervene against the forint (for the first time since May 2001) as it reached the upper limit of its band against the euro.

The Polish National Bank aggressively lowered interest rates in 2002: in eight consecutive steps, central bank rates were cut by some 6-7 percentage points.⁹⁰ However, these moves were not only aimed at a weakening of the zloty but also at a general relaxation of monetary policy, which had been partly blamed for the sluggish performance of the Polish economy in 2001 and 2002. Concerns about the efficiency of the available monetary policy instruments in preventing an excessive appreciation of the currency have prompted a renewed debate in Poland about the adequacy of the present exchange rate regime in the run-up to EMU.⁹¹

The general easing of monetary policy also extended to the CIS.⁹² In most countries for which relevant data are available, the central banks lowered their interest rates in 2002, in line with the general disinflationary trend.⁹³

Apart from using interest rates, some central banks resorted to a more active management of mandatory reserves in pursuit of their monetary goals. In preparation for accession to EU and EMU, the monetary authorities in several countries lowered their required reserve ratios with the goal of gradually harmonizing them with ECB regulations.⁹⁴ During the year the National Bank of Hungary increased its interest rate on the mandatory reserves of commercial banks from 4.25 to 5.75 following similar rises in 2002. The bank's motivation was to reduce income redistribution within the banking system, to improve the competitiveness of banks, and to continue the process of harmonization with the ECB's regulations. Reserve requirements were also lowered in Romania but they still remain much higher than in the accession countries.⁹⁵ In Ukraine, the required

reserve ratio was amended three times with the aim of closing the differences between the reserve requirements for deposits in domestic and foreign currency.⁹⁶

The lowering of official interest rates in 2002 had a favourable effect on the nominal lending rates of commercial banks, which generally declined throughout eastern Europe and the CIS (table 3.1.1).⁹⁷ However, the rather aggressive easing of monetary policies did not always have the same effect on real interest rates; in fact, both real lending and real deposit rates in the majority of the east European countries and in many CIS economies increased in 2002. The main reason for this was the rapid rate of disinflation, especially in relation to producer prices, which often exceeded the reduction in nominal interest rates. Thus, despite the fall in nominal lending rates, the real cost of credit to borrowers was generally rising and this is likely to have had a negative effect on economic activity throughout the region. In contrast, the increase in real deposit rates (which in some cases were negative in 2001) was a positive development in that it stimulated the placing of monetary holdings in the banking systems.

The developments in interest rates generally had a positive effect on money demand in eastern Europe and the CIS: in most of these economies remonetization continued at a relatively fast pace in 2002. This can be seen quite clearly in the share of broad money in GDP, which increased considerably in most countries in the region (table 3.1.2). In some (Bosnia and Herzegovina, Croatia, Latvia, Slovenia, Yugoslavia, the Republic of Moldova and Ukraine) the change was quite significant. The main factor behind the fast rate of remonetization was the rapid growth of deposits denominated in domestic currency (particularly, time deposits) driven by attractive real deposit rates.⁹⁸ Among the exceptions to this pattern were Poland and The former Yugoslav Republic of Macedonia, where weak economic activity coupled with uncertainties about future prospects weakened money demand, and the Czech Republic, where it was related to the on-going restructuring of the banking sector.

In most east European and CIS economies, credit to the non-government sector was generally rising in 2002 (table 3.1.2), despite the rise in real interest rates. This largely reflected a rapid expansion of household credit, as corporate credit grew more modestly in 2002 and in some countries even declined. However, credit to the non-government sector in the Czech Republic continued to shrink both in proportion to GDP and in absolute terms, largely due to the net withdrawal of financial resources by

⁹⁰ During the course of the year the key 28-day intervention rate was reduced from 11.5 to 6.75 per cent, the discount rate from 14 to 7.5 per cent and the Lombard rate from 15.5 to 8.75 per cent.

⁹¹ In particular, there have been suggestions to abandon the present free floating regime and switch to a managed float. *Reuters News*, 5 December 2002, reported in *Dow Jones Reuters Business Interactive* (Factiva).

⁹² The monetary statistics in a number of CIS economies is still unsatisfactory, which prevents a more comprehensive analysis of monetary developments in that region. Some central Asian economies (in particular Tajikistan, Turkmenistan and Uzbekistan) still do not publish any monetary statistics. Other countries such as Azerbaijan, Georgia and the Republic of Moldova started publishing such statistics only recently.

⁹³ In Armenia the refinancing rate was reduced from 15 to 13.5 per cent; the central bank in Belarus first raised its refinancing rate from 48 to 66 per cent in January but afterwards in a series of cuts this rate fell to 38 per cent in November; over the course of the year the Kazakh National Bank cut its refinancing rate from 9 to 7.5 per cent, the Central Bank of the Russian Federation from 25 to 21 per cent and the National Bank of Ukraine from 12.5 to the record low of 7 per cent.

⁹⁴ In 2002, the National Bank of Poland reduced its required reserve ratio from 5 to 4.5 per cent and announced its intention to cut it to 2 per cent by the year 2004, in order to bring it into line with the EU norm. Similarly, the National Bank of Slovakia lowered its reserve requirement from 5 to 4 per cent while the Bank of Latvia reduced the required reserve ratio from 6 to 5 per cent and, with effect in January 2003, to 3 per cent.

⁹⁵ In December 2002 the required reserve ratio for deposits in lei was 18 per cent and 25 per cent for deposits in foreign currencies.

⁹⁶ By the end of the year these were 8 and 10 per cent, respectively.

⁹⁷ The reported rise in nominal lending rates in Croatia is due to a change in reporting methodology (see the note to table 3.1.1).

⁹⁸ In most east European and CIS economies for which the relevant data are available, the share of domestic currency time deposits in broad money increased in 2002.

TABLE 3.1.1
Short-term interest rates in selected east European and CIS economies, 2000-2002
(Per cent per annum)

	Short-term credits						Short-term deposits						Average yield on short-term government securities		
	Nominal			Real			Nominal			Real			2000	2001	2002 ^a
	2000	2001	2002 ^a	2000	2001	2002 ^a	2000	2001	2002 ^a	2000	2001	2002 ^a			
Eastern Europe															
Albania	26.1	16.4	14.9	..	..	..	8.3	7.7	8.3	8.3	4.5	2.5	10.4	7.7	9.1
Bosnia and Herzegovina	30.5	..	..	..	..	..	14.7	..	..	13.1	..	..	..	..	..
Bulgaria	12.2	11.7	9.9	-4.1	6.9	7.5	3.2	3.2	3.0	-6.5	-3.9	-3.4	4.3	4.6	4.4
Croatia	12.1	9.6	13.4 ^b	2.2	5.7	14.8 ^b	3.7	3.2	2.0	-2.3	-1.6	0.2	9.2	5.9	..
Czech Republic	7.2	7.1	6.4	2.1	4.0	6.9	3.4	3.0	2.3	-0.5	-1.6	-	5.3	5.2	4.1
Estonia	7.8	7.8	7.2	2.8	3.2	6.6	3.8	4.0	2.7	-0.3	-1.7	-1.0	..	..	..
Hungary	12.6	12.1	10.2	0.8	6.6	11.4	9.6	9.3	7.4	-0.2	0.1	1.8	10.9	10.7	8.9
Latvia	11.9	11.2	8.7	11.2	9.3	7.5	4.4	5.2	3.3	1.7	2.7	1.3	3.9	5.1	..
Lithuania	12.1	9.6	7.0	11.6	10.2	8.7	6.7	4.6	2.9	5.6	3.2	2.1	5.9	5.6	..
Poland	20.0	18.2	13.4	11.3	16.4	12.5	13.9	10.2	6.6	3.5	4.5	4.3	16.6	13.8	8.1
Romania	53.8	45.4	37.1	1.5	2.2	9.3	32.9	26.6	20.7	-8.8	-5.9	-2.7	52.3	42.2	29.8
Slovakia	13.6	11.2	10.3	2.5	4.5	8.1	7.2	5.1	4.8	-4.2	-2.0	1.3	..	..	..
Slovenia	15.8	15.1	13.6	7.6	5.7	7.4	10.1	9.8	8.4	1.1	1.3	0.7	..	..	..
The former Yugoslav Republic of Macedonia	18.9	19.4	18.9	9.2	17.0	19.7	11.2	10.0	9.9	5.1	4.3	6.8	..	..	..
CIS															
Armenia	31.6	26.7	21.4	30.5	27.2	17.6	18.1	14.9	10.2	19.0	11.4	9.0	23.6	19.9	14.5
Azerbaijan	19.7	19.7	17.4	-4.0	17.6	17.1	12.9	8.6	8.5	10.9	7.0	5.8	16.7	16.4	15.2
Belarus	67.7	47.0	40.0	-41.3	-14.5	0.3	37.6	34.2	29.2	-48.8	-16.7	-10.8	..	..	..
Georgia	32.8	27.3	31.7	25.5	22.8	32.4	10.2	7.8	9.8	5.9	2.9	3.8	..	..	..
Kazakhstan	19.4	17.6	15.7	-13.5	17.2	19.0	16.5	14.7	11.3	2.9	5.8	5.1	11.6	5.4	5.2
Kyrgyzstan	57.0	40.5	38.1	19.1	26.3	31.3	23.9	13.7	8.2	4.4	6.4	6.1	32.3	19.0	10.7
Republic of Moldova	33.8	28.7	24.4	4.1	14.6	15.5	24.9	20.9	14.7	-4.7	10.3	8.6	22.3	14.2	5.4
Russian Federation	24.4	17.9	16.1	-5.4	6.5	5.9	6.5	4.9	5.0	-11.4	-11.6	-9.7	13.6	13.1	13.0
Ukraine	41.5	32.3	26.4	17.2	21.7	23.6	13.7	11.0	8.3	-11.3	-0.9	7.1	..	..	..

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 – Belarus: weighted average rate on short-term loans; 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; Kazakhstan: weighted average interest rates (for new credits); Kyrgyzstan: weighted average rate on loans in sums for one- to three-month maturities; 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; Russian Federation: weighted average rate on loans of up to one-year maturity; 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; Ukraine: weighted average rate on short-term loans. The real lending rates are the nominal rates discounted by the average rate of increase in the PPI for the corresponding period.

Deposits – Belarus: weighted average rate on short-term 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; Kazakhstan: weighted average interest rates (for new deposits); Kyrgyzstan: weighted average rate offered on time deposits of three-month maturities; 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; Russian Federation: prevailing rate for time deposits with maturity of less than one year; 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; Ukraine: weighted average rate on short-term deposits. 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; Kazakhstan: yield based on treasury bill prices established at the last auction of the month; Kyrgyzstan: weighted average rate on three-month treasury bills sold in the primary market; Latvia: weighted average auction rate on 91-day treasury bills; Lithuania: average auction rate on treasury bills with maturity of 91-days; Poland: yield on bills purchased, weighted average, 13 weeks; Romania: rate on 91-day treasury bills; Russian Federation: weighted average rate on government short-term obligations (GKO) with remaining maturity of up to 90 days; Slovenia: BS solar bills, 14 days overall nominal rate.

^a January-September.

^b Change in methodology in 2002 (see note above).

TABLE 3.1.2
Monetization^a in selected east European and CIS economies, 1999-2002
 (Per cent of GDP)

	M1 ^b				Total broad money ^c				Total credit ^d			
	1999	2000	2001	2002 ^e	1999	2000	2001	2002 ^e	1999	2000	2001	2002 ^e
Eastern Europe												
Albania	17.8	20.4	21.4	23.6	53.5	56.7	60.0	62.2	3.7	4.3	5.0	6.2
Bosnia and Herzegovina	4.1	12.0	18.0	29.9	12.4	12.0	31.5	50.2	26.1	21.5	45.6	47.5
Bulgaria	11.5	12.5	14.3	14.6	28.3	32.2	36.9	39.9	10.9	11.8	13.0	16.0
Croatia	9.3	10.0	11.9	15.3	38.9	41.7	51.4	62.6	41.1	37.6	41.8	47.7
Czech Republic	23.3	26.0	27.2	27.0	69.1	71.4	72.9	71.5	56.8	51.5	43.0	32.5
Estonia	19.4	22.0	22.9	23.9	30.6	34.8	38.1	40.6	31.9	34.6	40.5	45.0
Hungary	15.9	16.0	15.8	16.9	42.9	42.4	42.2	44.4	23.0	26.3	29.4	31.8
Latvia	15.2	15.5	16.3	17.3	24.1	26.3	29.6	33.1	15.9	18.0	23.3	30.1
Lithuania	12.4	11.5	11.7	13.5	20.3	20.9	23.3	26.2	14.9	13.5	12.7	13.9
Poland ^f	16.2	15.1	14.8	15.9	39.9	41.3	43.8	42.5	25.9	28.5	30.1	30.7
Romania	4.1	4.1	4.0	4.5	19.8	18.9	18.7	21.1	12.1	11.7	10.8	11.4
Slovakia	17.0	17.6	19.7	20.2	58.7	62.1	63.8	64.0	48.3	45.2	33.5	30.8
Slovenia	9.9	9.6	9.3	10.0	49.2	50.9	54.4	60.4	32.3	35.9	37.6	38.5
The former Yugoslav Republic of Macedonia	8.2	8.2	8.7	..	15.3	17.0	20.0	13.4	18.3	17.6	17.7	..
Yugoslavia ^g .....	..	5.3	5.6	9.2	..	9.9	11.9	18.1	..	27.2	31.0	13.0
CIS												
Armenia	4.8	5.2	5.7	5.9	10.1	11.9	13.2	12.3	8.8	9.9	8.5	7.0
Azerbaijan	5.9	5.9	5.6	5.9	12.9	11.0	10.4	11.7	12.6	8.0	7.3	6.7
Belarus	5.0	4.0	4.0	4.1	11.4	11.6	12.2	12.9	6.4	5.7	6.8	7.1
Georgia	4.6	4.9	5.5	5.7	7.6	8.6	10.1	10.9	6.9	7.8	8.0	9.3
Kazakhstan	6.5	8.0	7.8	7.2	9.5	12.4	14.4	15.9	7.5	9.2	13.1	15.6
Kyrgyzstan	7.9	6.5	6.5	8.1	12.4	10.7	10.0	11.9	4.8	3.9	3.7	3.9
Republic of Moldova	11.0	10.4	11.3	12.8	19.0	18.7	21.6	25.3	13.8	12.1	13.9	16.0
Russian Federation	8.6	9.1	10.9	11.5	16.3	17.3	20.0	21.9	9.5	10.0	13.0	15.9
Ukraine	9.2	9.9	11.8	14.8	13.9	15.4	18.1	23.3	8.5	10.0	12.6	13.7

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

^a Averages of monthly or quarterly figures.

^b Currency in circulation plus demand deposits.

^c M1 plus time deposits in domestic currency and foreign currency deposits.

^d Total outstanding claims on firms and households (except claims on government).

^e January-September. GDP data for 2002 are based on preliminary reports and estimates for Albania, Bosnia and Herzegovina and Yugoslavia.

^f In March 2002 Poland changed the definitions of monetary aggregates harmonizing them with ECB standards. Series were recalculated backwards to January 1997.

^g Excluding Montenegro.

the banking sector from enterprises following the introduction of more stringent prudential banking regulations. In Slovakia, total credit also shrank as a proportion of GDP but this was mainly due to reporting changes arising from the reorganization of the banking sector.⁹⁹ Credit to the household sector did increase in both countries but was not sufficient to fully offset the shrinking of credit extended to firms. In general, the rapid growth of household credit in many east European economies in 2002 was underpinned, on the one hand, by growing consumer confidence and, on the other, by a supply shift, namely the aggressive move of the banks into this segment of the market, which they see as the

principal area for their future expansion.¹⁰⁰ The rapid proliferation of credit cards and new banking products has also contributed to this development.

In Yugoslavia, there has been a rapid remonetization since the change of the political regime in late 2000. The radical reforms undertaken by the new government, particularly those in the financial sector, have helped to restore public confidence in the banking system and have contributed to the rise in money demand.¹⁰¹ Rapid

⁹⁹ As a result of the merger of Konsolidáční banka and Slovenská Konsolidáční agentúra, the reported stock of credit to enterprises and households fell by 28.4 billion koruny (equivalent to some 8.5 per cent of total credit to the non-government sector) in February 2002. National Bank of Slovakia, *Monetary Survey*, February 2002, p. 9.

¹⁰⁰ In Latvia, during the first nine months of 2002 the average stock of outstanding household credit increased by almost 59 per cent compared with the same period of 2001; in Hungary it rose by some 53 per cent; in Bulgaria it grew by 40 per cent; in the Czech Republic and Slovakia household credit increased by some 18 per cent.

¹⁰¹ The drop in the level of credit as a proportion of GDP is largely due to the closure of four large but insolvent banks in 2002, which was one of the important components of the financial reform package. This change also partly reflects the fact that the flawed practice of allocating

remonetization and credit expansion have also continued in a number of CIS economies (especially Kazakhstan, the Republic of Moldova, Russia and Ukraine). In much of the CIS, however, the overall level of monetization is still rather low and this is an obstacle to a faster rate of growth of these economies.

(ii) Fiscal policy

The slowdown of economic growth throughout eastern Europe and the CIS resulted in some cyclical weakening of fiscal positions: the average consolidated general government deficit¹⁰² in eastern Europe increased from 3.9 per cent in 2001 to 4.4 per cent in 2002 and in the CIS from 0.8 to 1.5 per cent (table 3.1.3).¹⁰³ This was a reversal of three years of falling fiscal deficits in the region. However, it should be added that the worsening of the average figures for 2002 was mostly due to the considerable widening of the fiscal gaps in several countries in the region; in fact, in 2002, seven east European and three CIS economies improved their fiscal positions compared with the previous year.

Between 2000 and 2002, the pattern of fiscal performance in eastern Europe and the CIS was quite varied: in many CIS countries this was a period of fiscal consolidation, but the reverse was the case in some east European economies (table 3.1.3 and chart 3.1.4). As a result, the average general government deficit in the CIS is now considerably lower than in eastern Europe. Thus, while in more than half of the east European economies fiscal deficits were higher than 3 per cent of GDP in 2002, in the CIS only three of the 12 countries (Armenia, Kyrgyzstan and Uzbekistan) had deficits above this level.

The reduction of the previously large fiscal gaps in the CIS has been facilitated by the economic boom in some of these countries: in recent years the CIS has been one of the fastest growing regions in the world.¹⁰⁴ After 1999, the fiscal balances of the commodity exporters benefited from the soaring world market prices, which generated large windfall gains for fiscal revenue. However, these favourable conditions alone cannot explain the improved fiscal performance in the region: in 2001 and most of 2002 there was a reversal in commodity prices but fiscal deficits nevertheless continued to shrink in many CIS countries. The fiscal consolidation in the CIS region is at least partly due to a dedicated policy effort in some of these countries.

directed credit to a few selected state owned firms (a form of hidden subsidies) has been discontinued. Accordingly, commercial bank credit now reflects a return to normal banking practices and conventional financial intermediation, which were virtually non-existent in the past.

¹⁰² On the definition of the fiscal deficit used in this section see the note to table 3.1.3.

¹⁰³ The fiscal deficits for 2002 in table 3.1.3 are the expected figures, based on preliminary estimates. The final figures may differ from these estimates.

¹⁰⁴ Kyrgyzstan is an exception, the economic downturn in 2002 leading to a fiscal deficit larger than expected.

TABLE 3.1.3

Consolidated general government deficit (-) / surplus (+) in eastern Europe and the CIS, 1998-2003
(Per cent of GDP)

	1998	1999	2000	2001	2002 ^a	2003 target
Eastern Europe						
Albania	-10.6	-11.1	-9.8	-9.1	-8.0	-6.5
Bosnia and Herzegovina ...	..	..	..	..	-0.3	0.6
Bulgaria	1.0	-0.9	-1.0	-0.9	-0.7	-0.7
Croatia	-3.0	-7.4	-5.7	-5.2	-6.2	-5.0
Czech Republic	-2.9	-2.4	-4.7	-6.0	-9.0	-7.8
Estonia	-1.6	-5.0	-1.3	-0.5	2.2	-0.3
Hungary	-7.2	-4.6	-4.5	-4.0	-9.5	-4.8
Latvia	0.1	-4.0	-5.2	-4.3	-2.5	-2.0 ^b
Lithuania	-5.5	-8.4	-3.1	-1.9	-1.5	-2.4
Poland	-3.1	-3.7	-4.3	-5.5	-5.8	-4.9
Romania	-5.5	-3.7	-4.2	-3.5	-2.9	-2.6
Slovakia	-6.0	-4.4	-8.5	-4.0	-7.7	-4.9
Slovenia	-1.2	-1.1	-1.6	-1.3	-2.8	-1.0
The former Yugoslav						
Republic of Macedonia	-1.9	-1.6	-1.3	-5.9	-4.5 ^b	-1.6 ^b
Yugoslavia ^c .....	..	..	-0.2	-1.7	-5.9	-4.0
CIS						
Armenia	-5.9	-10.1	-7.8	-3.8	-3.4 ^b	-3.5 ^b
Azerbaijan	-1.9	-4.5	-2.2	1.5	-0.1	-1.0 ^b
Belarus	-1.0	-2.1	-0.1	-1.4	-1.5 ^b	-1.5 ^b
Georgia	-6.2	-6.7	-4.1	-1.2	-1.1	-3.0
Kazakhstan	-7.9	-5.3	0.8	2.7	1.0	-2.0 ^b
Kyrgyzstan ^d	-2.7	-2.5	-9.3	-5.0	-5.4	-5.0
Republic of Moldova	-4.1	-4.2	-1.9	-0.5	-3.0	-2.4
Russian Federation	-6.1 ^e	-0.8 ^e	1.9 ^e	2.9 ^e	2.5 ^e	0.6 ^f
Tajikistan	-1.0	-3.1	-0.6 ^g	-0.1 ^g	-0.3 ^g	-0.5 ^g
Turkmenistan	-6.0	..	..	-1.2 ^b	-0.8 ^b	-1.1 ^b
Ukraine	-2.7	-2.4	-1.3	-1.7	-2.0	-0.8 ^b
Uzbekistan	-3.4	-2.2	..	-1.3	-3.6	-2.3 ^b

Source: UNECE secretariat estimates and calculations, based on direct communications from national Ministries of Finance and IMF data.

Note: The consolidated general government deficit, or financing requirement, is defined here as (current revenue and grants)-(current and capital expenditure plus net lending for policy purposes). A deficit is negative, a surplus is positive. With this definition of the deficit, it follows that privatization and other capital receipts are components of financing, not of revenue. The "IMF" method of the IMF Fiscal Affairs Division is generally to treat only privatization receipts, but not other capital receipts, as financing. Thus, the IMF methodology deficit is normally equal to the general government deficit plus other capital receipts. The general government deficit here is closest to the present definition of the "Maastricht criterion", as presently interpreted by Eurostat in the ESA-95 accounting methodology. The "IMF-GFS" method, frequently cited by national sources, defines the general government similarly but national practices may differ. Deficits projected at the start of 2003 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 2001-2003 may differ from the above definition. Sources are national Ministries of Finance, official press releases from Reuters, IMF publications and country information [www.imf.org/external/country] and official websites of Ministries of Finance.

^a Preliminary estimates.

^b Central government deficit/surplus.

^c Excluding Montenegro.

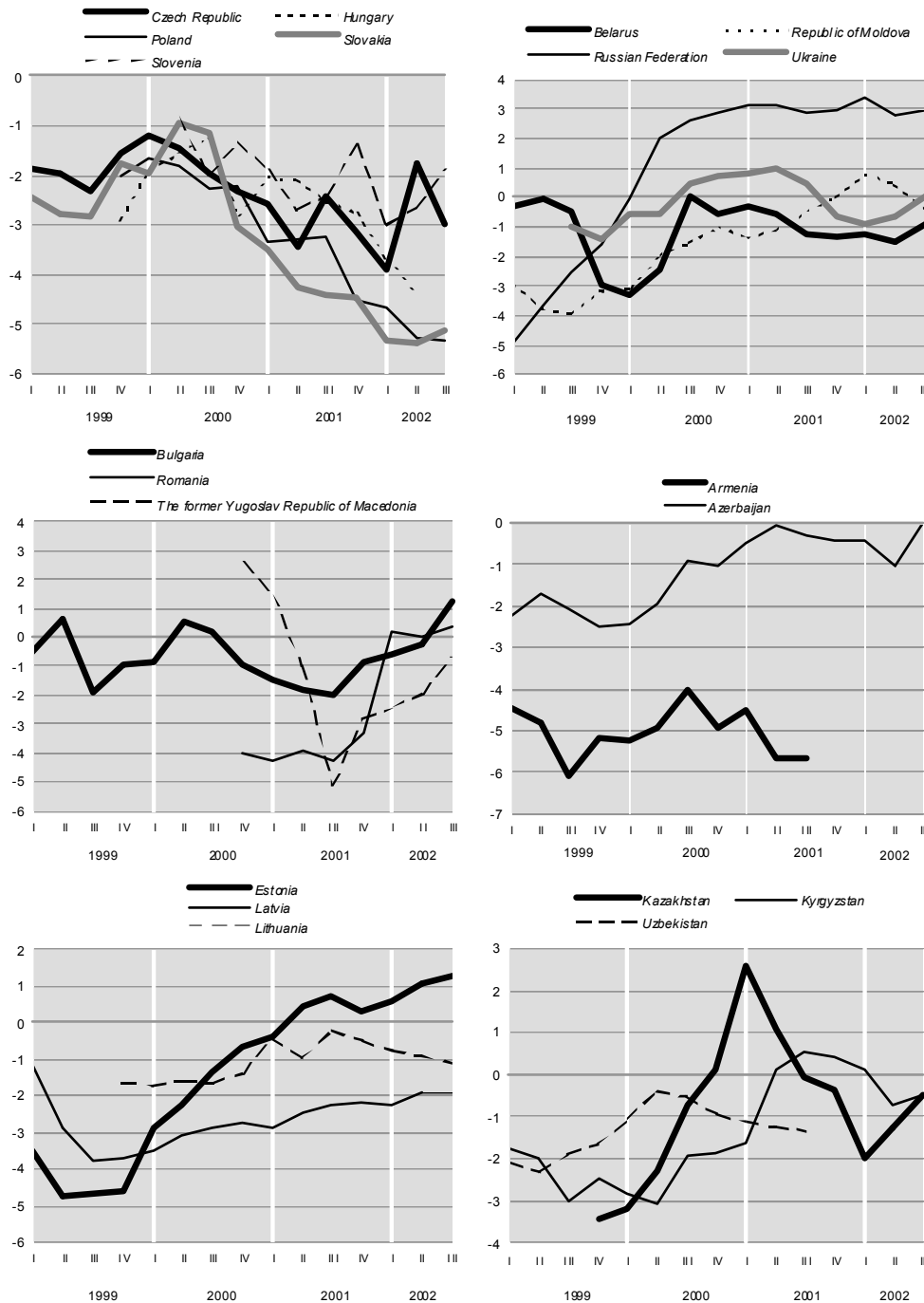
^d The officially reported deficit for Kyrgyzstan in 1998 and 1999 does not include the national public investment programme. According to IMF estimates, if expenditure under this programme were included in the fiscal accounts the consolidated government deficit would be as follows: 1998: -9.5 per cent; 1999: -12.0 per cent.

^e Consolidated central government (including social security and extrabudgetary funds) plus (without consolidation) regional and local government

^f Federal government.

^g Excluding the externally financed public investment programme.

CHART 3.1.4
Fiscal deficits^a in selected east European and CIS economies, 1999-2002
 (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; TACIS publications; 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 3.1.3 even when both refer to the same level of reporting. Due to this the deficit levels presented in table 3.1.3 and chart 3.1.4 may differ for some countries. Definition of public deficit/surplus: consolidated general government deficit/surplus – Armenia, Azerbaijan, Bulgaria, Estonia, Kazakhstan, Latvia, Republic of Moldova, Romania, the Russian Federation, Slovenia and Uzbekistan; central government deficit/surplus – Belarus (including social security and extrabudgetary funds), Czech Republic, Croatia (including extrabudgetary funds), Hungary, Kyrgyzstan, Lithuania, Poland, Slovakia, The former Yugoslav Republic of Macedonia and Ukraine.

^a The quarterly deficits in the chart are 12-month moving averages. A deficit is negative, a surplus is positive. For the methodology and level of reporting see the note above.

A number of CIS economies have been successfully implementing major fiscal reforms and this process continued in 2002. Russia is engaged in a complete overhaul of its tax code: due to be completed in 2003, it aims at simplification and transparency and should meet the new realities of the market economy.¹⁰⁵ The general thrust of the tax reforms has been to ease the overall tax burden in the economy and to reduce it still further.¹⁰⁶ Such a reduction follows the ongoing withdrawal of the state from the economy, which is part and parcel of the Russian reform effort. The synchronization of the two processes has made it possible to reduce taxes without jeopardizing the overall fiscal balance.

Kazakhstan's strong fiscal position made it possible to adopt similar tax reforms in 2002 with reductions in the level of tax on small- and medium-sized businesses. However, there is still a need to continue broadening the tax base (largely due to the existence of a large shadow economy) and improving the efficiency of tax collection. The relatively small tax base prevents the government from extending the scope of public services and improving their quality. A substantial reduction in the tax burden is envisaged also in Ukraine: a new tax code (which aims, in particular, to lower VAT and corporate taxes) was drafted and submitted to parliament in 2002. However, a vote on the new law was postponed and the budget for 2003 was adopted in the framework of the existing tax system. Although generally successful in keeping the fiscal balance under control, Ukraine's reforms have been mired for a long time in an unresolved dispute over large reimbursements of VAT to local exporters.

The most alarming fiscal development in eastern Europe was the emergence of large fiscal imbalances in a number of central European economies, which have otherwise made considerable progress in their market-oriented reforms. The average general government deficit in four central European economies (the Czech Republic, Hungary, Poland and Slovakia) in 2002 was expected to be around 8 per cent, up from 4.9 per cent in 2001 and 5.5 per cent in 2000 (table 3.1.3).¹⁰⁷ The factors

¹⁰⁵ Among the important changes introduced in 2002 were substantial tax cuts (affecting both corporate profit and payroll taxes) for small- and medium-sized firms, as part of the authorities' effort to invigorate that sector of the economy. As a result, the tax burden on small- and medium-sized firms is expected to be reduced by one half or even more. Statement by Economic Development and Trade Minister Alexei Gref, as reported by *Interfax International*, 10 July 2002. In addition, the remaining elements of the archaic sales tax were finally scrapped and replaced by VAT.

¹⁰⁶ According to Russian estimates, the overall tax burden was reduced between 2000 and 2002 by some 4 per cent of GDP and is expected to decline by another 6 percentage points of GDP during the next three years. Statements by Finance Minister Alexei Kudrin and Deputy Minister of Economic Development Arkady Dvorkovich, as reported by *Prime TASS*, 12 July 2002 and *Interfax Information Services*, 20 November 2002, respectively.

¹⁰⁷ The fiscal situation in Croatia has also been quite precarious in recent years. In 2002 the government initiated some steps towards narrowing the fiscal gap; however, in the short run will still remain sizeable.

behind this unfavourable development are numerous and diverse. Some of them are transitory and can be expected to be phased out in the years to come. Thus, the up-front costs of the pension and health care reforms in some of these countries inevitably open a deficit in the existing systems that will remain until the transition to the new systems is over; the government budget is the only possible source of financing these deficits.¹⁰⁸ In addition, the high costs of the ongoing process of bank restructuring (in particular, the covering of the losses due to non-performing bank loans) were partly responsible for the sharp rise in the fiscal deficits of the Czech Republic and Slovakia in 2002. Some countries in the region also suffered from severe floods in 2002 and addressing the flood-related damage had a negative impact on government budgets.

At the same time, there are also structural factors behind the widening fiscal imbalance and those will require a deliberate policy effort to deal with them. One of the underlying structural factors is the size of government (in terms of the overall level of public spending relative to GDP), which is generally higher than that in other countries at similar levels of per capita income.¹⁰⁹ This, in turn, is partly due to the relatively generous social welfare systems in central Europe. Thus, apart from transitory costs, pension and health care reform in these countries involve the correction of structural problems as well. There are also structural problems on the side of fiscal revenue: thus, although the overall tax burden in these economies is generally high, the level of tax collection is sometimes unsatisfactory because of existing exemptions and inefficiencies in tax collection. A combination of accumulating structural problems and mounting transitory costs were the main causes of the deteriorating fiscal position in Poland since 1998 and this prompted a change of policy in 2002.¹¹⁰

The widening of fiscal gaps in 2001 and 2002 was also at least partly due to a loosening of policy in some countries, which, in turn, was largely influenced by the 2002 electoral cycle. Thus, in 2001 the Hungarian government initiated an ambitious public infrastructure programme that continued in 2002; in addition, it pledged a substantial increase in public sector wages, a move that anticipated the upcoming elections. Although this was not sufficient for winning the 2002 elections by the incumbents, the newly elected government not only refused to overturn these moves but also initiated an even

¹⁰⁸ At the same time it should be added that the transition period, involving large claims on public funds, may be quite long, as some of these countries are only just starting their pension and health care reforms.

¹⁰⁹ D. Begg and C. Wyplosz, "How big a government? Transition economy forecasts based on OECD history", paper presented at the 5th Dubrovnik Conference on Transition Economies (Dubrovnik), 23-25 June 1999 (<http://www.unige.ch/~wyplosz/>).

¹¹⁰ UNECE, "Economic distress in Poland", *Economic Survey of Europe*, 2001 No. 1, pp. 63-69.

Box 3.1.1

Fiscal consolidation in Bulgaria in the context of a medium-term fiscal strategy

Since 1997 Bulgaria has achieved a remarkable fiscal consolidation in the context of a well-defined medium-term fiscal strategy. It is all the more remarkable, given that it was achieved after a long period of inconsistent policies (including fiscal mismanagement that triggered an escalating public debt), which culminated in a major economic and financial crisis in 1996-1997. In July 1997, a currency board was established as a policy of last resort against persistent macroeconomic and financial instability.

The period that followed was one in which a striking turnaround occurred in all aspects of economic performance. There was a radical break with past policies in the context of a reform agenda negotiated with the IMF; the medium-term fiscal strategy was a central part of this reform programme.¹ A key prerequisite for the successful implementation of a medium-term strategy is a political consensus on its principal objectives, so that the programme is not abandoned in the event of a change of government.

The main goal of Bulgaria's strategy was to reduce the level of public debt and achieve and maintain medium-term fiscal sustainability, a target that was largely neglected by the authorities in the early years of transition. To achieve this goal, the programme addressed key aspects of both the revenue and expenditure sides of the fiscal balance. On the revenue side, the main objective was to strengthen tax revenues and to improve the efficiency of tax collection. The tax reforms that followed combined the lowering of tax rates (both personal and corporate) with a broadening of the tax base (by expanding the scope of the formal economy and implementing specific organizational reforms to ensure a more efficient tax administration). On the expenditure side, the most radical changes were associated with the launching of major pension and health care reforms in 1999-2000 and the reorganization of the social security system, all of which were decoupled from the central government budget. An important positive effect of the macroeconomic stabilization was the sharp fall in interest rates, which eased considerably the servicing of the public debt.

The effects of the effort at fiscal consolidation can be clearly traced in the general government statistics (see table below). Thus while the average general government deficit in 1993-1996 was 8.2 per cent of GDP, in 1998-2001 it fell to 0.5 per cent. At the peak of the crisis in 1996, total public debt reached 150 per cent of GDP; subsequently it fell sharply, dropping to 59 per cent of GDP in September 2002 (see table 3.1.4).² There were also important changes in the composition of fiscal revenue and, especially, expenditure (see table below). As non-interest expenditure shrank considerably after 1997, much larger funds could be allocated to non-interest expenditure: both current and capital expenditure rose substantially after 1998 indicating that the government was able to allocate a larger share of funds to public services such as education, national security and the building of public infrastructure. The government maintains a healthy primary balance but there is no longer a need to achieve excessively high levels of primary surplus. Among the important benefits of fiscal consolidation and macroeconomic stabilization has been the revival of economic activity: prior to the crisis Bulgaria had not managed to overcome the transformational recession, but in 2000-2002 it became one of the fastest growing economies in eastern Europe.

Consolidated general government operations in Bulgaria, 1993-2002
(Per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 ^a
Total revenue	37.2	39.9	35.7	31.9	30.7	38.0	38.7	38.7	37.7	38.4
Tax revenue	28.9	31.8	29.3	25.8	26.1	29.8	29.4	29.9	28.8	29.5
Non-tax revenue	6.3	7.6	5.7	4.9	4.3	7.6	8.4	8.1	7.7	8.0
Other revenue	2.1	0.5	0.7	1.2	0.3	0.6	0.9	0.8	1.2	0.9
Total expenditure	48.1	45.7	41.3	42.3	33.1	37.0	39.6	39.7	38.6	39.1
Non-interest expenditure	38.7	32.2	27.2	22.6	25.4	32.7	35.8	35.7	34.8	36.9
Current expenditure	36.8	30.7	26.1	21.9	23.2	28.3	29.9	30.9	30.4	..
Net lending .....	..	..	..	..	0.6	0.3	1.1	0.4	0.3	..
Capital expenditure	1.9	1.5	1.1	0.7	1.6	4.1	4.9	4.3	4.2	..
Interest expenditure	9.3	13.5	14.1	19.7	7.8	4.3	3.8	4.0	3.7	2.2
External	1.0	1.3	2.8	2.7	2.4	3.1	2.9	3.1	2.9	..
Domestic	8.3	12.3	11.3	17.0	5.4	1.2	0.9	1.0	0.9	..
Primary balance	-1.5	7.7	8.5	9.3	5.3	5.3	2.8	3.0	2.9	1.5
Overall balance	-10.8	-5.8	-5.6	-10.4	-2.4	1.0	-0.9	-1.0	-0.9	-0.7

Source: Bulgarian Ministry of Finance; IMF, *Staff Country Reports* (Washington, D.C.), various issues.

^a Preliminary.

Since 1997 Bulgaria has been within the Maastricht reference level for the fiscal deficit and as of 2002 it also met the Maastricht criterion for debt, a prospect that seemed completely out of reach only a few years ago. Moreover, the debt ratio is expected to continue falling in the years to come. Provided it maintains its present prudent fiscal stance, Bulgaria seems well prepared for meeting the fiscal targets for participating in the euro area when the time approaches for EU and EMU membership. This example shows that given the political will and a dedicated, long-term policy effort, fiscal consolidation can be a feasible and realistic policy target.

¹ B. Horváth and I. Székely, *The Role of Medium-term Fiscal Frameworks for Transition Countries – The Case of Bulgaria*, IMF Working Paper WP/01/11 (Washington, D.C.), January 2001.

² The reduction in the debt ratio reflects in the first place the significant real appreciation of the currency after 1997 (a large part of the public debt being foreign – table 3.1.4); partial amortization (based on privatization revenue) and two debt restructuring operations in 2002 also contributed to the lowering of the debt burden.

TABLE 3.1.4
Public debt in selected east European and CIS economies, 1999-2002
(End of period values, per cent of GDP)

	Total public debt						Of which: foreign public debt					
	1999	2000	2001	2002			1999	2000	2001	2002		
				Mar.	Jun.	Sept.				Mar.	Jun.	Sept.
Eastern Europe												
Bulgaria ^a	90.5	77.1	70.1	69.0	60.9	59.2	77.5	70.5	63.8	62.6	54.6	52.8
Croatia	31.3	35.2	39.1	39.8	40.9	41.0	21.5	25.6	25.7	26.2	25.0	25.1
Czech Republic	12.0	14.6	16.0	16.3	17.6	18.2	1.1	1.0	0.4	0.4	0.3	0.3
Estonia	4.6	3.1	2.7	2.6	3.6	3.1	4.2	2.9	2.5	2.4	3.4	3.0
Hungary ^b	60.4	54.9	51.9	52.9	52.3	54.4	22.3	19.1	15.6	14.4	13.9	13.7
Latvia	13.1	13.1	15.0	14.5	15.0	14.8	9.2	8.0	9.6	9.4	9.4	9.2
Lithuania ^a	28.3	28.2	26.9	26.6	28.3	28.0	22.8	21.9	20.5	20.0	21.2	19.2
Poland	43.0	39.0	39.3	42.5	43.7	44.9	21.1	17.6	13.7	14.4	14.8	15.5
Romania	33.2	31.4	29.1	29.0	31.2	28.9	20.6	22.2	21.1	20.8	22.5	21.4
Slovakia	23.0	24.5	37.0	40.3	40.6	36.3	10.4	12.1	9.6	12.1	12.0	11.3
Slovenia	24.5	25.1	26.9	27.8	26.9	26.5	10.8	12.6	13.0	12.7	12.1	11.9
CIS												
Armenia .....	..	..	..	..	..	..	33.9	35.6	33.7	..	..	..
Azerbaijan .....	..	..	..	..	..	..	22.7	22.5	..	..	..	..
Belarus ^c	15.0	15.0	..	..	..	..	9.4	10.5	..	..	..	..
Kazakhstan ^a .....	..	25.5	20.2	20.2	19.7	19.4	27.8	18.3	14.9	14.6	14.3	13.9
Kyrgyzstan	130.9	112.4	100.4	..	..	..	120.0	102.4	91.3	..	..	..
Republic of Moldova	79.8	93.3	60.8	61.4	63.2	60.7	64.3	77.2	48.2	48.3	50.0	47.8
Russian Federation	101.7	63.3	50.2	49.2	46.5	42.1	89.5	55.7	44.4	43.5	40.9	36.2
Ukraine	61.2	..	31.3	31.0	30.3	..	..	..	20.9	20.8	20.1	..

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; TACIS publications.

Note: Definition of public debt: central government debt for the Czech Republic, Estonia, Latvia, Lithuania, Poland, Slovakia, Belarus, Kyrgyzstan and the Russian Federation; consolidated general government debt for Bulgaria, Hungary, Romania, Slovenia, Armenia, Azerbaijan, Kazakhstan, Republic of Moldova and Ukraine.

^a Including government guaranteed debt.

^b Excluding foreign debt in the books of the National Bank of Hungary.

^c Consolidated central government (including social security and extrabudgetary funds).

larger pay rise for the public sector.¹¹¹ Similarly, the government of the Czech Republic initiated a large-scale two-year fiscal stimulus programme in 2001 aimed at invigorating the economy. The 2002 general elections in Slovakia prompted the postponement of some planned but unpopular restrictive fiscal measures and this also contributed to the widening of the fiscal deficit. Such fiscal policies associated with electoral cycles may be rather dangerous because of the difficulty of reversing them. Thus, the generous increase in public sector wages in Hungary has only added to the structural problems of the country's fiscal balance.

Addressing this myriad of fiscal problems requires a dedicated policy effort and persistence in implementing unpopular measures, a task that may be particularly difficult due to political constraints and pressures. It is even more difficult because of the long-term nature of some of the underlying factors. Structural problems cannot be addressed by one-off austerity measures that have little chance of surviving the political cycle but require years of gradual but persistent movement in the

required direction. In this regard, the recent experience of Bulgaria, which managed a successful fiscal consolidation within a medium-term fiscal framework in a relatively short period of time, is a case in point (box 3.1.1).

The adopted budgets for 2003 in all the central European countries envisage a reduction of fiscal imbalances and in some cases (such as Slovakia) they include austerity measures to reduce current expenditure. According to the targets, the average general government deficit in the four countries should be lowered to 5.5 per cent (table 3.1.3). However, this is not going to be an easy task and some analysts have already expressed scepticism about the feasibility of these targets, given the fact that the programmes do not envisage radical reforms. These difficulties have raised serious concerns about the prospects of meeting the fiscal reference targets required for EMU accession by some of the acceding countries.

Indeed, meeting the Maastricht deficit requirement is now becoming the main stumbling block to EMU accession for some of the acceding countries, and especially the central European economies. Public debt levels, while high in some countries, do not appear to be a major obstacle at this stage (table 3.1.4). The Maastricht nominal convergence criteria imply that

¹¹¹ The rise in public sector wages in Hungary was a response to the emerging gap in remuneration compared with the private sector. What is debatable, however, is the actual magnitude of the pay increase.

countries should display a steady progression towards meeting the deficit target; moreover, reducing the fiscal deficit below the 3 per cent reference level has to be met at least two years ahead of the envisaged date for EMU accession. Clearly, in terms of their total deficits (no accurate estimates of structural deficits exist yet), most of the central European economies appear to be a long way from being able to meet this requirement.

Fiscal consolidation in the acceding countries will be even more difficult due to the fact that EU accession will generate new claims on public spending. Thus, while the accent in recent policy debates (including the heated discussions that preceded the Copenhagen summit and continued during the final negotiations) has usually been placed on the likely net balance of transfers to and from the EU budget, an even more important policy issue is the overall fiscal effect of EU membership, of which the balance of transfers is only a part. For example, while all the acceding countries will be recipients of structural funds, in order to absorb them they will have to provide matching national funds, which will represent a net new claim on government budgets. The requirement to meet EU standards of environmental protection (including the very high costs of repairing past environmental damage) and infrastructure will also generate large demands on public spending. A detailed account of all the fiscal benefits and costs of EU membership is an extremely complicated task that has not been addressed in a comprehensive manner so far, but some preliminary estimates suggest that the overall direct net fiscal cost of EU membership for the acceding central European and Baltic economies could be around 3-4 per cent of GDP per annum, while the total net fiscal cost (including indirect benefits and costs, some of which may only materialize in the medium term) could be around 2-3 per cent of GDP per annum.¹¹²

Thus the net fiscal cost of EU membership will, *ceteris paribus*, make a significant addition to the current fiscal deficits of the acceding countries, which in many cases are already rather high. At the same time, privatization revenues (which have been an important source of financing for fiscal deficits in recent years) are expected to tail off in the near future. Thus, given these additional problems, the need for a carefully designed medium-term strategy of fiscal consolidation in some of the acceding economies becomes even more urgent.

3.2 Output and demand

(i) Patterns of output and demand in 2002

The rate of economic growth in eastern Europe and the CIS combined continued to slow down in 2002 but it still remained relatively high. GDP in the region as a

whole increased by 4.1 per cent¹¹³ against 4.8 per cent in 2001. The area thus remained less affected by the global downturn than initially expected, and was still one of the fastest growing in the world (table 1.1.3). Growth in the CIS was again higher than in the economies of eastern Europe, which are generally more open and thus more dependent on external demand. However, the lower rate of growth for the region as a whole in 2002 was entirely due to the slowdown in the CIS, since growth in eastern Europe was virtually unchanged from 2001. Individual country developments within each subregion were somewhat less dispersed than in 2001.

Growth in 2002 continued to be affected by a subdued external environment – although economic activity picked up slightly during the year in the industrialized western countries – and also by differences in real exchange rate developments.¹¹⁴ Growth was mainly supported by strong domestic demand and in some cases by accommodating policies, although real interest rates did not generally decline owing to fast rates of disinflation (section 3.1). On the supply side, growth in most countries was sustained by modest or relatively solid gains in productivity, which, however, were smaller than in 2001.¹¹⁵

In general, growth in 2002 was in line with governments' expectations¹¹⁶ at the beginning of the year, which had already factored in the change in external conditions to a large extent: only a few economies were below or at the lower end of the forecasts, mostly for country-specific reasons. In eastern Europe, this holds for Albania, Bosnia and Herzegovina and the Czech Republic. In The former Yugoslav Republic of Macedonia post-conflict recovery has continued to proceed more slowly than expected. In contrast, outcomes exceeded official expectations in Croatia and in all three Baltic countries. GDP growth in the CIS region as a whole was broadly in line with official forecasts, with Armenia, Belarus and Kazakhstan performing well above expectations, while in Kyrgyzstan the outcome was disappointing. The Russian economy performed more or less in line with expectations, but in Ukraine growth remained somewhat below the forecast.

The deceleration in output growth is probably petering out in eastern Europe, but not in the CIS as a whole: while the three main east European regions (central Europe, the Baltic countries and south-eastern

¹¹³ Unless noted otherwise, all growth rates presented in this section are year-on-year rates. It should be noted that the full year GDP figures for 2002 are based on estimates and preliminary national accounts statistics.

¹¹⁴ Sect. 3.1, especially charts 3.1.2 and 3.1.3. The strength of the Russian rouble against the major currencies caused the real exchange rates of most CIS economies to depreciate against the Russian rouble during 2002.

¹¹⁵ This supply-side view is to some degree reflected in table 3.3.2, according to which the rates of growth of labour productivity in industry during the first three quarters of 2002 exceeded 2.5 per cent in most countries of the region.

¹¹⁶ UNECE, *Economic Survey of Europe, 2002 No. 1*, p. 11, table 1.3.1.

¹¹² G. Kopits and I. Székely, "Fiscal policy challenges of EU accession for central European accession countries", paper presented at the East-West Conference, *Structural Challenges ...*, op. cit.

TABLE 3.2.1

GDP and industrial output in eastern Europe and the CIS, 2000-2002
(Percentage change over the same period of the preceding year)

	GDP						Industrial output									
	2001			2002			2000	2001	2001			2002				2002*
	QII	QIII	QIV	QI	QII	QIII			QII	QIII	QIV	QI	QII	QIII	QIV*	
Eastern Europe	3.0	2.9	2.7	2.2	2.8	3.3	8.1	3.8	4.0	1.8	3.0	0.5	2.5	5.7	4.7	3.4
Albania .....	..	..	..	..	..	..	12.0	-20*	..	..	..	..	..	..	..	12
Bosnia and Herzegovina .....	..	..	..	..	..	..	8.8	12.2	12.6	13.9	6.7	-2.1	4.3	12.5	12.6	9.2
Bulgaria.....	4.1	3.9	4.2	3.2	5.3	4.5	10.3	-2.4	-2.1	3.2	-3.8	-2.1	7.7	7.0	3.6	3.5
Croatia.....	4.8	4.1	2.8	4.3	4.0	6.5	1.7	6.0	6.2	6.0	6.1	1.9	2.5	8.2	9.2	5.4
Czech Republic	3.5	3.3	2.7	2.8	1.9	2.7	5.4	6.5	7.2	4.2	5.8	4.1	4.9	5.6	5.2	4.9
Estonia	5.5	3.9	5.1	3.2	7.0	6.7	14.6	7.8	5.8	7.7	9.5	-1.7	6.9	8.3	4.2	4.5
Hungary.....	4.0	3.7	3.3	2.9	3.1	3.5	18.7	3.5	5.6	-1.6	0.6	-0.4	1.3	5.4	1.6	1.9
Latvia	9.3	6.4	6.8	3.8	4.9	7.4	4.7	9.2	9.5	9.0	5.6	0.1	5.8	7.3	8.8	5.5
Lithuania.....	5.7	4.8	9.6	4.4	6.9	6.8	5.3	16.9	19.0	10.3	25.8	1.7	8.1	4.6	1.5	3.9
Poland.....	0.9	0.8	0.2	0.4	0.8	1.6	6.7	0.3	-0.6	-0.6	-1.3	-1.5	-0.7	3.7	3.8	1.5
Romania.....	5.1	5.7	5.3	3.1	5.7	4.7	7.1	8.2	10.1	4.3	7.8	3.1	4.0	8.2	8.0	5.9
Slovakia.....	2.8	3.5	3.9	3.9	4.0	4.3	8.6	6.9	8.0	7.3	4.8	1.0	5.8	9.4	7.6	6.0
Slovenia	2.8	3.3	2.6	2.2	3.2	3.4	6.2	2.9	1.8	2.7	2.6	1.7	2.5	4.0	1.1	2.3
The former Yugoslav																
Republic of Macedonia	-4.0	-6.3	-1.5	-2.2	-0.5	1.0	3.5	-3.1	-8.9	-14.1	-8.8	-14.4	-8.0	-5.8	4.9	-5.2
Yugoslavia .....	..	..	..	..	..	..	11.2	-	-4.1	-6.0	10.1	-4.4	-0.1	5.6	2.3	1.7
CIS	6.7	6.9	5.1	4.2	4.6	4.7	11.8	6.7	8.1	6.2	5.4	3.3	3.8	5.6	4.0	4.7
Armenia	4.0	13.5	8.4	7.4	11.8	11.8	6.4	3.8	3.0	8.5	-3.4	13.9	10.4	9.0	31.3	16.0
Azerbaijan	8.5	9.4	9.3	4.7	12.2	12.6	6.9	5.1	5.3	4.3	2.5	0.1	2.9	5.4	6.0	3.6
Belarus	5.4	5.3	5.4	3.7	5.7	4.2	7.8	5.9	6.5	6.0	8.4	2.0	4.7	3.6	5.7	4.3
Georgia	11.5	1.1	2.7	5.7	-4.3	4.7	10.8	-5.0	-2.4	1.6	1.3	1.2	-1.0	8.0	3.9	3.0
Kazakhstan.....	17.0	13.1	12.4	10.4	8.0	9.6	15.5	13.5	15.9	13.7	12.8	12.2	6.1	11.4	11.0	9.8
Kyrgyzstan.....	8.8	7.1	0.4	-3.0	-7.1	-0.5	6.0	5.4	-0.1	5.8	-0.8	-10.7	-14.3	-25.1	-7.3	-13.1
Republic of Moldova	3.6	4.6	11.6	4.8	7.8	5.3	7.7	13.7	17.4	10.3	15.0	8.8	13.2	13.3	7.3	10.6
Russian Federation.....	5.3	5.8	4.3	3.7	4.1	4.3	11.9	4.9	5.9	4.5	4.1	2.7	3.8	5.5	2.6	3.7
Tajikistan	12.3	13.1	8.1	9.3	7.3	10.1	9.9	14.8	12.8	20.8	7.5	5.4	10.4	3.5	13.6	8.2
Turkmeristan.....	..	..	..	..	..	..	14*	11*	..	..	..	..	..	..	..	10
Ukraine	11.3	11.3	5.7	4.1	4.7	4.3	13.2	14.2	18.4	12.5	7.6	1.6	1.9	2.2	4.2	7.0
Uzbekistan.....	4.3	6.9	3.3	3.1	5.3	0.7	5.9	7.6	12.6	3.1	8.6	6.7	-0.3	17.6	8.6	8.0
Total above	5.2	5.3	4.1	3.4	3.9	4.2	10.4	5.6	6.6	4.6	4.6	2.3	3.3	5.7	4.2	4.2
<i>Memorandum items:</i>																
Baltic states	6.7	5.1	7.7	3.9	6.3	6.9	7.1	13.0	13.7	9.4	17.2	0.6	7.3	6.0	3.8	4.4
Central Europe	2.1	2.1	1.6	1.6	1.8	2.5	8.3	3.0	3.1	1.2	1.4	0.4	1.7	5.0	4.0	2.8
South-east Europe	4.6	4.7	4.6	3.2	4.9	4.6	7.5	4.5	4.8	2.1	5.1	0.6	3.5	7.8	6.6	4.8
Caucasian CIS	8.5	7.6	7.0	5.6	7.0	10.0	7.6	2.8	3.3	4.5	1.2	2.7	3.5	6.5	9.9	5.6
Central Asian CIS	11.2	10.1	8.1	7.2	6.4	6.3	12.9	11.7	13.7	11.3	11.3	9.5	4.9	9.8	9.6	8.3
Three European CIS	9.4	9.4	5.8	4.0	5.1	4.3	11.5	11.8	14.9	10.6	7.9	1.8	2.9	2.8	4.7	6.3

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

Note: Quarterly industrial output figures in this table are based on monthly data. Annual figures are shown as reported by countries. Because of differences in coverage, there may be slight discrepancies between the quarterly and the annual indices for some countries.

Europe) grew at similar or only slightly lower rates in 2002 as compared with 2001, the deceleration in Russia, the European CIS and central Asia was more pronounced. The only subregion where growth in GDP accelerated was the Caucasian Rim.

The downward trend appears to have bottomed out in the first quarter of 2002 in the majority of east European and CIS economies (table 3.2.1). Picking up the tentative improvement in the industrialized western economies (table 2.1.1), GDP growth recovered in the second and accelerated in the third quarter in many countries.¹¹⁷

Preliminary data and estimates, however, suggest some slowing down again towards the end of the year. Given the tentative character of the global and, especially, the very uncertain west European recovery, it would be premature to conclude at this stage that the recent slowdown in economic growth in eastern Europe and the CIS has come to an end.

Due to the weak external environment, the substitution of domestic sources of growth for external

¹¹⁷ There were some significant deviations from the general pattern. GDP growth did not accelerate in the third quarter in south-eastern Europe and the European CIS, and in central Asia it bottomed out only in

the third quarter of 2002. The Slovak economy's underlying acceleration between mid-2001 and the third quarter of 2002 was strong enough to outweigh downward pressures from abroad. Activity in the CIS was somewhat more volatile. In Kyrgyzstan there was a pronounced trough in the second quarter, due to a standstill in gold production.

demand, a development already underway in 2001, continued in the first three quarters of 2002. However, while the magnitude of the domestic demand contribution to growth remained fairly constant in eastern Europe, it weakened in Russia (chart 3.2.1) and in the CIS. In general, the contribution of consumption outweighed that of gross fixed capital formation in eastern Europe as well as in Russia and the CIS during 2002. The data on retail trade (table 3.2.6), gross fixed capital formation (tables 3.2.2 and 3.2.3) and investment (table 3.2.5) confirm these relative changes.

Compared with 2001, industrial output growth weakened in most countries in 2002 except in Albania, Bulgaria, Poland, Yugoslavia, Armenia, Georgia and Uzbekistan. Industrial production fell only in The former Yugoslav Republic of Macedonia and in Kyrgyzstan.

(ii) Eastern Europe

Preliminary figures and estimates suggest that in 9 of the 15 east European countries there was no further slowing down of GDP growth in 2002. In fact, growth accelerated in Bosnia and Herzegovina, Croatia, Estonia, Poland and Slovakia, and recovered in The former Yugoslav Republic of Macedonia. In eastern Europe¹¹⁸ as a whole, GDP in the first three quarters of 2002 was almost entirely driven by consumption, with only a small contribution (about one fifth of a percentage point) from gross fixed capital formation, mostly offset by a slightly negative contribution from net trade (chart 3.2.1).

Investment differed considerably across regions (table 3.2.2). In aggregate gross fixed capital formation accelerated in the Baltic countries, while it slowed down although remaining firm in the larger economies of south-eastern Europe (Bulgaria, Croatia and Romania). However, it was weak in central Europe except in Hungary. Constraints on internal sources of finance of gross fixed capital formation were generally limited: the pressure on operating profits was less in eastern Europe than in the CIS, except perhaps in Hungary and Latvia (section 3.3) where FDI remained a significant source of investment.¹¹⁹ The noticeable weakness of fixed investment in central Europe (except in Hungary) was largely due to the sluggish state of the Polish economy and to the uncertain prospects for west European recovery, the region's most important trading partner.

Rates of growth of both exports and imports of goods and services declined sharply in the first three quarters of 2002 in central Europe and south-eastern Europe, but less so in the three Baltic states (table 3.2.2).

¹¹⁸ Eastern Europe here is represented by the countries for which these data are available, see the note to chart 3.2.1. These countries together account for about 94 per cent of the total PPP-weighted eastern European GDP.

¹¹⁹ While gross fixed investment in Latvia increased less spectacularly than in other Baltic countries, in Hungary it was assisted by strong public spending.

Decelerating import growth in the face of sustained domestic demand and a trend towards real exchange rate appreciation largely reflects the high import content of the region's decelerating exports.¹²⁰

Retail trade figures across eastern Europe confirm the strength of personal consumption (table 3.2.6), which responded to wage growth and falling rates of inflation. The volume of retail trade sales in eastern Europe as a whole increased by 5.7 per cent in the first three quarters of 2002, some 3.6 percentage points higher than a year earlier.¹²¹ It grew at double-digit rates in all the Baltic countries, Croatia, Hungary and Yugoslavia. The volume of sales also grew strongly in Poland, Slovakia and Slovenia but only modestly in the Czech Republic.¹²² The picture in south-eastern Europe, however, is mixed: a partial recovery from the previous year's slump in The former Yugoslav Republic of Macedonia was accompanied by comparatively modest growth in Bulgaria and Romania. Albania was the only east European economy where retail sales volumes fell during 2002.¹²³

Expansionary fiscal policies tended to give an additional boost to overall economic activity in much of eastern Europe; general government expenditures grew strongly during the first three quarters of the year 2002 in many of these countries, Croatia being an exception (table 3.2.2).¹²⁴

Although GDP growth in *central Europe* accelerated in 2002, it still was the weakest of all the east European and CIS regions. It was mostly driven by consumption, with no positive support from net trade (chart 3.2.1), although individual country developments were more varied (tables 3.2.2 and 3.2.3): Hungary,¹²⁵ and to a lesser extent the Czech Republic, were closest to the aggregate pattern, while the contributions of consumption and gross fixed capital formation to total final domestic demand were evenly split in Slovenia. Gross fixed capital formation shrank in Slovakia and fell considerably, for the second consecutive year, in Poland. Confirming the dominance of consumption as a source of growth on the demand side, wholesale and retail trade were

¹²⁰ UNECE, *Economic Survey of Europe, 2002 No. 1*, chap. 3.2(iv), pp. 88-94.

¹²¹ UNECE secretariat calculations, based on PPP-adjusted, GDP-weighted data from the UNECE Common Database.

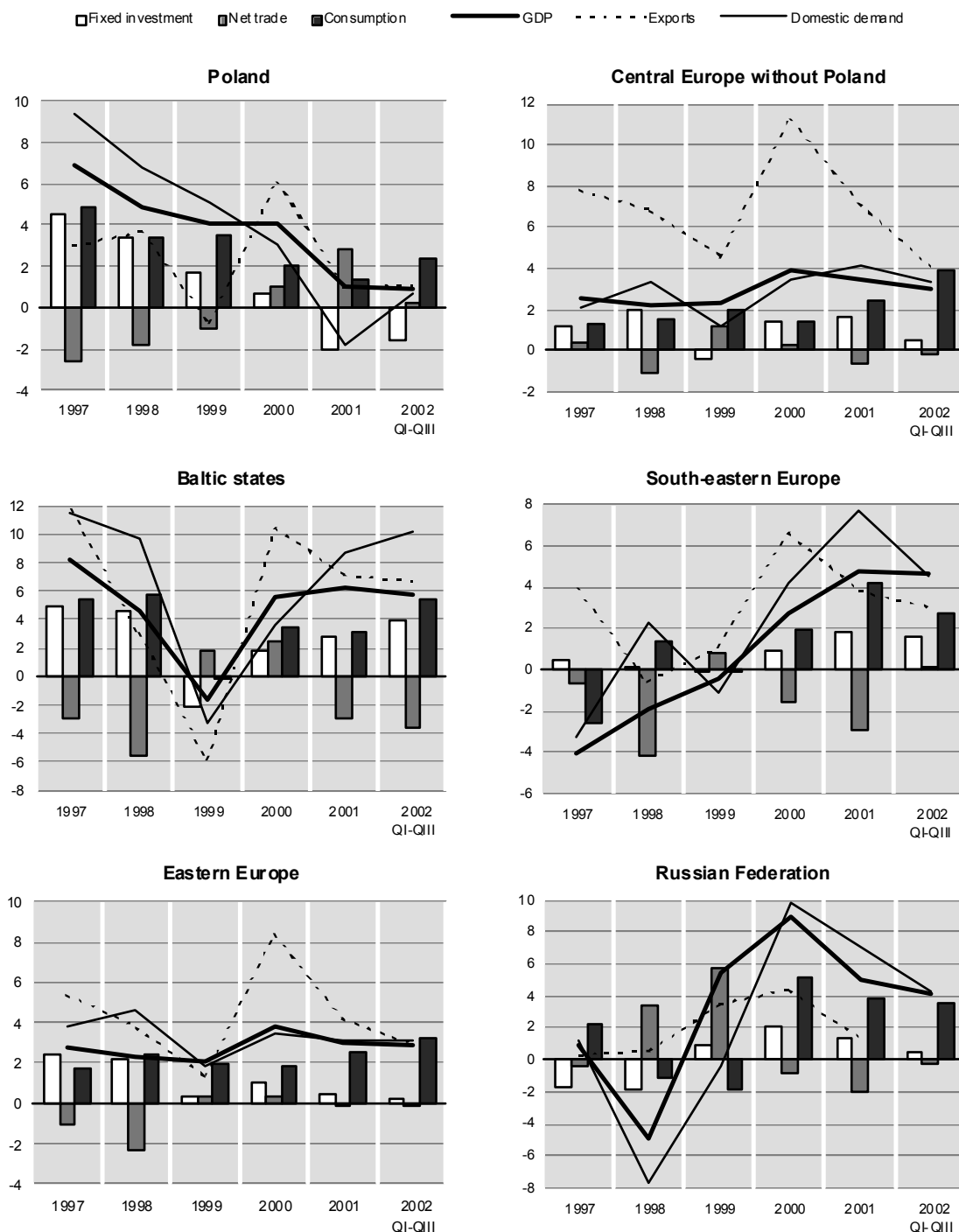
¹²² While monthly and quarterly retail sales data in the Czech Republic point to a deceleration during 2002, this is not reflected in the national accounts data on personal consumption. A possible explanation might be the strong influence of tourism on retail trade: tourism weakened in the Czech Republic over the course of the year, especially after the August floods.

¹²³ However, the data in table 3.2.6 for Albania mask a strong recovery during 2002. After a slump during the first and second quarters the volume of retail trade sales grew by 9.2 per cent in the third quarter.

¹²⁴ Flood repair costs in the Czech Republic drove up government spending by a considerable amount after the summer of 2002.

¹²⁵ Consumption in Hungary was driven by a recent surge in real wages, see sect. 3.3.

CHART 3.2.1
Contributions of the major components of final demand to changes in real GDP in selected east European and CIS economies and subregions, 1997-2002
 (Percentage points)



Source: UNECE Common Database.

Note: Regional aggregations are based on PPP-adjusted, GDP-weighted data. Underlying data for south-eastern Europe and eastern Europe are without Albania, Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia. Due to ongoing major revisions of the Czech national accounts data, Q1-Q3 data on exports and imports of goods and services are currently unavailable (see section 3.5(ii)). The chart uses instead data for the first half of 2002 for Czech exports of goods and services.

TABLE 3.2.2

Components of real demand in selected east European and CIS economies, 2000-2002
(Percentage change over the same period of the preceding year)

	Private consumption expenditure ^a			Government consumption expenditure ^b			Gross fixed capital formation			Exports of goods and services			Imports of goods and services		
	2000	2001	2002 QI-QIII	2000	2001	2002 QI-QIII	2000	2001	2002 QI-QIII	2000	2001	2002 QI-QIII	2000	2001	2002 QI-QIII
Eastern Europe															
Bulgaria	4.4	5.1	2.7	11.7	2.4	1.8	15.4	19.9	7.4	16.6	8.5	1.3	18.6	13.0	0.5
Croatia	4.0	4.8	6.3	-2.6	-3.8	-1.7	-3.8	9.7	11.4	12.0	8.6	1.6	3.7	9.4	8.0
Czech Republic	2.5	3.9	4.5	-1.0	0.3	6.0	5.3	7.2	0.5	17.0	12.3	.. ^c	17.0	13.6	.. ^c
Estonia	6.7	4.8	8.9	0.1	2.1	4.7	13.3	9.1	17.8	28.6	-0.2	4.1	27.9	2.1	7.7
Hungary	4.4	4.9	8.8	1.9	0.1	3.9	7.7	3.1	5.9	21.8	9.1	6.9	21.1	6.3	8.4
Latvia	7.4	7.1	7.8	-1.9	-4.4	5.7	20.0	17.0	7.9	12.0	6.9	5.5	4.9	12.6	7.3
Lithuania	4.6	2.0	6.3	-0.7	0.4	2.0	-3.9	8.7	18.4	12.9	20.8	15.9	4.5	18.6	18.3
Poland	2.8	2.0	3.0	1.1	0.4	1.7	2.7	-8.8	-9.0	23.2	3.1	3.9	15.6	-5.3	2.7
Romania	-0.6	6.5	3.7	10.0	1.8	1.3	4.6	6.6	7.6	24.1	10.6	11.4	28.2	17.5	7.8
Slovakia	-1.8	3.9	5.3	1.3	5.1	5.3	1.2	9.6	-0.6	13.8	6.5	3.8	10.2	11.7	2.9
Slovenia	0.8	1.7	1.7	3.1	3.2	2.4	0.2	-1.9	3.1	12.7	6.2	5.7	6.1	2.1	4.6
The former Yugoslav Republic of Macedonia	11.1	..	..	-2.6	..	..	-3.2	..	..	19.0	..	..	24.2	..	..
CIS															
America	8.3	6.4	5.8	2.8	-	-3.2	16.2	4.0	21.0	19.0	22.9	24.9	7.2	2.1	11.7
Azerbaijan	11.6	9.8	..	2.3	5.3	..	2.6	20.6	..	15.4	34.1	..	17.3	48.0	..
Belarus	7.8	17.3	10.9	6.0	3.3	0.4	2.3	-2.3	7.1	12.7	10.5	7.1	13.4	12.4	8.7
Kazakhstan	0.9	7.7	14.9	15.0	19.2	-2.4	16.1	25.3	4.4	28.7	-1.1	11.9	26.1	2.5	0.3
Kyrgyzstan	-5.0	2.2	4.2	5.9	-1.3	-19.0	26.9	-1.9	-2.9	10.5	-3.2	9.8	0.4	-13.8	18.3
Republic of Moldova	20.9	6.1	9.6	-1.2	-6.2	13.3	-8.7	17.3	5.3	9.5	17.2	22.0	32.3	10.6	22.3
Russian Federation	9.1	8.5	6.3	1.4	-1.0	2.4	14.6	8.1	2.9	10.0	2.9	..	19.7	13.8	..
Ukraine	2.3	8.9	7.6	1.0	10.4	-5.7	12.4	6.2	4.5	21.5	3.5	6.0	23.8	6.0	2.8

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

^a Expenditures incurred by households and non-profit institutions serving households.

^b Expenditures incurred by the general government on both individual consumption of goods and services and collective consumption of services.

^c Due to ongoing major revisions of Czech national accounts data, QI-QIII data for exports and imports of goods and services were not available at the time of writing.

more buoyant than construction and industry in the region. Again, sectoral growth rates were more or less equal in Slovenia, while in Slovakia wholesale and retail trade fell during the first three quarters of the year. While construction was weak, in line with the investment slowdown and due to a fall in the volume of construction work done abroad, Slovak agricultural output grew strongly. Construction was very weak in the first half of the year in the Czech Republic, but recovered with the demand for rebuilding after the August floods.

The combination of strong domestic demand and a limited stimulus from west European demand after the first quarter was instrumental in accelerating GDP growth in the second and third quarters of 2002 in all of central Europe except the Czech Republic. This was particularly the case for Poland, which appears to be embarking on a fragile recovery from its year-long stagnation. In Hungary, the upturn after a rather weak performance in the first quarter (when the year-on-year growth rate was the lowest in five years) was probably due more to fiscal expansion.

In the *Baltic countries* growth received strong support from both consumption and FDI-assisted investment (chart 3.2.1). After a weak start in the first quarter, the growth of exports of goods and services

recovered and strengthened over the rest of the year (table 3.2.2), largely due to transit fees boosting service exports. Export was particularly strong in Lithuania, underpinned by a surge in exports of wood manufactures and oil products.¹²⁶ Estonian exports were seriously hampered by the weak markets for electronic components (chart 3.2.3). Although the competitiveness of Latvian industry suffered from a double-digit increase in real unit labour costs during the first nine months of the year, and in spite of weaker activity in its key sector, transport services,¹²⁷ GDP growth accelerated steadily between the first and the third quarters of 2002. This was due to a strong growth in construction and in wholesale and retail trade, although industrial output also recovered after the first quarter. This pattern was common to all the Baltic countries, although in Lithuania agricultural output also grew strongly.

¹²⁶ As Lithuanian exports of refined oil products exports rely on imports of crude oil, net trade subtracted some 5.1 percentage points from GDP growth in Lithuania in the presence of strong import demand for consumption and investment.

¹²⁷ Transport services grew by only 2 per cent. Oil and oil products transported by pipelines decreased by 26 per cent, year-on-year. *Dow Jones Reuters Business Interactive* (Factiva), 23 December 2002, p. 9.

TABLE 3.2.3

Contributions of the major components of final demand to changes in real GDP in selected east European and CIS economies, 2000-2002
(Percentage points)

	Final consumption expenditure			Gross fixed capital formation			Changes in stocks			Total domestic expenditure ^a			Net exports		
	2000	2001	2002 ^b QI-QIII	2000	2001	2002 ^b QI-QIII	2000	2001	2002 ^b QI-QIII	2000	2001	2002 ^b QI-QIII	2000	2001	2002 ^b QI-QIII
Eastern Europe															
Bulgaria	5.0	3.9	2.2	2.3	3.1	1.2	-	0.2	0.6	7.4	7.3	4.0	-2.0	-3.2	0.4
Croatia	2.0	1.7	3.3	-0.9	2.1	2.6	-1.3	0.7	2.6	-0.2	4.5	8.5	3.2	-0.9	-3.5
Czech Republic	1.2	2.2	3.4	1.7	2.4	0.2	1.3	0.7	-0.9	4.3	5.3	2.7	-1.0	-2.0	-0.2
Estonia	3.8	3.2	5.9	3.2	2.3	4.5	2.9	-0.6	2.1	9.9	4.9	12.5	-0.5	-2.2	-3.7
Hungary	2.7	2.5	5.3	1.8	0.8	1.2	0.7	-1.2	-2.4	5.2	2.1	4.1	-	1.7	-1.0
Latvia	3.4	5.1	5.7	5.2	3.4	2.0	-5.0	2.9	-0.9	3.6	11.4	6.7	3.2	-3.9	-1.4
Lithuania	3.3	1.6	4.9	-1.2	2.4	4.7	-1.9	4.6	1.5	0.2	8.6	11.2	3.5	-2.6	-5.1
Poland	2.0	1.4	2.3	0.7	-2.1	-1.6	0.3	-1.1	-	3.0	-1.8	0.7	1.0	2.8	0.2
Romania	1.0	4.9	2.8	0.8	1.2	1.4	2.5	2.4	-0.4	4.3	8.5	3.8	-2.5	-3.3	0.8
Slovakia	-0.7	3.1	3.7	0.4	2.7	-0.2	-0.6	1.6	-	-0.9	7.5	3.5	2.2	-4.0	0.6
Slovenia	1.1	1.6	1.4	0.1	-0.5	0.8	0.1	-0.6	0.1	1.2	0.5	2.3	3.4	2.5	0.7
The former Yugoslav Republic of Macedonia	7.2	..	..	-0.5	..	..	2.4	..	..	9.1	..	..	-4.6	..	..
CIS															
Algeria	8.4	6.2	5.1	2.7	0.7	3.5	-1.7	1.6	0.1	9.3	8.5	8.7	0.4	4.3	1.1
Azerbaijan	9.1	7.1	..	0.7	4.8	..	-0.1	-0.5	..	9.8	11.4	..	-2.9	-4.7	..
Belarus	5.8	10.5	6.3	0.6	-0.6	1.5	2.9	1.1	0.6	9.2	11.0	8.3	-0.8	-1.7	-1.2
Kazakhstan	2.4	7.0	8.0	2.6	4.4	0.9	-0.7	3.0	-	4.3	14.4	9.0	1.7	-1.8	5.6
Kyrgyzstan	-2.8	1.2	-0.4	4.2	-0.3	-0.3	-0.2	-0.8	0.8	1.2	0.1	0.1	4.2	5.2	-2.8
Republic of Moldova	15.4	4.5	10.7	-1.6	2.7	0.7	4.3	-1.4	-	18.2	5.7	11.3	-16.1	0.4	-5.4
Russian Federation	5.1	3.8	3.5	2.1	1.3	0.5	2.6	1.9	0.3	9.8	7.0	4.3	-0.9	-2.0	-0.2
Ukraine	1.5	7.0	3.3	2.4	1.2	0.8	1.9	2.3	-1.7	5.8	10.5	2.4	0.1	-1.3	1.9

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

Note: The sum of the component changes does not add up to the GDP change for Croatia, Estonia, Slovakia and most CIS economies because of a reported statistical discrepancy, which appears on the expenditure side because the statistical offices take the total GDP from the production side rather than using the sum of expenditure components. In many transition countries the existing sources and methods allow for better estimates of GDP by the production method.

^a Total consumption expenditure plus gross capital formation.

^b Over the same period of 2001.

Among the *south-east European* economies, the pattern of domestic demand in Bulgaria, Croatia and Romania was generally similar to that in the Baltic states, although the relative contributions of consumption and investment to growth were somewhat smaller. In aggregate, the contribution of net trade to growth in these three economies was close to zero (chart 3.2.1), although this masks important differences (table 3.2.3). Thus, particularly strong domestic demand in Croatia – both for consumption and investment – led to a surge in imports and a substantial negative contribution of net trade to GDP growth. The pace of growth in construction and trade, the latter largely due to the tourism industry, exceeded that of industry. In contrast, a strong export performance in Romania and lower import growth in Bulgaria resulted in a positive contribution of net exports to GDP growth in both countries.¹²⁸

Developments in the rest of south-eastern Europe were mixed. A partial recovery in industrial activity after the slump in 2001 was insufficient to prevent a sharp slowdown in GDP growth in Albania. Lower growth in Yugoslavia relied mostly on the services sector, industrial production remaining frail after a year of zero growth in 2001.¹²⁹ Overall activity remained weak in Bosnia and Herzegovina. Good harvests and growing industrial output indicate progress, but sustained growth is yet to take hold, as private sector activity is still held back by the slow progress in privatization and restructuring and by impediments to the entry and exit of firms.¹³⁰ The former Yugoslav Republic of Macedonia is the only east European economy where gross industrial output is estimated to have declined in 2002 as a whole. The economy was close to stagnation, as agricultural output also fell during 2002, and there was only a fragile recovery in construction and services.

¹²⁸ Romania's strong export performance in mostly traditional items such as food products, textiles, chemicals and basic metals (see also the industrial output figures in table 3.2.4) is to some extent attributable to the fact that it is one of the very few east European countries where real unit labour costs declined during the first three quarters of 2002 (table 3.3.2). This, however, reflects the limited success in fighting moderate inflation during 2002 rather than productivity gains in industry, which in fact declined. In consequence, high wage growth, especially in the public sector, remains a continuing problem in the country's discussions with the IMF.

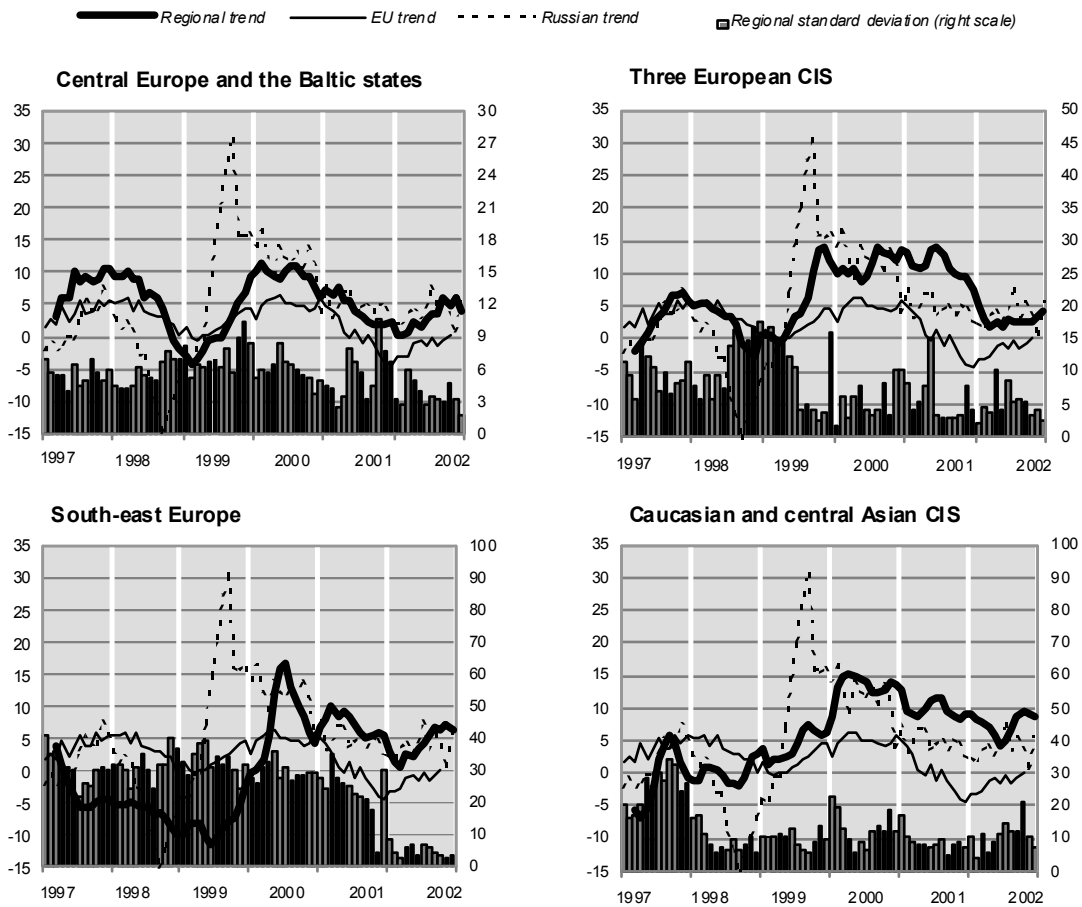
IMF Country Report No. 02/194, *Romania: First and Second Reviews Under the Stand-By Arrangement* (Washington, D.C.), September 2002.

¹²⁹ Although there were no official estimates of investment in Yugoslavia at the time of writing, it is estimated to have increased by 18 per cent during 2002. Institute of Economic Sciences, *Monthly Analyses and Prognoses* (Belgrade), November 2002, p. 15.

¹³⁰ IMF Staff Country Report No. 03/4, *Bosnia and Herzegovina: First Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria* (Washington, D.C.), January 2003.

CHART 3.2.2

Trend and dispersion of monthly changes in industrial production in east European and CIS subregions, 1997-2002
(Per cent)



Source: UNECE Common Database.

Note: Trend is the three-month moving average of cross-country weighted averages of monthly year-on-year rates of change of industrial output in each group of countries, using industrial production as weights. Dispersion is measured by the unweighted standard deviation of the same rates of change. South-east Europe excludes Bosnia and Herzegovina. Trends of EU and Russian industrial production are used as benchmarks. Selected December 2002 figures are based on preliminary data or UNECE secretariat estimates.

Very strong trade links imply that the timing of industrial production cycles in central Europe and the Baltic states – and more recently also in south-east Europe – follows that of the European Union (chart 3.2.2). Strong impulses from domestic demand and from exports to the CIS, however, were sufficient to raise average industrial output growth rates in eastern Europe to well above those in the European Union. The pattern of demand varied in its impact on individual sectors in eastern Europe (table 3.2.4). While the production of textiles, chemicals and basic metals were the worst affected relative to overall industrial production in central Europe, the two latter industries made relative gains in south-eastern Europe. In both regions, machinery and equipment and other manufacturing fared better than total industrial production.¹³¹ This was also the

case for food production in south-eastern Europe. Basic metal production declined in relative terms in the Baltic economies during 2002, except in Estonia. A common feature in the Baltic region was the strong performance of machinery and equipment and other manufacturing.

Within the machinery and equipment industry, the development of heavily export-oriented branches, such as electrical and optical equipment and rubber and plastics (in which the highest rates of job creation had occurred during the 1990s)¹³² differed from country to country. While Estonia, Hungary and Slovenia were significantly affected by waning growth in both of these important branches, in the Czech Republic their expansion accelerated over the last two years (chart 3.2.3).

¹³¹ There were also some exceptions to this pattern, such as the weakness of machinery and equipment output in Poland, Romania, and The former Yugoslav Republic of Macedonia. Other manufacturing

performed relatively poorly in Croatia, the Czech Republic, Slovenia and Yugoslavia (table 3.2.4).

¹³² UNECE, *Economic Survey of Europe, 2002 No. 1*, chap. 3.4(iii), pp. 119-127.

TABLE 3.2.4

Rates of relative growth ^a of real industrial output by NACE sectors in selected east European and CIS economies, January-September 2002
(Per cent)

	NACE sectors ^b										
	C	D	15,16	17-19	20-22	23-25	26	27,28	29-35	36,37	E
Czech Republic	-5.6	0.6	-1.4	-9.0	-0.2	1.1	-1.8	-6.5	5.7	-0.9	-4.1
Hungary	-6.2	0.5	1.0	-7.6	-1.0	1.8	0.5	-7.1	1.7	13.1	-4.3
Poland	-7.2	-2.6	-1.2	-4.0	1.8	-5.5	-0.2	-1.3	-4.7	-	-2.4
Slovakia	22.8	1.5	-0.5	3.1	-8.9	1.4	-5.6	-0.2	7.2	9.8	-10.9
Slovenia	5.6	-0.8	-2.9	-15.2	0.5	2.5	-0.7	-0.6	3.0	-4.2	6.9
Central Europe	-3.3	-0.9	-0.9	-5.8	-0.2	-1.6	-1.0	-3.4	0.3	2.6	-3.4
Estonia	13.0	0.1	-4.4	4.0	-5.2	-0.6	6.3	2.0	4.3	1.2	-7.0
Latvia	1.5	0.7	2.0	-6.7	-2.9	10.6	7.1	-11.6	2.6	4.4	-1.8
Lithuania	-5.8	-0.1	-2.7	-0.9	17.7	-5.3	3.7	-11.7	4.7	8.3	0.7
Baltic states	-	0.1	-2.0	-1.2	8.0	-0.6	5.0	-8.7	4.1	5.9	-1.6
Bulgaria	-7.3	1.3	-4.4	4.4	8.2	-6.4	7.9	3.1	5.2	8.6	-2.4
Croatia	11.7	-0.5	0.4	-12.9	3.9	-3.3	8.6	-3.2	1.5	-3.3	-1.8
Romania	-7.0	1.4	5.4	-0.4	-6.3	1.4	-11.5	17.2	-3.3	3.4	-6.8
The former Yugoslav Republic of Macedonia	-4.6	5.0	14.6	-3.0	38.7	4.7	24.9	-13.2	-16.2	-0.3	3.4
Yugoslavia	2.0	0.7	6.6	-24.4	-8.2	4.8	-	1.1	13.9	-10.0	-3.0
South-east Europe ^c	-3.7	1.2	3.9	-4.4	-1.9	0.3	-3.7	9.7	0.4	1.5	-4.8
Eastern Europe ^c	-3.3	-0.3	0.2	-5.2	-0.2	-1.1	-1.4	-0.3	0.5	2.5	-3.7
Armenia	-4.4	12.6	-5.9	-15.2	0.6	-41.8	16.1	12.3	-46.0	..	-28.4
Azerbaijan	-0.5	-1.1	-3.1	-1.6	23.0	35.3	37.6	23.3	-40.2	..	1.1
Georgia	-4.8	7.0	2.7	6.6	36.2	38.3	8.2	15.6	-20.2	..	-7.7
Kazakhstan	3.6	-1.3	0.9	18.8	0.5	-1.2	-3.1	-2.3	-9.5	-8.3	-10.9
Kyrgyzstan	-14.6	8.9	24.4	49.6	35.6	4.1	40.0	-17.8	26.1	4.2	0.5
Republic of Moldova	9.2	0.6	9.8	-9.7	10.0	11.9	17.5	6.7	4.1	..	-7.1
Ukraine	-4.4	1.8	2.6	-5.1	4.5	8.0	-2.5	-4.6	1.9	..	-5.6
Selected CIS (as listed above)	-1.8	1.1	2.2	4.2	6.3	6.8	2.5	-1.2	-5.7	..	-7.1

Source: UNECE Common Database.

Note: The regional aggregates are weighted averages, where the weights are the shares in regional industrial production in 2001.

^a Each sector's relative growth rate is calculated as $[(y/y_t)-1] \times 100$, where y is the index of production in January-September 2002, with January-September 2001=100, j refers to the sector, and t to total industrial output. Individual sector's higher growth (as compared to the total industry's growth) is positive, lower growth is negative.

^b 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, publishing activity (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).

^c Excluding Albania and Bosnia and Herzegovina.

(iii) Common wealth of Independent States

Although it remained relatively high, average GDP growth in the CIS was weaker during 2002 than in 2001, largely because of the slowdown in Russia and Ukraine. Growth accelerated in Armenia, Azerbaijan, Georgia, the Republic of Moldova and, most probably, in Turkmenistan. It remained unchanged in Belarus, and slowed down in Kazakhstan and Tajikistan. Apart from the two largest economies, Russia and Ukraine, growth also weakened in Uzbekistan, and in Kyrgyzstan GDP actually fell.

On the basis of the available quarterly national accounts statistics (tables 3.2.2 and 3.2.3),¹³³ there was

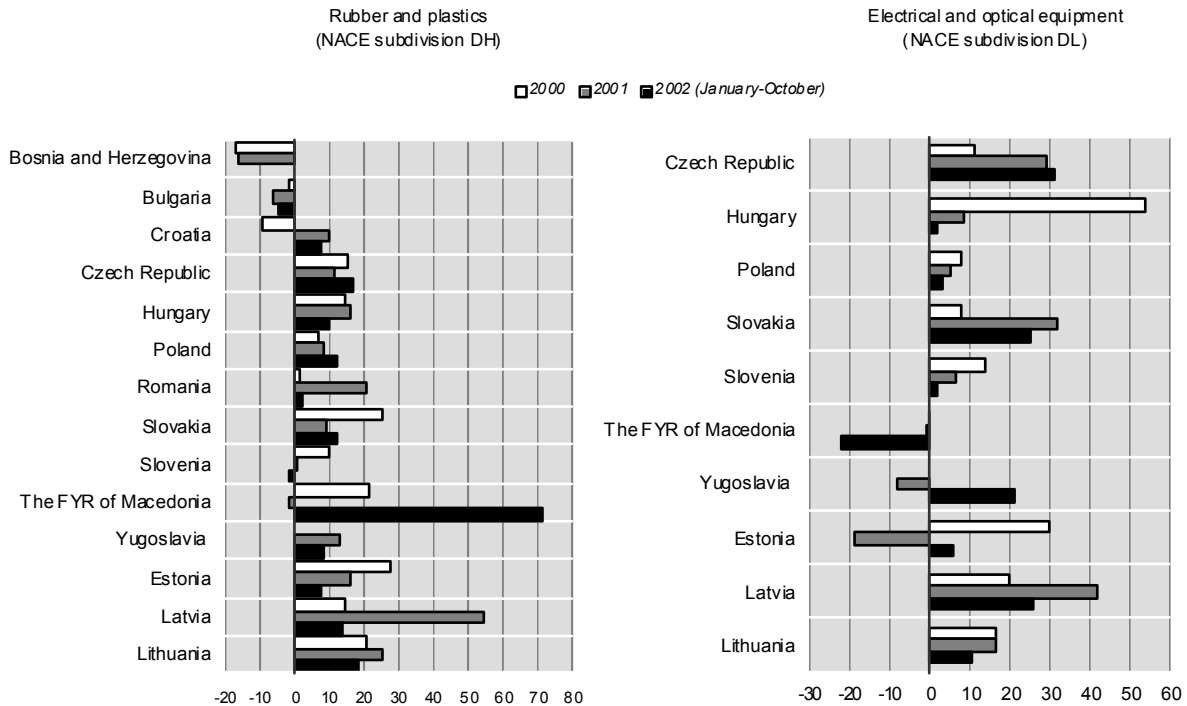
little contribution from net trade to overall growth in the CIS in the first three quarters of 2002: about half a percentage point was mostly due to strong net trade contributions in Kazakhstan and in Ukraine.¹³⁴ Thus, much as in eastern Europe, CIS growth was mainly driven by domestic demand, which, however, was weaker during 2002 than in the previous year.

The available data also suggest that there was only a limited contribution to growth from gross fixed capital formation. The statistics on capital investment outlays in those CIS economies that do not provide quarterly national accounts statistics confirm that investment growth was very strong in Azerbaijan but was more modest elsewhere

¹³³ Only seven CIS countries report quarterly GDP by expenditure in constant prices: Armenia, Belarus, Kazakhstan, Kyrgyzstan, the Republic of Moldova, Russia and Ukraine. However, together they represent about 92 per cent of the total PPP-weighted GDP in the CIS.

¹³⁴ UNECE secretariat calculations. While merchandise exports in Kazakhstan recovered from the previous year's decline, especially during the third quarter of 2002, merchandise exports and imports both lost pace in Ukraine. However, that was made up by large increases in exports of services (see sect. 3.5).

CHART 3.2.3
Manufacturing output by NACE industries in selected east European economies, 2000-2002
 (Percentage changes over the same period of the preceding year)



Source: UNECE Common Database.

Note: Missing bars correspond to missing data points. For The former Yugoslav Republic of Macedonia, 2002 data refer only to January-September.

(table 3.2.5).¹³⁵ Summing up the information coming from the two sources, a rough estimate suggests that gross fixed capital accumulation probably contributed no more than about 0.6 percentage points to aggregate CIS GDP growth during the first three quarters of 2002. At least to some extent, the investment slowdown in Russia and other CIS economies during 2002 may be attributable to the pressure on operating profits resulting from producer price inflation falling behind the rise in unit labour costs, especially as internal financing is by far the major source of investment financing in these economies.¹³⁶

Consumption in the CIS economies remained strong and was the main source of growth during the first three quarters of 2002, driven by rising disposable incomes – backed by wage growth and also some new job creation – as well as continuing disinflation. Thus, at least to some extent, it is the high wage growth in the region that was behind both the strength of consumption and the weakness of investment in the CIS.

¹³⁵ Investment in fixed capital in the CIS as a whole increased by 6 per cent during the first nine months of 2002 year-on-year, down from 10 per cent a year ago. To a large extent, this reflects the decline in Russia. Interstate Statistical Committee of the CIS, *Press Release* (Moscow), 4 November 2002.

¹³⁶ Real unit labour costs were growing significantly faster than in eastern Europe, except for Armenia, where they in fact decreased slightly during the first three quarters of 2002 (table 3.3.2).

Retail trade figures (table 3.2.6) also confirm the dominant role of private consumption demand: in the CIS as a whole, the volume of retail sales increased by 9.6 per cent during the first three quarters of the year, even slightly higher than the 8.9 per cent increase of a year ago.¹³⁷ It grew at high rates in most CIS economies, except for Georgia and Uzbekistan, where it decelerated compared with 2001.

The deceleration of growth in industry was more pronounced and more widespread than that of GDP (tables 1.1.3 and 3.2.1). CIS industries in general were less responsive than eastern European ones to the hesitant recovery of growth in the western industrialized countries, and especially the European Union (chart 3.2.2). This reflects the weaker trade links of the CIS with western Europe and the generally more volatile nature of the resource-dependent CIS economies, where a few key commodities are usually responsible for growth.¹³⁸ The sectoral pattern of industrial growth, at least in those economies that provide data according to the NACE classification system, was significantly different from that in eastern Europe. The CIS industries that did relatively

¹³⁷ Interstate Statistical Committee of the CIS, *Press Release* (Moscow), 5 November 2002.

¹³⁸ On the link between diversification and systemic reform in resource-dependent CIS economies, see chap. 5 of this *Survey*.

TABLE 3.2.5

Real investment outlays in selected east European and CIS economies, 2000-2002

(Percentage changes over the same period of the preceding year)

	2000	2001	2002 ^a
Eastern Europe			
Czech Republic	3.8	..	..
Hungary	7.4	3.2	5.9
Latvia	22.4	7.9	14.0
Lithuania	-2.0	28.1	..
Poland	1.4	-9.5	-15.5
Romania	3.5	5.1	6.4
Slovakia	4.3	..	..
CIS			
Armenia	27.3	14.0	33.0
Azerbaijan	3.0	21.0	82.2
Belarus	2.0	-6.1	3.0
Georgia	2.0	0.3	4.5
Kazakhstan	38.2	21.0	16.0
Kyrgyzstan	4.2	-16.0	-12.3
Republic of Moldova	-15.0	11.0	4.0
Russian Federation	17.4	8.7	2.5
Turkmenistan	8.0	..	5.0
Ukraine	14.4	20.8	6.2
Uzbekistan	1.0	3.7	2.0

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

Note: "Gross capital formation" and "gross fixed capital formation" are standard categories of the United Nations 1993 SNA (System of National Accounts) and the European Union's 1995 ESA (European System of Accounts). Gross capital formation includes gross fixed capital formation plus changes in inventories and acquisitions less disposal of valuables. "Investment outlays" (also called "capital investment" in some transition economies) mainly refers to expenditure on construction and installation works, machinery and equipment. Gross fixed capital formation is usually estimated by adding the following components to "capital investment": net changes in productive livestock, computer software, art originals, the cost of mineral exploration and the value of major renovations and enlargements of buildings and machinery and equipment (which increase the productive capacity or extend the service life of existing fixed assets).

^a January-September for Hungary, Latvia, Poland, Romania, Armenia, Georgia, Republic of Moldova, Russian Federation, Turkmenistan, Ukraine and Uzbekistan.

well were textiles, wood and paper processing, chemical products and the manufacture of non-metallic mineral products, i.e. all sectors that were relatively weak in eastern Europe. On the other hand, the growth of output of machinery and equipment was significantly less than the rest of industry in the CIS (table 3.2.4).

Also, there was a very sharp fall in the rate of growth of agricultural output in the CIS: in the first nine months of 2002 it rose by only 0.6 per cent (year-on-year) compared with 7 per cent in the first three quarters of 2001.¹³⁹

GDP growth in *Russia* slowed in 2002 for the second consecutive year. Industrial output growth accelerated after the first quarter, but is estimated to have fallen again towards the end of the year. The highest growth rates were in low value added export industries such as non-ferrous metals, glass and porcelain, and

fuels.¹⁴⁰ Food processing, more dependent on domestic demand, also grew strongly, but growth in the engineering branches was less than for industry as a whole.¹⁴¹ Agricultural output rose by only 1.7 per cent in 2002,¹⁴² while construction stagnated due to the investment slowdown. The nominal share of gross fixed capital formation in GDP dropped to 15.5 per cent during the first three quarters of 2002, down from 17.7 per cent for 2001 as a whole. The dominant role of consumption is illustrated by the fact that during the first three quarters of the year services increased their share of total economic activity by 3 percentage points, rising to 58 per cent of total GDP.¹⁴³

In the *European CIS*, the dwindling growth rate of the Ukrainian economy was particularly noticeable in 2002. In addition to worsening exports to other CIS countries, this was due to weaker domestic demand during the first nine months of the year, which resulted from large falls in government consumption and inventories (tables 3.2.2 and 3.2.3). Economic activity was also affected by the slowdown in both agriculture¹⁴⁴ and, especially, in industry, although the situation in the latter improved somewhat during the course of the year (table 3.2.1). The deceleration in industry was to a large degree due to the weak output and export growth of the metalworking industries (table 3.2.4), especially during the first half of the year.¹⁴⁵ Data for the first 11 months of 2002 suggest that the main impetus came from the petrochemical industries and timber processing, although both grew less than in 2001. In spite of falling rates of growth of industrial output in both countries, GDP growth in Belarus was basically unchanged from the previous year, while in the Republic of Moldova GDP grew more rapidly in 2002. In Belarus growth held up mainly because of services, especially retail trade. Together with the deceleration in real wage growth, the

¹⁴⁰ 2002 marked the fourth consecutive year of growth for the Russian oil industry. Oil extraction grew by 8.8 per cent over the whole year, to reach a 10-year peak of 7.6 million barrels per day. *Oxford Analytica, East European Daily Brief/Executive Summaries*, 21 January 2003.

¹⁴¹ The strength of the Russian rouble against the major currencies implied a real exchange rate appreciation that provided an additional barrier to the process of restructuring and diversification of Russian industry. As Russia does not yet publish industrial output data according to the NACE classification system, it is difficult to place its data into the comparative perspective of those in table 3.2.4. However, the 2002 data tend to support the impression gained from table 3.2.4 for other CIS countries.

¹⁴² Goskomstat, *Osnovnye ekonomicheskie i sotsial'nye pokazateli* [www.gks.ru].

¹⁴³ Bank of Finland, Institute for Economies in Transition, *Russian & Baltic Economies, The Week in Review*, Weeks 51-52 (Helsinki), 20 December 2002.

¹⁴⁴ During the first nine months of 2002, agricultural output increased by 3 per cent, against 11 per cent a year previously. Interstate Statistical Committee of the CIS, *Press Release* (Moscow), 3 December 2002.

¹⁴⁵ A value added tax on Ukrainian products sold to Russia took effect by mid-2001. Industrial producers and exporters therefore accelerated planned deliveries, and thus created a high base level during the first half of 2001.

¹³⁹ Interstate Statistical Committee of the CIS, *Press Release* (Moscow), 3 December 2002.

TABLE 3.2.6

Volume of retail trade in the east European and CIS economies, 2000-2002

(Percentage changes over the same period of the preceding year)

	2000	2001	2002 ^a
Eastern Europe			
Albania .....	..	..	-2.2
Bulgaria	12.7	4.3	2.2
Croatia	8.0	7.5	12.8
Czech Republic	5.3	4.3	2.6
Estonia	16.0	13.0	14.3
Hungary	2.0	5.4	10.0
Latvia	9.0	9.5	17.2
Lithuania	10.9	9.8	14.2
Poland	1.0	0.2	4.2
Romania	-3.8	1.3	1.3
Slovakia	2.3	4.5	3.7
Slovenia	7.4	7.8	4.6
The former Yugoslav Republic of Macedonia	11.1	-10.7	6.7
Yugoslavia	10.3	16.0	16.0
CIS			
Armenia	8.5	15.5	15.0
Azerbaijan	9.8	9.9	9.6
Belarus	11.8	21.2	12.9
Georgia	11.9	8.9	1.6
Kazakhstan	4.8	15.4	8.6
Kyrgyzstan	7.7	6.1	8.2
Republic of Moldova ^b	4.0	14.8	22.3
Russian Federation	8.8	10.7	9.1
Tajikistan	-21.2	1.2	16.6
Ukraine	6.4	14.0	16.1
Uzbekistan	7.8	9.5	3.6

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

Note: Retail trade covers mainly goods in eastern Europe, Kazakhstan and the Russian Federation; it comprises goods and catering in other CIS countries. The most recent data for The former Yugoslav Republic of Macedonia are subject to regular and large revisions. The coverage in 2002, based on current monthly statistics, may differ from the coverage of annual statistics.

^a January-September for Albania and Uzbekistan; January-October for Lithuania, Romania, Slovenia, and The former Yugoslav Republic of Macedonia; January-November for Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Poland, Slovakia, Slovenia, Armenia, Georgia and Tajikistan.

^b Registered enterprises for 2000.

growth of this sector, however, was falling during the course of the year (table 3.2.6), while capital investment was picking up. In the Republic of Moldova, both household and government consumption rose perceptibly during the first three quarters of 2002, but such consumption-led domestic demand resulted in a large external imbalance.¹⁴⁶

The sources of growth differed among the three *Caucasian rim* economies. In Azerbaijan, accelerating GDP growth was mainly driven by a virtual doubling of investment as compared with 2001 (table 3.2.5), a result of the recent launching of major investment projects in the energy sector. In Armenia, strong growth of household

consumption and investment were joined by vigorous external demand for jewellery and wood and metal processing products. Construction activity increased and the growth rate of industrial output quadrupled as compared with 2001. In Georgia, a return to growth in the relatively small industrial sector in 2002, mainly in wood processing and the chemical industry, was sufficient to raise the overall growth rate, in spite of continuing problems in the energy sector.

On average, the economies of *central Asia* in 2002 slowed down more than the CIS as a whole. Turkmenistan's heavily gas-dependent economy was an exception, while in Kyrgyzstan GDP even fell. Marginal growth in Kyrgyzstan's agricultural output in the first three quarters of the year could not make up for the losses in industrial output that were due to a halt in production at the important Kumtor gold mine, which was hit by a landslide during the summer. The deceleration of industrial output in this region was even more pronounced than that of GDP, except for Uzbekistan and to a lesser degree in Kazakhstan. Growth in Kazakhstan continued to be driven by crude oil and gas output, with a rate of growth in mining twice as high as that of manufacturing¹⁴⁷. The former was sustained by external demand, the latter by the increasing contribution of total consumption to GDP growth. Strong growth of both agriculture¹⁴⁸ and industry underpinned the high rate of GDP growth in Tajikistan, which relies heavily on aluminium and cotton production, although light industry and private farming also expanded in 2002.

3.3 Costs and prices

The downward trend in consumer price inflation, which generally resumed in early 2001, continued in 2002 in most of the east European and CIS economies. Lower domestic prices for imported goods and fuels, in addition to the sharply weaker food prices, were the main factors behind this development, particularly after the first quarter. Thus, lower inflation rates in 2002 were mainly a reflection of lower imported inflation due to exchange rate appreciation (particularly against the dollar), which alleviated external cost pressures,¹⁴⁹ and in some cases good harvests. In addition, cost pressures coming from western Europe were weakened due to the intensified competition in the international markets arising from depressed domestic demand in the developed market

¹⁴⁷ For January-November 2002, 14.8 versus 7.4 per cent year-on-year, UNECE Common Database.

¹⁴⁸ At a rate of 15 per cent. AFP, 15 January 2003, quoted in *Dow Jones Reuters Business Interactive* (Factiva).

¹⁴⁹ During the 12 months to December 2002 world commodity prices recovered by some 33 per cent in dollar terms from their severe cyclical downturn in 2001. However, this was largely due to the significant increase in crude oil prices. Total world commodity prices excluding energy, over the same period, rose by 14 per cent in dollars, and remained stable in euro terms. Industrial raw material prices, in euros, in December 2002 were slightly (1.3 per cent) below their level in the same period of 2001. Also see chap. 2.1 above.

¹⁴⁶ The commodity structure of the Republic of Moldova's exports is dominated by agricultural products, while energy dominates its imports. Both of these trade flows are with Russia.

economies.¹⁵⁰ In short, disinflation in 2002 was not the result of more moderate domestic cost-push and/or demand-pull pressures or of macroeconomic policies apart from exchange rate policy in a few cases.¹⁵¹ In fact in many of the east European economies for which the relevant data are available, the rates of core inflation (CPI excluding food and energy prices) remained rather stable as a result of the strong growth of various service prices. The core rate fell only in Poland, largely due to lagged effects of a long period of tight monetary policy and a strong zloty.

On the cost side, wage inflation in 2002 remained strong and rose more than measured labour productivity in industry, particularly in those countries where the slowdown in industrial output was significant. Consequently, the steep upward trend in unit labour costs continued throughout the region, with only a few exceptions. Industrial wages not only rose faster than labour productivity but also significantly faster than producer prices in some of the east European countries and especially in most of the CIS economies. Hence, real unit labour costs picked up strongly in 2002 in many parts of the region. This may in turn suggest that unless the dampening effect of imported disinflation on unit material input prices was large enough to offset the rise in wage costs, unit operating profits were probably stagnating or falling in 2002, particularly in those manufacturing branches where the share of exports is large or where the competition in the domestic market from cheap imports is intense.

On the demand side, the pressures on prices varied somewhat across the region. Real household incomes were rising in most of these economies, particularly in those where the labour markets performed relatively better in 2002; there was a general increase in real wages, and there was also increased income from tourism and/or fiscal stimuli in some countries. Thus, demand-pull factors probably intensified, albeit at varying degrees, in some of the east European countries such as Croatia, the Czech Republic, Hungary, Slovakia, Yugoslavia and the three Baltic states. In the other east European economies private consumption growth continued to be moderate or to lose steam during 2002, reflecting in the main a persistent weakness in the labour markets¹⁵² and a slower growth of real incomes (Bulgaria and Romania). Continued large increases in real wages and improvements in the labour markets in 2002 led to further increases in real disposable incomes and higher levels of private consumption throughout the CIS except in Georgia and Uzbekistan.¹⁵³

¹⁵⁰ In the EU, the export unit values of manufactured goods over the first three quarters of 2002 remained basically flat in euro terms, the major trading currency for most of the east European countries.

¹⁵¹ This has generally been the case during the transition except for the period immediately following the initial price shocks in the early 1990s. UNECE, *Economic Survey of Europe, 2001 No 1*, chap. 3, pp. 102-112.

¹⁵² See tables 3.4.1 and 3.4.2 below.

¹⁵³ In the absence of national accounts data for household consumption in some CIS countries, retail sales data are used as proxy for private consumption demand. See tables 3.2.2 and 3.2.6.

Although 2002 was favourable in terms of overall price changes, achieving sustainable price stability through the moderation of domestic demand-pull and cost-push pressures remains a challenge at the start of 2003. However, as the inflationary expectations of households have recently moderated in many of these economies and rising job insecurity may start to erode consumer confidence, the major domestic source of pressure on prices in the short run is likely to come from the supply side especially if there is a further slowdown in export-led growth and labour productivity while wage inflation fails to abate. However, the low inflation environment in general and weak labour markets in many of the region's economies may check wage demands. Furthermore, given the increasing competition in both domestic and international markets, increases in industrial producer price are expected to be small. Thus, unless a further surge in crude oil prices caused by supply disruptions leads to large increases in material input costs, inflation for the year as a whole can be expected to continue to fall in most of the economies of the region.

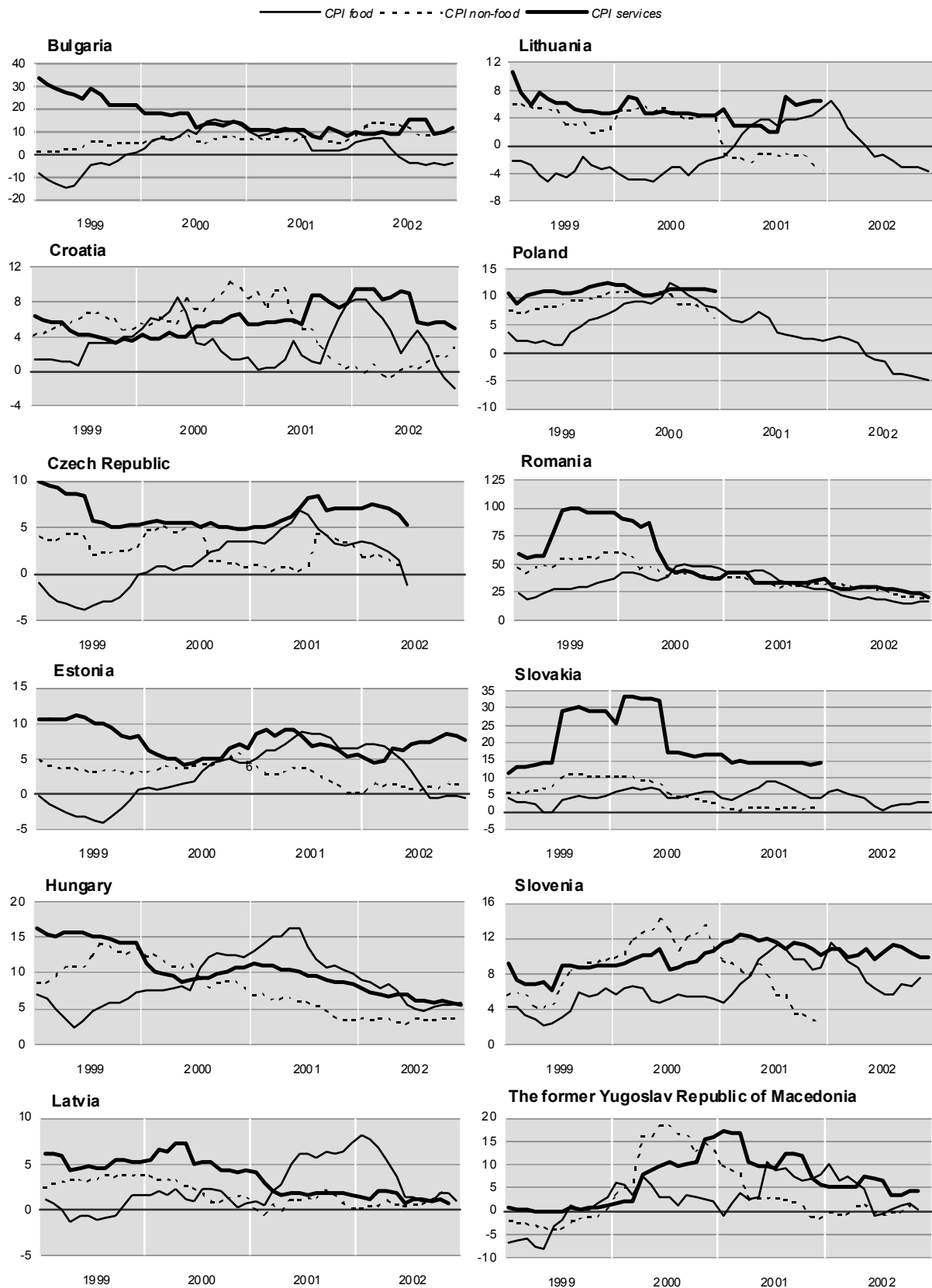
(i) Consumer prices

The continuing fall in consumer price inflation was largely due to the reduced import price pressures on non-food consumer goods in general, a development that was amplified by considerably weaker food prices in most countries as a result of better than average harvests (chart 3.3.1). Food prices in 2002, although rising less than in 2001, added to inflationary pressure only in Hungary, Azerbaijan and Tajikistan. In all the other countries (except the Republic of Moldova), the major source of upward pressure in 2002 again came from service prices. They not only rose faster than the other two major components of the CPI but also by more than in 2001 in Bulgaria, Estonia, Belarus and Kazakhstan. This persistent pressure from service prices is partly due to continued increases in administered or controlled prices of utilities, public transport and communications, rents, etc. The so-called "Balassa-Samuelson" effect,¹⁵⁴ albeit at varying magnitudes in different countries, is also generating an upward pressure on service prices and thus on overall inflation rates.

At the end of 2002, the year-on-year rate of inflation was higher than in 2001 only in four countries, namely in Slovenia, Tajikistan and, at low single digits, in Azerbaijan and Georgia (table 3.3.1). Although the rate fell as targeted by nearly two fifths in Romania, at some 18 per cent it remained the second highest in the region after Belarus (over 30 per cent).

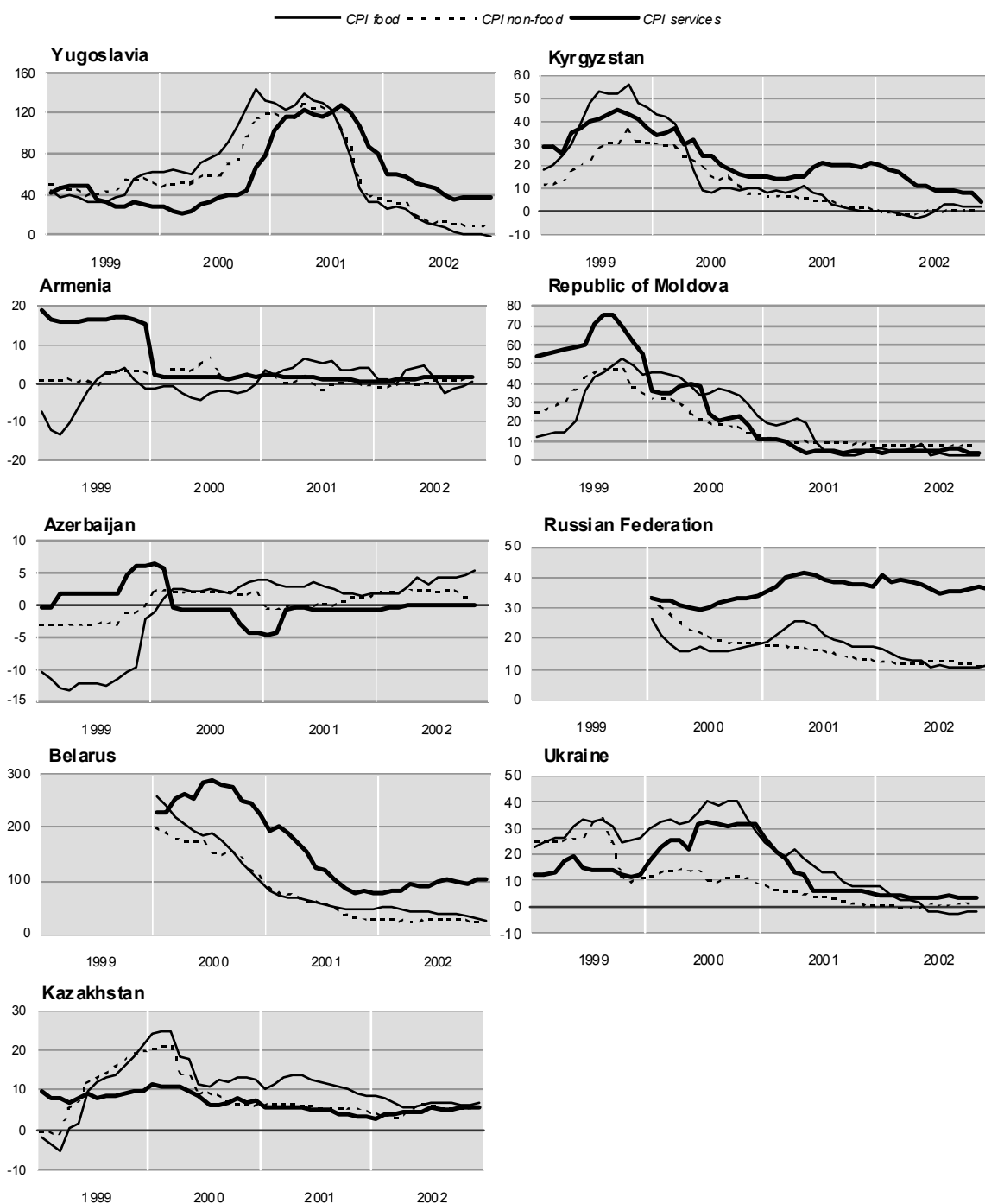
¹⁵⁴ Due to economy-wide wage equalization, real wages tend to increase not only in sectors with rapid productivity growth (mainly cost-efficient, export-oriented manufacturing branches) but also in relatively less productive sectors (i.e. most of the non-tradeable service branches). For some of the consequences of this effect on the real exchange rate, see sect. 3.1 above.

CHART 3.3.1
Components of consumer prices in eastern Europe and the CIS, 1999-2002
 (Monthly, year-on-year percentage change)



(For source see end of chart.)

CHART 3.3.1 (concluded)
Components of consumer prices in eastern Europe and the CIS, 1999-2002
 (Monthly, year-on-year percentage change)



Source: National statistics and UNECE secretariat estimates.

TABLE 3.3.1
Consumer prices in eastern Europe and the CIS, 2001-2002
(Percentage change)

	Annual average		Dec. over previous Dec.		2002, year-on-year			
	2001	2002	2001	2002	QI	QII	QIII	QIV
Eastern Europe								
Albania.....	3.1	5.3	3.5	2.0	7.2	4.9	5.0	4.0
Bosnia and Herzegovina.....	1.8	..	1.5	..	..	..	..	..
Bulgaria.....	7.3	5.8	4.8	3.8	8.2	7.1	4.6	3.4
Croatia.....	4.7	1.8	2.5	1.8	2.9	1.4	1.1	1.9
Czech Republic.....	4.7	1.8	4.2	0.6	3.8	2.3	0.8	0.6
Estonia.....	5.8	3.5	4.3	2.3	4.4	4.2	2.8	2.6
Hungary.....	9.2	5.4	6.9	5.0	6.3	5.6	4.8	5.0
Latvia.....	2.4	1.9	3.0	1.5	3.2	1.9	0.9	1.6
Lithuania.....	1.5	0.4	2.1	-0.9	2.7	0.6	-0.7	-1.0
Poland.....	5.5	1.9	3.6	0.7	3.5	2.0	1.1	0.8
Romania.....	34.5	22.5	30.2	17.9	26.8	24.2	21.3	18.5
Slovakia.....	7.0	3.3	6.2	3.3	4.7	3.1	2.5	3.0
Slovenia.....	8.6	7.6	7.1	7.4	8.1	7.7	7.3	7.2
The former Yugoslav Republic of Macedonia ^a	5.2	2.7	3.5	1.3	4.5	3.1	1.1	..
Yugoslavia.....	90.4	19.3	40.5	11.7	35.2	18.8	14.9	12.0
CIS								
Ameria.....	3.2	1.0	2.8	1.9	0.4	3.0	-0.2	0.8
Azerbaijan.....	1.5	2.8	1.5	3.2	1.7	2.9	3.2	3.3
Belarus.....	61.4	42.8	46.3	34.9	47.2	44.6	43.1	37.4
Georgia.....	4.6	5.7	3.4	5.6	5.3	6.7	5.3	5.5
Kazakhstan.....	8.5	6.0	6.6	6.7	5.7	5.5	6.4	6.4
Kyrgyzstan.....	7.0	2.1	3.8	2.4	2.7	0.4	2.8	2.6
Republic of Moldova.....	9.8	5.3	6.4	4.4	6.1	6.1	4.6	4.4
Russian Federation.....	21.6	16.0	18.8	15.1	18.0	15.8	15.1	15.1
Tajikistan.....	38.6	12.2	12.5	14.4	11.0	10.2	13.1	14.5
Turkmenistan.....	..	..	..	..	..	..	..	..
Ukraine.....	12.0	0.8	6.1	-0.6	3.7	0.8	-0.9	-0.5
Uzbekistan.....	..	..	..	..	..	..	..	..

Source: UNECE secretariat estimates, based on national statistics.

^a January-November data for 2002.

As mentioned above, in 2002 Slovenia was an exception to the general pattern of decelerating inflation in eastern Europe: its year-on-year rate in December reached 7.4 per cent, the highest among the 10 EU accession countries. This was partly due to very large wage increases, particularly in the service sector, some loosening of fiscal policy, and a rise in various taxes and administered prices.¹⁵⁵ Also in Bulgaria increases in administered prices kept the inflation rate from falling faster than might have been expected given a relatively tight fiscal policy and weak consumer demand¹⁵⁶ In Hungary, in spite of the favourable effect of a very strong forint on the domestic prices of imports, disinflation over the first three quarters was relatively slow due to the rising demand pressures, in turn a reflection of large increases in real wages.¹⁵⁷ In September even this modest

deceleration in the inflation rate came to a halt due to increases in certain administered prices (which previously had been kept artificially low) and in the excise tax on tobacco. In contrast, inflationary pressures in Poland were virtually non-existent in 2002. A strong zloty, falling food prices and a relatively modest recovery of consumer demand kept the monthly inflation rates falling steadily throughout the year to record low levels. Over the 12 months to December 2002, consumer prices in Poland rose by only 0.7 per cent. In the Czech Republic the 12-month cumulative inflation rate in 2002 was also very modest at 0.6 per cent, thanks mainly to the strong koruna, weak food prices and a further slowdown in the adjustment of regulated prices (partly reflecting the postponement of increases in VAT and excise taxes). Whereas in Poland the core inflation rate (excluding food and energy) also fell, in the Czech Republic it remained more or less stable as a result of increased consumer demand supported by strong growth in real wages. Real wage growth also fed household demand pressure in Slovakia in 2002. However, the strong koruna and large gains in labour productivity helped to keep inflation under control and the 12-month cumulative rate in December fell to 3.3 per cent down from 6.2 per cent a year earlier. However, consumer prices in Slovakia in 2003 are expected to surge because of envisaged

¹⁵⁵ In 2002 there were increases in the main VAT rate (from 19 to 20 per cent) and in the excise taxes on alcohol and fuel. The administered prices, measured year-on-year, were 22 per cent higher in September 2002.

¹⁵⁶ Early in 2002 excise taxes on beer and tobacco, fuel oil, gas oil and other hydrocarbons were increased. Furthermore, prices of heating fuels increased by 20 per cent and of electricity by 30 per cent during the year.

¹⁵⁷ In the first 9 months of 2002 average real net wages in the total economy (CPI deflated) were more than 12 per cent higher than a year earlier.

increases in regulated prices,¹⁵⁸ although these are likely to be partly offset by the tightening of fiscal policy. As a result, the core inflation rate should fall despite an expected acceleration in the headline rate in 2003. Rapidly expanding consumer demand was also the major source of price pressures in Croatia and the three Baltic states. Their strong currencies and good harvests, however, largely offset this inflationary pressure, particularly in the second half of the year. In fact, in Lithuania, consumer prices actually fell by some 1 per cent over the year.

The strengthening of household demand, a result of rising real disposable incomes since early 2000, was one of the major sources of inflationary pressure in most of the CIS economies. Nevertheless, the relatively coherent and consistent macroeconomic policies in these countries in recent years has contributed to the strengthening of economic growth, and their progress with macroeconomic stabilization is reflected, *inter alia*, in falling inflation rates. By the end of 2002, consumer price inflation in most CIS countries was in low single digits, and well below the target rates incorporated in their budgets. In Armenia and Ukraine consumer prices actually fell over the 12 months to December. In Armenia this was largely due to continued gains in labour productivity but in Ukraine it reflected much weaker household demand in the rural areas where there was a pronounced slowdown in the growth of agricultural incomes. In Russia disinflation continued more modestly. The 12-month cumulative rate (15.1 per cent) remained above the government's original target range of 12 to 14 per cent, but it was still the lowest since 1997 and the gap between the actual and target rates was much smaller than in previous years. However, the Russian economy, like most of the other CIS economies, still has to face large relative price corrections to administered and controlled prices, particularly in the energy sector, which have helped to keep current rates of inflation artificially low.

(ii) Producer prices and labour costs in industry

The rapid disinflation of industrial producer prices, which started in mid-2001, continued in the first half of 2002 in most of eastern Europe and the CIS (chart 3.3.2). However, due to transmission lags, the effects of rising world commodity prices, particularly of crude oil, which have been recovering from their low levels in the last quarter of 2001, worked their way through to industrial material costs only after mid-2002. This delayed effect reversed the downtrend in producer price inflation in a few east European countries such as Bulgaria, Croatia, Estonia, Poland and The former Yugoslav Republic of Macedonia. The reversal was more pronounced in the CIS countries given their relatively weaker currencies against the dollar. In Russia, the rate, which had been falling without interruption since the summer of 1999,

started to climb in the second quarter, reaching 17 per cent year-on-year in December, up from 5.5 per cent in March. Similar trends prevailed in the rest of the CIS, albeit in most of them at much lower rates than in Russia with the main exception of Belarus. Over the 12 months to December 2002 industrial producer prices in all the CIS countries rose faster than in 2001 and also, in contrast to 2001, faster than consumer prices, partly because the latter benefited from lower prices for food and various imported consumer goods. However, in many of these economies the cap on prices for household energy and for some public services such as transport and communications kept consumer price inflation artificially low.

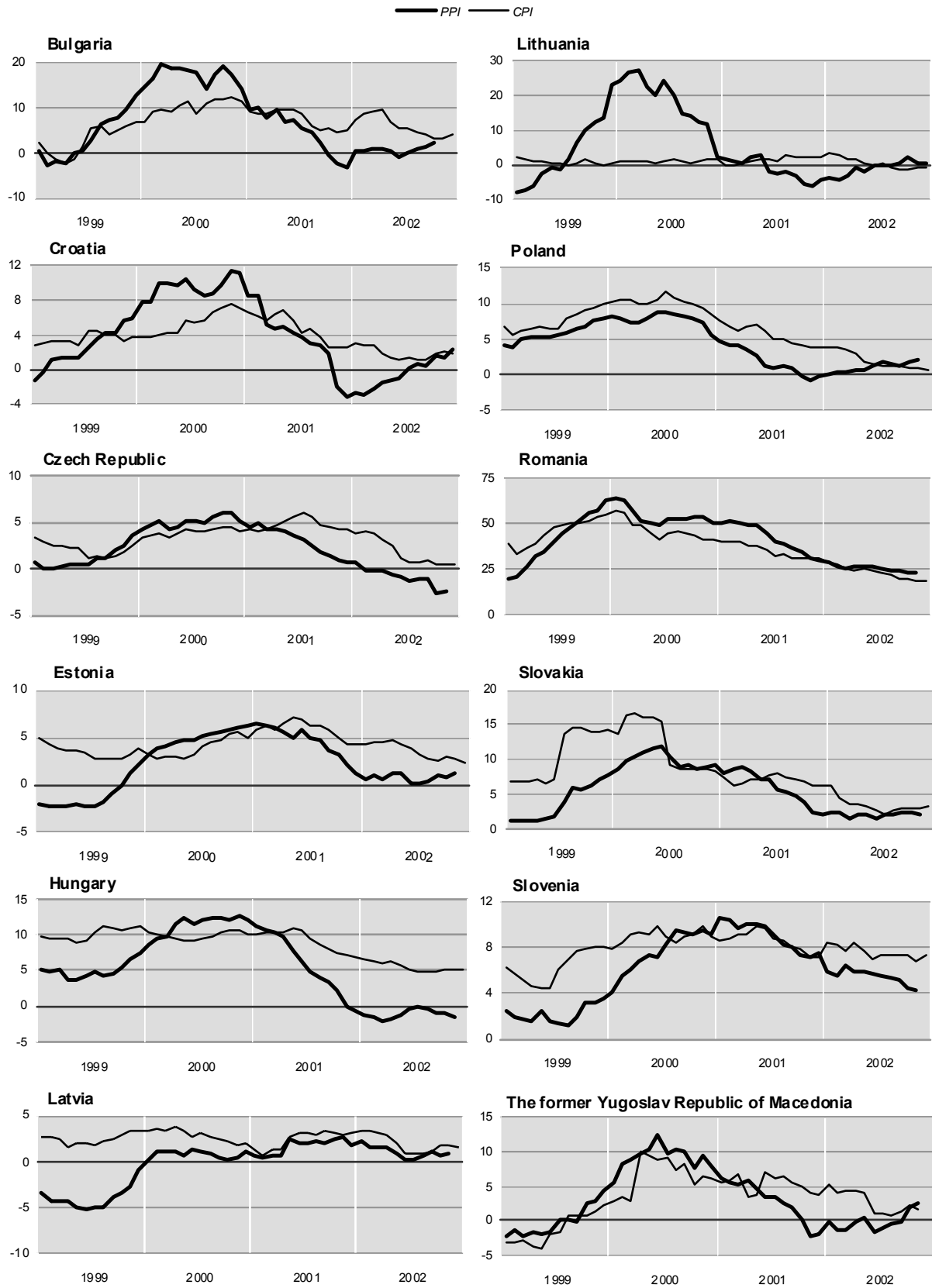
Wage inflation in industry in 2002 remained strong or even accelerated and rose more than producer prices in most countries of the region with the main exceptions of Bulgaria, Poland and Romania (table 3.3.2). *Real product wages*¹⁵⁹ increased considerably in Yugoslavia (nearly 60 per cent) and in most of the CIS economies. It is worth noting that, over the last two years in most of the CIS, real product wages, which had collapsed throughout most of the 1990s, recovered by some 30 to 50 per cent. The main exceptions were Armenia and Kyrgyzstan where they still rose in double digits but less than 20 per cent. Also in Estonia, Hungary and Latvia, real product wages increased by more than 10 per cent in the first three quarters of 2002. Growth in *measured labour productivity* in industry, however, lost steam during 2002 in most of these economies as a result of the slowdown in industrial output. Productivity growth remained strong and rose as fast or even faster than wages only in Croatia, the Czech Republic, Estonia and Poland. Thus, *unit labour costs* in industry continued their steep upward trend in most of eastern Europe and the CIS. The rates of growth of unit labour costs were the highest in Romania, The former Yugoslav Republic of Macedonia, Yugoslavia and throughout the CIS except Armenia. They increased in double-digit rates also in Hungary and Latvia where the wage rise was more than five times faster than the rate of growth of labour productivity. There were, nevertheless, few exceptions where the unit labour costs remained stable as either wage pressures were relatively weak (Bulgaria) or labour productivity grew as fast or even faster than wages.

Real unit labour costs (which basically measure the change of labour's share in value added), which had been falling in the last two years in most of the east European economies, started to pick up in 2002. In some cases (Hungary, Latvia, and especially in The former Yugoslav Republic of Macedonia and Yugoslavia) they rose substantially. In the CIS, where real unit labour costs had been falling since the mid-1990s, they accelerated sharply in the course of 2001 and continued to rise in 2002, generally at double-digit rates (except in Armenia where

¹⁵⁸ For example, natural gas prices are planned to increase by 40 per cent, and electricity prices by 20 per cent.

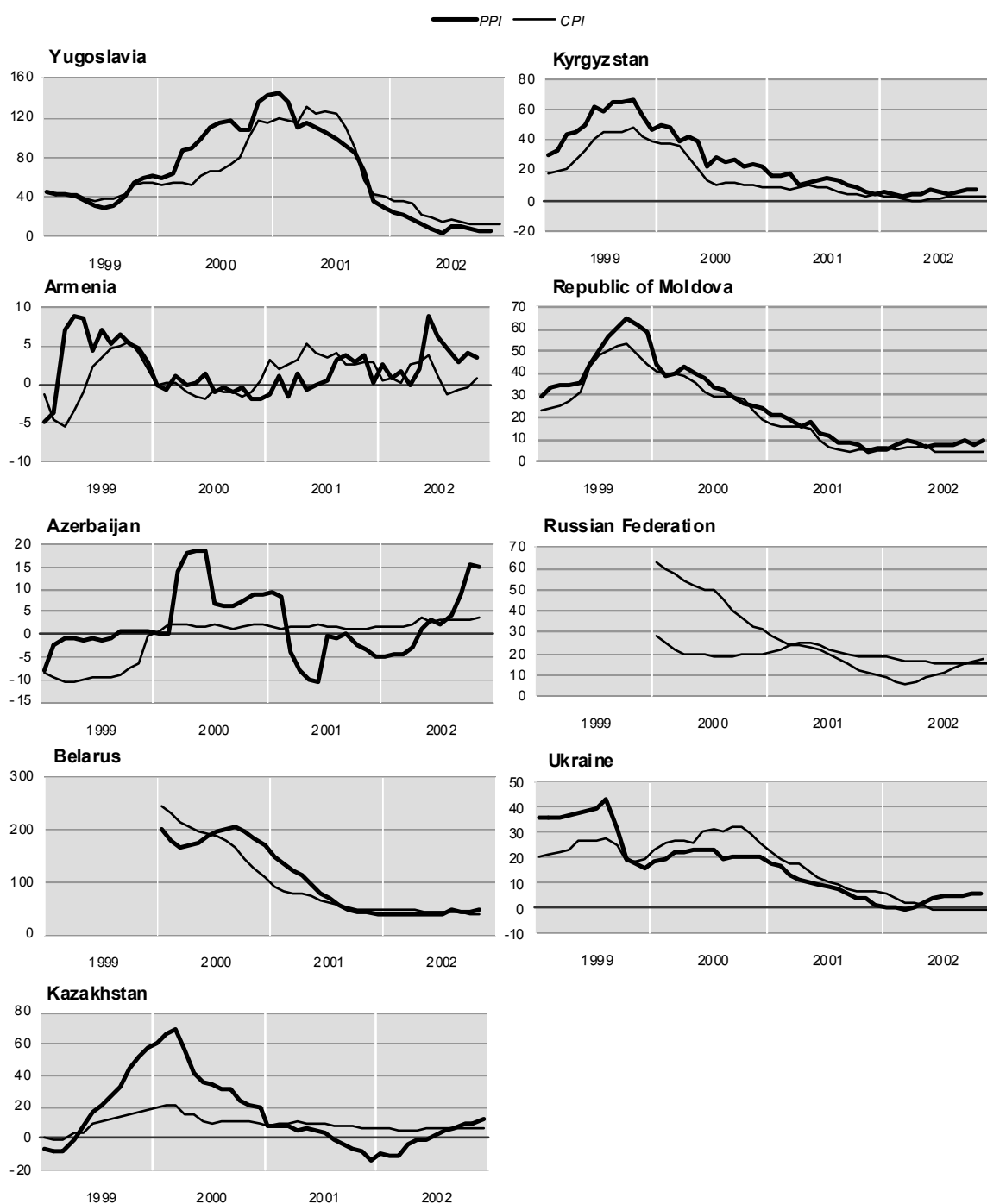
¹⁵⁹ Average wages deflated by PPI.

CHART 3.3.2
Consumer and industrial producer prices in eastern Europe and the CIS, 1999-2002
(Monthly, year-on-year percentage change)



(For source see end of chart.)

CHART 3.3.2 (concluded)
Consumer and industrial producer prices in eastern Europe and the CIS, 1999-2002
 (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^a in eastern Europe and the CIS, 2001-2002
(January-September over same period of previous year, percentage change)

	Producer prices		Nominal wages ^b		Real product wages ^c		Labour productivity ^d		Unit labour costs ^e		Real unit labour costs ^f	
	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002
Eastern Europe												
Albania .....	..	..	..	..	..	..	..	..	..	..	..	..
Bosnia and Herzegovina	1.7	..	..	..	..	..	20.3	..	..	..	..	..
Bulgaria	6.8	0.4	6.7	2.6	-0.2	2.2	7.4	1.7	-0.6	0.9	-7.0	0.5
Croatia	5.0	-1.2	8.4	5.7	3.2	7.0	7.0	6.2	1.3	-0.6	-3.6	0.7
Czech Republic	3.6	-0.5	6.7	6.9	3.0	7.4	6.2	6.8	0.5	0.1	-3.0	0.6
Estonia	5.4	0.6	13.5	10.8	7.8	10.1	6.3	11.0	6.8	-0.2	1.4	-0.9
Hungary	7.5	-1.1	14.9	13.2	6.9	14.4	2.7	2.1	11.9	10.8	4.2	12.1
Latvia	1.4	1.1	-0.6	15.4	-2.0	14.1	12.1	2.9	-11.3	12.1	-12.6	10.9
Lithuania	-0.2	-1.5	-2.0	4.9	-1.8	6.4	18.2	2.9	-17.1	1.9	-16.9	3.4
Poland	2.5	0.8	7.0	4.3	4.4	3.5	6.4	7.3	0.6	-2.8	-1.9	-3.5
Romania	44.9	25.4	54.6	25.9	6.7	0.4	10.9	2.3	39.4	23.1	-3.8	-1.8
Slovakia	7.0	2.0	9.7	8.1	2.4	6.1	6.5	5.4	3.0	2.6	-3.8	0.6
Slovenia	9.6	5.7	11.4	8.8	1.7	3.0	2.1	1.8	9.1	6.9	-0.4	1.1
The former Yugoslav												
Republic of Macedonia	4.2	-0.7	3.9	6.2	-0.3	6.9	-4.8	-12.5	9.1	21.3	4.7	22.2
Yugoslavia	107.7	12.6	129.2	79.2	10.3	59.1	-0.2	7.2	129.6	67.1	10.5	48.4
CIS												
Armenia	0.7	3.2	11.9	11.6	11.1	8.1	10.1	9.4	1.6	2.1	0.9	-1.1
Azerbaijan	-2.2	0.3	25.7	21.2	28.6	20.9	7.6	4.5	16.9	15.9	19.6	15.6
Belarus	87.9	39.6	121.7	59.6	18.0	14.3	6.0	5.2	109.2	51.7	11.3	8.7
Georgia	2.4	..	..	..	..	..	..	..	..	..	..	..
Kazakhstan	4.1	-2.8	25.7	18.1	20.8	21.5	..	8.3	..	9.0	..	12.2
Kyrgyzstan	14.0	5.2	22.1	14.8	7.1	9.1	11.4	-18.2	9.6	40.3	-3.9	33.4
Republic of Moldova	15.0	7.7	28.1	30.5	11.4	21.2	12.7	5.6	13.7	23.7	-1.1	14.8
Russian Federation	21.9	9.7	45.5	36.5	19.3	24.5	2.9	5.6	41.5	29.3	16.0	17.9
Tajikistan	32.0	6.1	50.0	35.8	13.6	28.0	15.1	4.7	30.3	29.7	-1.3	22.3
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine	10.8	2.2	37.0	21.7	23.6	19.1	20.7	4.0	13.5	17.1	2.5	14.5
Uzbekistan	43.4	..	51.1	..	5.4	..	..	..	..	..	..	..

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.

^a Industry = mining + manufacturing + utilities.

^b Average gross wages in industry except in Bosnia and Herzegovina: net wages in industry; in Estonia and all the CIS economies: gross wages in total economy; in The former Yugoslav Republic of Macedonia and Yugoslavia: net wages in total economy.

^c Nominal wages deflated by producer price index.

^d Gross industrial output deflated by industrial employment.

^e Nominal wages deflated by productivity.

^f Real product wages deflated by productivity.

they fell slightly). This sharp upward trend in the CIS reflects the much faster growth of wages than of labour productivity and the fact that producer price inflation remained relatively modest in spite of a gradual acceleration after the first quarter. The more rapid rise of unit labour costs than of producer prices in many east European and CIS economies suggests, *ceteris paribus*, a squeeze (in some cases severe) on *unit operating profits* in industry, a reflection not only of weaker external demand but also of increased competition on the domestic markets, which reduced the pricing power of producers. In 2002, this pressure was alleviated to some extent, albeit to varying degrees among individual countries, by the appreciation of exchange rates against the dollar.

3.4 Employment and unemployment

In 2002, the labour markets in many countries, particularly in eastern Europe, remained rather tense for the fourth consecutive year. Following the sharp deterioration in 1999 triggered by the Russian financial crisis, the situation has been further aggravated by a more rapid rate of enterprise restructuring (partly stimulated by progress in the EU accession negotiations). Nevertheless, there were signs of a modest improvement in a few countries (mainly in the Baltic states and the CIS). After peaking in 2000 and 2001, unemployment in eastern Europe generally stabilized in 2002 and even started to decline in several countries as a result of relatively

TABLE 3.4.1

Total and industrial employment in eastern Europe and the CIS, 2001-2002
(Percentage change over the same period of preceding year)

	Total employment ^a					Employment in industry ^a				
	2001		2002			2001		2002		
	Annual	QIV	QI	QII	QIII	Annual	QIV	QI	QII	QIII
Eastern Europe	-0.6	-1.6	-1.3	-1.0	-1.2	-1.5	-2.7	-4.1	-4.5	-4.5
Albania	-2.5	0.1	-0.9	-0.9	-0.4	..	..	..	..	..
Bosnia and Herzegovina ^b	-0.8	-1.6	-1.5	-3.9	-3.7	-4.0	-4.5	..	..	..
Bulgaria	-1.3	-3.9	0.3	1.8	1.1	-4.2	-4.5	1.0	1.9	3.6
Croatia	-0.6	1.1	0.6	1.1	1.3	-1.5	0.4	-0.8	-2.1	-2.8
Czech Republic	-1.1	0.6	0.4	1.3	1.5	2.1	0.3	-1.1	-2.0	-2.4
Estonia	0.9	1.8	2.0	0.9	1.6	0.1	-2.0	-1.2	-6.6	-9.7
Hungary	0.3	-1.2	-0.6	0.2	-0.1	1.7	0.9	1.7	0.1	-1.8
Latvia	2.2	2.3	1.0	2.7	2.4	-3.6	-3.7	2.6	1.6	0.5
Lithuania	-4.0	-1.3	..	..	..	-1.7	-0.2	..	..	..
Poland	-0.6	-3.4	-3.2	-3.0	-3.4	-3.8	-5.7	-6.8	-6.6	-5.4
Romania	-0.6	-1.8	..	..	..	-1.6	0.6	..	..	..
Slovakia	1.0	0.8	0.2	-0.2	0.1	1.0	0.2	-1.9	1.5	0.4
Slovenia	1.4	0.6	1.3	0.9	0.1	0.7	-0.2	0.9	1.1	0.6
The former Yugoslav Republic of Macedonia	-4.5	-4.5	-4.5	-6.6	-5.7	-4.5	-4.5	6.1	1.8	2.4
Yugoslavia ^c	0.2	-0.3	-0.8	-1.2	-0.9	-3.4	-4.9	-4.1	-7.4	-6.9
CIS .....	..	-0.5	2.0	1.5	1.4	..	-1.9	-0.3	-0.4	-
Armenia	-1.0	0.2	1.4	1.5	1.3	-5.6	-5.6	2.4	0.6	1.7
Azerbaijan	0.3	0.2	-0.2	-0.1	0.1	-1.0	2.4	-	-3.3	-3.2
Belarus	-0.5	-1.0	-2.0	-2.3	-2.7	-1.2	-2.0	-1.1	-1.8	-1.3
Georgia	2.2	..	..	..	..	..	..	..	..	..
Kazakhstan	2.6	..	..	..	..	-2.9	..	..	..	..
Kyrgyzstan	1.1	1.1	1.0	1.0	1.1	-4.0	-4.1	1.4	0.7	0.7
Republic of Moldova	-1.1	-1.4	0.9	0.1	0.6	2.5	-1.7	5.5	6.4	1.2
Russian Federation	0.2	-0.3	2.8	2.5	2.4	1.0	-2.2	-1.0	-2.5	-1.2
Tajikistan	4.8	4.6	-	1.4	-2.0	1.2	0.8	0.8	2.5	-
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..
Ukraine	-1.5	-2.8	0.9	0.5	0.5	-3.9	-5.7	2.2	1.7	2.3
Uzbekistan	1.7	..	..	..	..	1.3	..	..	..	..
<i>Memorandum items:</i>										
Baltic states	-1.2	2.1	1.3	2.0	2.1	-1.8	-1.6	0.9	-2.1	-4.1
Central Europe	-0.4	-1.9	-1.7	-1.4	-1.6	-1.0	-2.3	-3.3	-3.2	-3.2
South-east Europe	-0.8	-1.4	-0.5	-0.4	-0.4	-2.1	-1.4	-2.9	-1.6	-2.4

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

^a Regional quarterly aggregates of total employment exclude Lithuania, Romania, Georgia, Kazakhstan, Turkmenistan and Uzbekistan; those of industrial employment exclude in addition Albania and Bosnia and Herzegovina.

^b Figures cover only the Bosnian-Croat Federation. Data for Republika Srpska are not available.

^c Data exclude Kosovo and Metohia.

buoyant economic activity and, in some of them, active labour market policies. In many CIS countries, the strong economic recovery in recent years finally resulted in the creation of new jobs and there was some reduction in unemployment. However, the situation differed considerably between countries and subregions.

In *central Europe*, labour markets became more heterogeneous in 2002 reflecting the diversity of macroeconomic situations. In the first three quarters of 2002, employment was broadly flat in Hungary and Slovakia (table 3.4.1). Although it continued to increase in Slovenia, due to expansion in the construction and manufacturing sectors, its rate of growth was decelerating in the course of the year. After several years of decline, employment started to increase in the Czech Republic, where the expansion in the service sector more than offset the fall in agriculture and industry. In contrast,

sluggish economic growth in Poland, combined with the restructuring of unprofitable industries, resulted in a decline in total employment of more than 3 per cent. All sectors of the economy were affected but there were particularly steep falls in industry and construction (some 6 and 12 per cent, respectively).

Reflecting these developments, the average registered unemployment rate in the region increased by 0.5 percentage points in the 12 months to November 2002, to about 15 per cent (table 3.4.2).¹⁶⁰ Slovakia was the only central European country where unemployment declined steadily during the year and in November the

¹⁶⁰ The regional average unemployment rate is heavily affected by Poland, which accounts for nearly 60 per cent of the region's labour force and where unemployment has doubled since 1998.

TABLE 3.4.2
Registered and labour force survey unemployment in eastern Europe and the CIS, 2000-2002
(Per cent of labour force)

	Registered unemployment							Labour force survey unemployment						
	2000	2001		2002				2001				2002		
	Nov.	Nov.	Dec.	Mar.	Jun.	Sep.	Nov.	QI	QII	QIII	QIV	QI	QII	QIII
Eastern Europe	14.4	14.8	15.3	16.5	15.4	15.3	15.3	..	..	..	..	..	..	..
Albania	17.0	14.6	14.5	16.2	16.1	16.0	16.2	..	..	..	..	..	..	..
Bosnia and Herzegovina	39.2	39.9	39.9	40.4	42.0	42.5	42.7	..	..	..	..	..	..	..
Bulgaria	17.7	17.7	17.9	17.5	17.2	17.4	16.9	21.6	19.4	18.6	19.5	19.5	17.6	17.3
Croatia	22.4	22.5	23.1	23.8	22.2	21.7	21.6	..	15.3	..	16.3	..	15.2	..
Czech Republic	8.5	8.5	8.9	9.1	8.7	9.4	9.3	8.5	8.0	8.3	7.9	7.7	7.0	7.2
Estonia ^a	7.1	7.9	7.7	8.3	7.0	6.8	6.9	14.1	12.4	11.9	11.9	11.2	9.4	9.1
Hungary	8.6	7.7	8.0	8.6	7.6	7.8	7.7	6.0	5.6	5.6	5.6	5.8	5.6	5.9
Latvia	7.8	7.6	7.7	8.2	7.9	7.8	7.7	13.3	..	12.8	..	13.7	13.3	10.8
Lithuania	12.1	12.5	12.9	12.6	10.7	10.5	10.7	16.5	..	17.5	..	17.1	13.0	11.9
Poland	14.5	16.8	17.5	18.1	17.4	17.6	17.8	18.2	18.4	17.9	18.5	20.3	19.9	19.8
Romania	10.3	8.0	8.8	13.4	9.9	8.4	8.1	7.7	6.5	5.6	6.4	10.0	8.0	..
Slovakia	16.7	17.7	18.6	19.1	17.6	16.6	16.8	19.7	19.2	19.0	18.7	19.4	18.6	18.2
Slovenia	11.9	11.6	11.8	11.7	11.3	11.7	11.5	6.7	5.9	5.9	7.1	6.9	5.9	6.0
The former Yugoslav Republic of Macedonia ^b	44.8	41.6	41.7	44.7	44.8	45.3	45.3	..	30.5	..	..	..	31.9	..
Yugoslavia ^c	26.6	27.9	27.9	28.7	29.0	31*	32*	..	..	..	..	..	..	..
CIS ^d	2.2	2.2	2.3	2.5	2.4	2.4	2.3	..	..	..	..	..	..	..
Armenia	11.0	10.0	9.8	9.7	9.5	9.3	9.2	..	..	..	..	..	..	..
Azerbaijan	1.2	1.3	1.3	1.3	1.3	1.3	1.3	..	..	..	..	..	..	..
Belarus	2.2	2.4	2.3	2.6	2.6	2.9	3.0	..	..	..	..	..	..	..
Georgia .....	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Kazakhstan	3.8	2.8	2.8	3.6	3.6	2.9	2.7	12.5	9.5	9.2	11.1	10.7	8.8	8.1
Kyrgyzstan	3.1	3.1	3.1	3.2	3.3	3.2	3.1	..	..	..	..	..	9.0	..
Republic of Moldova	1.9	2.0	1.7	2.2	1.9	1.8	1.6	..	..	..	6.8	7.9	6.3	5.8
Russian Federation	1.4	1.5	1.6	1.8	1.7	1.7	1.7	9.4	8.6	8.6	9.0	8.2	7.7	7.2
Tajikistan	3.0	2.6	2.6	2.6	2.7	2.7	2.7	..	..	..	..	..	..	..
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine	4.1	3.6	3.7	3.9	3.7	3.6	3.6	12.1	10.6	10.3	11.2	10.6	9.7	9.2
Uzbekistan	0.5	..	..	..	..	..	..	..	..	..	..	..	..	..
<i>Memorandum items:</i>								..	..	..	..	..	..	..
Baltic states	9.8	10.0	10.2	10.4	9.1	8.9	9.0	..	..	..	..	..	..	..
Central Europe	12.8	14.1	14.7	15.2	14.4	14.6	14.7	..	..	..	..	..	..	..
South-east Europe	16.4	16.0	17.1	19.6	17.9	17.6	17.4	..	..	..	..	..	..	..

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).

^a UNECE secretariat estimates. The Estonian Statistical Office calculates the rate of registered unemployment as the number of registered unemployed to the people between 16 and pension age. The officially reported figure for November 2002 based on this methodology was equal to 5.6 per cent

^b UNECE secretariat estimates. The rate of registered unemployment is calculated as the officially reported number of registered unemployed divided by the labour force derived from the labour force survey.

^c Data exclude Kosovo and Metohia.

^d Regional aggregates of registered unemployment exclude Georgia, Turkmenistan and Uzbekistan.

rate was nearly 1 percentage point lower than 12 months earlier. In Hungary and Slovenia, the unemployment rate was basically unchanged from a year ago, but it increased in the Czech Republic¹⁶¹ and particularly in Poland. The labour market imbalances differed considerably between countries: in November 2002 the registered unemployment rate ranged from some 8 per cent in

Hungary to nearly 18 per cent in Poland. The more accurate and more internationally comparable labour force surveys (LFS) sharpen these differences even more. In the third quarter of 2002, the LFS rate was 6 to 7 per cent in the Czech Republic, Hungary and Slovenia, but exceeded 18 per cent in Slovakia and was close to 20 per cent in Poland.

There are various factors behind the recent steep rise in joblessness in Poland. These include the long delays in enterprise restructuring which have now given rise to a belated surge in "transformational" unemployment. This coincided with a sharp economic downturn which, in turn, has created "cyclical" unemployment. Finally, a large rise

¹⁶¹ The growth of registered unemployment in the Czech Republic is at variance with other labour market indicators. Employment grew by 1 per cent during the first three quarters and labour force survey data indicate a fall in unemployment in 2002 (table 3.4.2). The Czech Republic was the only central European country where the two unemployment measures point in different directions.

in the working age population (over 1.7 million people during the 1990s) has led to an increase in the supply of labour, which the economy would have had difficulty in absorbing even if enterprise restructuring had proceeded in a more timely and smooth manner and if market conditions had remained favourable. In consequence, the rate of unemployment has been growing steadily, by nearly 2 percentage points annually since 1999, and in February 2002 it reached a record high of 18.2 per cent of the labour force making it one of the most pressing issues for domestic policy.¹⁶² Although the government considers the reduction of unemployment a central task,¹⁶³ the situation is unlikely to improve in the short run. National analysts believe that no major improvements in the situation can be expected in the short run and that unemployment is more likely to remain flat in 2003 at around 17 to 18 per cent of the labour force.¹⁶⁴

In 2002 there was a further deterioration in the already very tense situation in the labour markets of the south-east European countries. The available data suggest that Bulgaria and Croatia were the only countries in the region where employment increased in the first three quarters of 2002 (table 3.4.1).¹⁶⁵ In Bulgaria this was the first increase since 1997 and was mainly due to a recovery of output in some manufacturing industries, to active labour market policies, which include incentives for investment in regions with high unemployment, and to the launching of public works programmes.¹⁶⁶ In Croatia, the increase of employment was mainly in small enterprises and self-employment in the service sector and construction. Elsewhere in the region employment declined, particularly in The former Yugoslav Republic of Macedonia where economic recession led to a fall of nearly 6 per cent.

Unemployment has thus continued to rise in south-eastern Europe. The average registered unemployment rate in the region was above 17 per cent in November

2002, 1 percentage point more than a year earlier. In the 12 months to November, the rate of unemployment was basically unchanged in Romania,¹⁶⁷ and there were slight falls in the rates (less than 1 percentage point) in Bulgaria and Croatia. Elsewhere they continued to rise, with increases in Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia of 3 percentage points or more. Except in Romania, unemployment rates stood above 16 per cent reaching highs of some 30 per cent or more in Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia. Moreover, unemployment in these three countries is not expected to fall in the short run as privatization and structural reforms are likely to result in further increases in the number of people thrown out of work.

While there is no doubt that high unemployment is a major economic and social problem in this region, the figures for registered unemployment in some countries, especially in the successor states of the former SFR of Yugoslavia, may overstate the actual number of the jobless. The labour force surveys conducted in these countries indicate much lower unemployment rates.¹⁶⁸ The main reason for these differences 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.¹⁶⁹ Often registration data also include people who are not actively searching for work or people who are required to register in order to preserve their health insurance. Recently, the Croatian government announced tougher measures to combat fictitious unemployment and "black labour" in the construction industry.¹⁷⁰

¹⁶² Nearly 3.3 million people are registered as out of work, of which some 2.7 million are not eligible for unemployment benefit.

¹⁶³ The Polish Sejm (the lower house of Parliament) adopted earlier in 2002 a multi-faceted "anti-crisis" government programme where fighting unemployment is given high priority. In June, the Labour Ministry launched a "First Job" programme, the cost of which is estimated at 330 million zloty (some 0.2 per cent of central government expenditure) and which is aimed at reducing the very high rate of unemployment (more than 40 per cent) among young people. Also, the recently adopted new Labour Code, which takes effect at the beginning of 2003, aims at introducing more flexibility to the Polish labour market.

¹⁶⁴ *Interfax Poland Weekly Business Report*, 2 January 2003, as quoted by *Dow Jones Reuters Business Interactive* (Factiva).

¹⁶⁵ It is rather difficult to assess employment developments in Romania as in 2002 the National Statistical Office changed the methodology of its most comprehensive measure of employment, the quarterly labour force survey. Consequently, data for the first three quarters of 2002 are not comparable with those of previous years.

¹⁶⁶ During 2002 some 96,000 new jobs were created and the government aims for another 100,000 in 2003. *Reuters News*, 16 January 2003, as quoted by *Dow Jones Reuters Business Interactive* (Factiva).

¹⁶⁷ In Romania, unemployment declined steadily during the year and by the end of November 2002, registered unemployment had fallen to 756,000, equivalent to 8.1 per cent of the labour force, from the February peak of 1,268,000 when the unemployment rate reached a record high of 13.5 per cent of the labour force. The main reason behind the jump in unemployment in January and February appears to be the change in the regulations concerning unemployment benefit, which increased the incentives to register with the unemployment office. There were also large lay-offs in enterprises undergoing restructuring. *PlanEcon*, Vol. XVIII, No. 19, 13 December 2002, p. 24; EIU, *Country Report. Romania* (London), July 2002, pp. 23-24.

¹⁶⁸ Thus, in Croatia the semi-annual labour force survey suggests a rate of 15.2 per cent in the first half of 2002, as opposed to 23.4 per cent according to the registration figures. Also, in The former Yugoslav Republic of Macedonia, the 31.9 per cent unemployment rate derived from the labour force survey in April 2002 was more than 10 percentage points lower than the registration measure (see table 3.4.2).

¹⁶⁹ For example, according to some estimates, the shadow economy in The former Yugoslav Republic of Macedonia accounts for up to 37 per cent of GDP and nearly 240,000 persons were employed in the black market 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).

¹⁷⁰ 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).

Strong economic growth in the *Baltic states* since 2000 has finally resulted in some easing in the labour markets. In the first three quarters of 2002, employment continued to increase in Estonia and Latvia (table 3.4.1). Although comparable quarterly employment data are still not available for Lithuania, the large reduction in unemployment suggests that for the first time since 1997 employment started to grow.¹⁷¹ In Estonia, as in 2001, the growing employment was mainly in the service sector, where new jobs more than offset the decline in other branches of the economy including sizeable cuts in manufacturing. Also in Latvia, new jobs in the service sector were the main source of employment growth but, unlike Estonia, employment in industry was also growing.

In November 2002, the average registered unemployment rate in the Baltic states was 9 per cent, 1 percentage point lower than a year earlier (table 3.4.2); however, the situation differed among the three countries. In Latvia, despite a relatively large increase in employment, the registered unemployment rate was basically unchanged in the 12 months from November 2001. This may indicate a high level of structural unemployment and low labour mobility, but it may also just reflect problems with the registration statistics, which fail to report accurately either the level or the trend of unemployment.¹⁷² Indeed, in the third quarter of 2002, the unemployment rate derived from labour force surveys was 3 percentage points higher than the registered measure but indicated a clear downward trend, being 2 percentage points lower than 12 months earlier. Unemployment was on the decline in Estonia and particularly in Lithuania: in the 12 months to November 2002, the registered unemployment rate was 1 percentage point or more below that of a year earlier. For both countries, this is the first year-on-year fall since 1998. Also in both countries, the LFS data indicate a marked reduction in the unemployment rate.

The available data suggest that the relatively strong economic recovery in the *CIS countries*, has also helped to ease labour market tensions. In the first three quarters of 2002, employment increased in most countries for which quarterly data are available (table 3.4.1). Belarus was an exception as employment fell, reflecting the deteriorating performance of the enterprise sector due to insufficient restructuring and investment. In Russia, employment increased by more than 2 per cent, considerably more than in 2001¹⁷³ and almost entirely

located in the rapidly growing services sector. It should be noted that in Russia, the employment data coming from the labour force survey, on the one hand, and from enterprise surveys (which only cover large- and medium-size enterprises), on the other, currently point in different directions. Thus, the reported fall in the number of payroll employees in large- and medium-size enterprises reflects the relocation of employed labour to other forms of business organization (small businesses, foreign and joint ventures, informal sector, etc). Moreover, the reduction in reported employment was concentrated in the goods-producing sector (industry, construction, agriculture) whereas it increased in the service sector (mainly in public sector services such as health care, education and culture).

Despite the relatively strong recovery in output registered unemployment, which is the only series available for most CIS countries, little change is indicated in the 12 months to November 2002 (table 3.4.2). Unemployment rates remained very low, most of them ranging between 1.3 per cent (Azerbaijan) and 3.6 per cent (Ukraine), the main exception being Armenia (just above 9 per cent). These figures, however, are unreliable and misleading both as to the magnitude and the dynamics of unemployment¹⁷⁴ since a large proportion of the jobless, although willing to work, do not, for various reasons, register as unemployed.¹⁷⁵ Unemployment figures based on the LFS, however, indicate ongoing improvements in the three largest CIS economies. In all three unemployment rates declined steadily during the year and in the third quarter of 2002 they were more than 1 percentage point below those of a year earlier, varying between some 7 per cent in Russia and 9 per cent in Ukraine. In Russia, the downward trend has been underway since the end of 1999 and the 7.1 per cent unemployment rate in December 2002 was the lowest since 1993. However, it should be kept in mind that in Russia there may still be considerable amounts of hidden or suppressed unemployment insofar as enterprise restructuring is still lagging behind that in central Europe.¹⁷⁶

reported by large- and medium-size enterprises and organizations in the civilian sector with a coverage of around 60 per cent of total employment.

¹⁷⁴ Russia is a case in point: in the 12 months to November 2002, the number of registered unemployed increased by 0.2 million people whereas figures based on the ILO definition indicate a reduction of more than 1.1 million over the same period. Due to the different direction of these changes the share of registered unemployed in the total number of jobless derived from labour force survey increased from some 17 to 24 per cent.

¹⁷⁵ This proportion varies in different countries between 50 and 80 per cent of total unemployment. Among the factors that discourage the jobless to register are the low unemployment benefits (often paid in arrears), undeveloped employment services, as well as the inefficient operation of local labour offices. For a detailed discussion of unemployment insurance systems in eastern Europe and the CIS and their effect on the behaviour of the unemployed, see chap. 7.1.

¹⁷⁶ Although declining, the numbers of people on involuntary leave or working part-time in January-September 2002 were some 1.5 million (2.3 per cent of the total employment) and 942,000 (1.4 per cent of the total), respectively. Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii, yanvar'-oktyabr' 2002 goda* (Moscow), p. 253.

¹⁷¹ Population censuses carried out in the three Baltic states in 2001 resulted in significant revisions to the figures for total and working-age population (and, consequently, the labour force). Based on these revised data Estonia and Latvia have already revised their labour market indicators including employment. Lithuania is still in the process of adjusting these time series.

¹⁷² Another possible reason may be new entries, or re-entries, to the labour market increasing the size of the labour force.

¹⁷³ The data are based on labour force surveys. In 2002, Goskomstat stopped publication of the monthly employment data based on the so-called "balance of labour" method. Currently the main source of information on the dynamics of employment is the labour force survey conducted four times a year. Another source is the monthly statistics

3.5 Foreign trade and payments

(i) Current account developments

Against the background of a sluggish world economy, the combined current account surplus of eastern Europe and the CIS continued to decline in 2002.¹⁷⁷ In the first three quarters of the year it fell by over \$6 billion to about \$9 billion (table 3.5.1), due to the diminishing surplus of Russia and larger current account deficits in most other countries. Although many of these deficits are large by widely accepted criteria, they generally appear to have been easily financed. In eastern Europe (and some members of the CIS), capital inflows, including FDI, increased, and in virtually all countries there were additions to official reserves. However, several countries continued to face balance of payments constraints.

On balance the external economic conditions facing the transition economies continued to worsen in 2002. Economic activity in western Europe remained subdued while output growth in Russia, a key market for the other CIS countries, continued to slow down. However, the decline in international oil prices was reversed in the first quarter of 2002 and that boosted the export earnings of several fuel producers, especially Russia. These factors led to considerable differences in the movement of national current account balances in the region, changes that also reflect differences in the growth of domestic demand and exports and movements in real exchange rates.

One notable feature in 2002 was the parallel growth of fiscal and current accounts deficits (the twin deficits) in a sizeable number of countries. In fact, the twin deficit problem, which marred the macroeconomic performance of many east European and CIS economies in the first half of the 1990s, seems to be re-emerging in some of them, especially in central Europe. It is an indication of structural problems in the economy (for a discussion of some problems of this type see section 3.1(ii)), which require a dedicated and lasting policy effort in implementing – sometimes painful and unpopular – structural reforms. The windfall fiscal revenue associated with the period of high growth in central Europe during the second half of the 1990s temporarily eased the structural pressure on governments' financial balances but, at the same time, it weakened the urgency to implement the needed structural reforms. However, the re-emergence of sizeable twin deficits highlights the seriousness of the underlying structural problems and calls for urgent policy measures to address them.

Data for the first three quarters of 2002 indicate an increase in the aggregate current account deficit of *eastern Europe*, to about \$16 billion (4.5 per cent of GDP). Although the current dollar value of merchandise exports and imports continued to expand at 8 to 9 per cent, the growth rate of receipts from services slowed while that of service imports doubled to 14 per cent. As a result, the combined trade deficit rose by some \$1 billion (see below) and the surplus on services diminished by a similar amount. There was a sharp rise in net income payments abroad, boosted by foreign investors' repatriation and reinvestment of profits. However, net transfers, mostly remittances from east Europeans working abroad, continued to rise and are likely to have exceeded \$10 billion in 2002. Together with net receipts from services (over \$9 billion in 2001), transfers provided a considerable offset to the deficits on merchandise trade and income.

In *central Europe*, strong internal demand, fuelled in part by larger fiscal deficits, has contributed to a worsening of current account deficits in several countries. In the Czech Republic an improvement in the current account balance was reversed in the third quarter due to much larger net income payments abroad, including profit repatriation. Moreover, the decline in the surplus on services, including net receipts from tourism, was exacerbated by the floods in August, which also led to increased imports to offset the damage. The impact of this development continued to be felt in the rest of the year, raising estimates of the current account deficit in 2002 to above 5 per cent of GDP.¹⁷⁸ In Hungary, the faster growth of imports of goods and services, and a sharp fall in tourist revenues led to a more than tripling of the current account deficit. Returns for October-November put the annual current account deficit at over \$3 billion (around 5.5 per cent of GDP).¹⁷⁹ A sharp deterioration in the trade balance in the closing months of the year indicates that the current account deficit of Slovakia will have remained high in 2002 (around 8 per cent of GDP), but below some earlier official projections. In Poland the impact of a larger budget

¹⁷⁸ Since the tables in this section were completed, there has been a major revision to the Czech merchandise trade statistics for July-November 2002 (see subsect. ii) that has markedly lowered the trade deficit. The revised trade data are not yet reflected in the available balance of payments data.

¹⁷⁹ It should be borne in mind that the country's officially reported current account deficit as shown in table 3.5.1 is understated because of the national practice of excluding reinvested earnings from FDI. The OECD has estimated that reinvested earnings amounted to some \$2 billion in 2001. OECD, *Economic Surveys: Hungary*, Vol. 2002/10 (Paris), June 2002, tables 5 and 6. Inclusion of this outflow raises the current account deficit in 2001 from \$1.1 billion to around \$3.1 billion (or from 2.1 to 5.9 per cent of GDP). Hungary's officially reported current account deficit exceeded \$3 billion in 2002, but the inclusion of reinvested earnings (assuming little change from 2001) would raise the deficit to over \$5 billion (about 10 per cent of GDP). It should be noted that the inclusion of reinvested earnings (a debit) in the current account does not change the overall balance of payments because these earnings also enter the financial account (as a credit). Accordingly, Hungary's official data on net financial and FDI inflows (tables 3.5.6 and 3.5.10) are also understated.

¹⁷⁷ In this section unless otherwise stated, all growth rates are January-September 2002 relative to the same period in 2001, and all balances refer to January-September 2002 (changes are also relative to the same period in 2001). Subsect. (i) is based on national balance of payments statistics, which in some cases differ from the merchandise trade data used in subsect. (ii).

TABLE 3.5.1
Current account balances of eastern Europe and the CIS, 2000-2002
(Million dollars, per cent)

	Million dollars					Per cent of GDP				Net FDI current account ^a (per cent)		
	2000	2001	Jan.-Sep.		2002 ^b	2000	2001	Jan.-Sep.		2001	Jan.-Sep.	
			2001	2002				2001	2002		2001	2002
Eastern Europe	-20 731	-20 152	-13 466	-16 341	..	-5.1	-4.5	-4.1	-4.5	103	99	108
Albania	-156	-218	-192	-319	..	-4.1	-5.3	-6.2	-9.2	95	81	30
Bosnia and Herzegovina	-957	-1 126	-740	-1 000*	..	-21.5	-24.4	-21.4	-26.9	12	13	18
Bulgaria	-702	-842	-427	-60	-216	-5.6	-6.2	-4.4	-0.5	81	114	471
Croatia	-439	-617	-200	-524	..	-2.4	-3.2	-1.4	-3.2	222	384	113
Czech Republic	-2 718	-2 625	-1 995	-2 536	..	-5.3	-4.6	-4.8	-5.1	184	155	274
Estonia	-294	-340	-189	-544	-687	-5.7	-6.2	-4.6	-11.5	101	125	20
Hungary ^c	-1 328	-1 105	-637	-2 292	-2 976	-2.8	-2.1	-1.7	-5.0	190	238	28
Latvia	-493	-732	-385	-403	-504	-6.9	-9.7	-7.0	-6.7	19	60	86
Lithuania	-675	-574	-260	-365	-441	-6.0	-4.8	-2.9	-3.7	76	132	151
Poland	-9 952	-7 166	-5 413	-4 859	-6 734	-6.1	-3.9	-4.1	-3.6	97	76	50
Romania	-1 355	-2 223	-1 225	-957	-1 291	-3.7	-5.6	-4.5	-3.2	53	62	78
Slovakia	-702	-1 756	-1 131	-1 211	-1 446	-3.6	-8.6	-7.4	-7.1	83	70	278
Slovenia	-548	31	49	370	486	-3.0	0.2	0.4	2.4	..	..	..
The former Yugoslav Republic of Macedonia	-75	-235	-209	-212	..	-2.1	-6.9	-8.1	-7.7	188	193	32
Yugoslavia	-339	-624	-513	-1 429	-1 703	-4.9	-6.0	-6.6	-14.0	26	16	22
CIS^d	48 001	33 834	28 396	24 865	..	13.7	8.2	9.4	7.3	..	..	..
Armenia	-278	-196	-129	-100*	..	-14.6	-9.3	-9.2	-6.5	36	45	60
Azerbaijan	-168	-52	18	-350*	..	-3.2	-0.9	0.5	-8.4	437	..	257
Belarus	-323	-275	27	-39	..	-3.1	-2.2	0.3	-0.4	40	..	287
Georgia	-262	-211	-154	-160*	..	-8.6	-6.6	-6.6	-6.7	52	53	63
Kazakhstan	675	-1 241	-542	-245	..	3.7	-5.6	-3.3	-1.4	221	351	590
Kyrgyzstan	-80	-19	15	-10	..	-5.8	-1.3	1.3	-0.9	..	..	16
Republic of Moldova	-105	-92	-70	-53	..	-8.1	-6.2	-6.6	-4.6	174	193	92
Russian Federation	46 839	34 842	28 487	23 984	31 700	18.0	11.2	12.6	9.5	..	..	..
Tajikistan	-62	-74	-73	3	..	-6.3	-7.0	-10.5	0.4	12	11	..
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine	1 481	1 402	1 246	2 085	..	4.7	3.7	4.6	7.0	..	..	..
Uzbekistan	184	50*	-50	..	..	1.3	0.4	-0.6	..	..	110	..
Total above^d	27 270	13 682	14 931	8 524	..	3.6	1.6	2.4	1.2	..	..	..
<i>Memorandum items:</i>					..							
Baltic states	-1 462	-1 646	-834	-1 312	..	-6.2	-6.6	-4.5	-6.3	56	97	77
Central Europe	-15 246	-12 621	-9 126	-10 528	..	-5.1	-3.8	-3.8	-4.0	124	107	137
South-east Europe	-4 022	-5 885	-3 506	-4 501	..	-4.6	-6.2	-5.1	-5.8	71	79	51
CIS without Russian Federation^d	1 162	-1 008	-91	881	..	1.3	-1.0	-0.1	1.0	438	3483	..
Caucasian CIS	-708	-460	-265	-610	..	-6.9	-4.2	-3.4	-7.5	88	94	174
Central Asian CIS^d	817	-1 584	-1 030	-502	..	2.1	-3.8	-3.3	-1.4	188	203	334
Three European CIS	1 053	1 035	1 204	1 993	..	2.5	2.0	3.2	4.8	..	..	..

Source: UNECE secretariat calculations, based on national balance of payments statistics; IMF, *Staff Country Reports* (Washington, D.C.) for Bosnia and Herzegovina, Tajikistan and Uzbekistan [www.imf.org]; TACIS, *Azerbaijan Economic Trends* (Baku). No balance of payments data have been available for Turkmenistan since 1998.

^a This ratio is calculated only when net FDI is positive and the current account balance is negative.

^b January-November for Estonia, Hungary, Romania, Slovenia and Yugoslavia; January-October for Bulgaria, Latvia, Lithuania, Slovakia; full-year data for Poland and full-year Central Bank of Russia estimates for the Russian Federation.

^c Excludes reinvested profits (a net outflow).

^d Totals include UNECE secretariat estimates for Turkmenistan and Uzbekistan.

deficit on the current account balance was held in check (despite much higher income outflows) by a tight monetary policy. Slovenia is one of the few economies to post a (larger) current account surplus in 2002, thanks to the growth of merchandise exports and receipts from transport services. In the *Baltic* area, Latvia and, especially, Estonia again posted a sizeable current account deficit. In Estonia a rapid expansion

of domestic demand (also the case in Latvia) resulted in a much larger merchandise trade deficit and a smaller surplus on services. However, Latvia and Lithuania benefited from larger surpluses on service transactions, and Latvia from considerably larger transfers. Lithuania has made considerable progress reducing its current account deficit, from a peak of 10 to 12 per cent of GDP in 1997-1999.

In *south-east Europe*, Bulgaria and Romania, the two EU candidate countries in the region, reported smaller current account deficits in the first three quarters of 2002. In Bulgaria the improvement resulted from a smaller trade deficit, increased revenues from tourism and smaller outflows of net income, but in Romania the change was due entirely to record transfers. Import growth in both countries was held down by tight fiscal policies. In Croatia a large increase in the trade deficit was partially offset by a surge in revenues from tourism. The other countries in this group had large and rising current account deficits. In Albania, the deterioration was mitigated only by the growth of transfers. The downward trend in exports of goods and services tended to exacerbate imbalances in The former Yugoslav Republic of Macedonia, but transfers from abroad doubled in the first three quarters of 2002. In Yugoslavia, a boom in imports of goods and services nearly tripled the current account deficit in 2002, despite some increase in remittances.

Considerable variation continued to characterize current account developments in the CIS countries. In the first quarter of 2002, the upturn in world oil prices slowed the downward trend in the current account surplus of *Russia*. Whereas projections made early in the year pointed to an expected surplus of around 5 per cent of GDP for 2002 as a whole, it is now expected to be about \$32-\$33 billion, or nearly twice the original estimate relative to GDP. In January-September, Russian merchandise exports fell slightly, although revenues from services, including transport and tourism continued to rise. Merchandise imports have been boosted by domestic demand and the real appreciation of the rouble, which is likely to have contributed to the much larger expenditures on foreign tourism. As regards the other fuel producers, the balance of Azerbaijan deteriorated sharply because of a boom in imports of goods and services, the latter consisting mainly of oilfield services associated with foreign investment. However, Kazakhstan's current account improved thanks to the upturn in oil prices. Data are not available for Turkmenistan but the current account is likely to have been roughly in balance with a deficit on services offsetting a trade surplus.

Many of the other members of the CIS have only limited access to external finance, which restricts the size of their current account deficits. Moreover, some of the high-debt, low-income countries are committed to programmes aimed at reducing their current account imbalances and debt burdens (subsection iv). The Republic of Moldova, one of the *three European CIS* countries, has managed to do that in the first three quarters of 2002 as a result of boosting its exports of goods and services (by 17 per cent) and of higher transfers. The service exports of Ukraine (mostly fees received for the transit of Russian gas) and sharply higher workers' remittances from abroad helped to boost the current account surplus. In Belarus, the current account remained roughly in balance, higher remittances and

services offsetting an increase in the trade deficit. As for the other CIS, up-to-date data are only available for Kyrgyzstan. It is also a low-income, highly-indebted country whose current account has moved almost into balance (despite sluggish merchandise exports).

(ii) International trade

(a) Eastern Europe

Along with the acceleration of domestic economic growth during the course of 2002, the east European countries' foreign trade expanded strongly after an initial slump in the first quarter. The dollar value of exports and imports grew by some 10 and 9 per cent, respectively, in January-September 2002 (year-on-year), close to their growth rates in 2001.¹⁸⁰ The growth of export and import volumes also accelerated in the course of the year to 5 and 5.5 per cent, respectively, but these increases were notably smaller than in 2001, particularly for exports.¹⁸¹ Thus, on average, trade had a small negative impact on GDP growth in 2002 (section 3.2). Export unit values in dollars (mainly for manufactured goods) edged up, partly owing to the dollar's depreciation, while those for imported inputs, on average, were below the previous year's levels.¹⁸² The resulting improvement in the terms of trade mitigated the deterioration of the region's merchandise trade deficit, which widened by \$1.7 billion, to \$33.4 billion in January-September 2002 (about 9.2 per cent of the region's aggregate GDP). However, the Czech, Hungarian and Slovene trade deficits narrowed markedly from their levels of a year earlier¹⁸³ and deficits

¹⁸⁰ The strengthening of the euro – in which most of the region's trade is denominated – relative to the dollar, inflated export and import values expressed in dollars: in euro terms, east European trade rose by only 6 and 5 per cent in January-September 2002, following increases of 14 and 12 per cent in 2001. The quarter-to-quarter acceleration was also more moderate for values expressed in euros. In turn, although positive in both dollars and euros, the year-on-year growth rates of trade values expressed in domestic currencies were flat or even negative in the Czech Republic and Hungary (for both exports and imports) due to the nominal effective appreciation of their currencies.

¹⁸¹ According to UNECE secretariat estimates, based on preliminary data from a subset of east European countries (table 3.5.4).

¹⁸² In January-September 2002, according to national statistics, dollar export unit values for manufactured goods increased (year-on-year) most noticeably in Croatia (14 per cent), Hungary (6 per cent), and the Czech Republic and Poland (3.8 and 3 per cent, respectively). In the EU, export unit values in dollars for manufactured goods increased in the first nine months of 2002, year-on-year, by 2 per cent. United Nations Statistics Division, *Monthly Bulletin of Statistics On-line* (manufactured goods exports, unit value indices in dollars, 1990=100). Even though it had gained quite markedly since early spring, the average world market price in dollars for energy resources in January-September was still some 7 per cent lower than in the same period of 2001; world commodity prices excluding energy were lower by 3.5 per cent over the same period. For more details on world market price developments in 2002, see chap. 2.1 and charts 2.1.5-2.1.6 above.

¹⁸³ In its *News Release* of 16 January 2003, the Czech Statistical Office reported important corrections on previously released export and import data for July to November 2002, which resulted in a substantial narrowing of the earlier reported merchandise trade deficit for those months (for January-September 2002, the revised deficit amounts to \$1,288 million instead of the earlier reported \$1,823 million; the revised export dollar value leads to year-on-year growth of 13.7 per cent instead of 11.4 per cent). These revisions are reflected in the above-mentioned aggregates for eastern

were also somewhat smaller in Bulgaria, Poland and Slovakia. In the Baltic states and most south-east European countries, on the contrary, trade deficits increased substantially (table 3.5.2).

The merchandise *exports* of the east European countries, after losing momentum in the last quarter of 2001 and a poor performance in the first months of 2002, picked up noticeably in the second quarter and accelerated further during the third. If the better performance in the second quarter was driven to some extent by the heightened business and consumer confidence in a recovery in the global economy, this does not provide a sufficient explanation of the strengthening of exports, in value and volume, in the third quarter.

The recovery in western Europe – the major export market for the region – failed to gather momentum in the second half of the year, and the economic outlook was constantly being lowered for nearly all the EU countries (see chapter 2). The aggregate volume of imports of goods and services into western Europe in 2002 as a whole actually fell,¹⁸⁴ as did the specific external demand facing many east European economies (chart 3.5.1). At the same time, most of the east European currencies appreciated in real effective terms, thus potentially reducing their competitiveness on international markets. In particular the appreciation based on unit labour costs picked up noticeably from late 2001 in the Czech Republic, Hungary and several other countries (see section 3.1 and chart 3.1.2 above).

The region's aggregate exports, nonetheless grew by some 5 per cent in volume and by nearly 10 per cent in current dollar value in January-September 2002. The largest rise in the first nine months of 2002 was in the aggregate dollar value of central European exports (tables 3.5.2 and 3.5.3). The latter reflects double-digit increases in Czech and Hungarian exports and growth rates in the range of 8 to 9 per cent in Poland, Slovakia and Slovenia. In the former two countries, total export growth was backed by strong exports to the EU, which rose by some 10 per cent in dollar value and 5 to 6 per cent in volume, and by large increases of sales to developing countries, particularly to those in Asia (up 33 to 35 per cent in value). According to European Union data, purchases from the Czech Republic were among the fastest growing of all extra-EU imports in January-September 2002 (a 10 per cent year-on-year increase in euros).¹⁸⁵

Europe (table 3.5.2), but could not be included in the analysis of Czech data further on in this section (tables 3.5.3-3.5.4, and chart 3.5.2), which is based on the initial reports, as corrected data in volume terms or by partner countries and commodities were not available at the time of writing this *Survey*.

¹⁸⁴ Between the first and second quarters of 2002, the volume of imports of goods and services into western Europe rose by 1.3 per cent, and between the second and third it increased 1.5 per cent. However, if compared with the same period of 2001, the volume of west European imports of goods and services was lower by 1.4 per cent in January-September 2002.

¹⁸⁵ Eurostat, Euro Indicators, *News Release*, No. 153/2002, 20 December 2002.

TABLE 3.5.2

Trade performance and external balances of east European and CIS economies, 2001-2002

(Rates of change and shares, per cent)

	Merchandise exports (growth rates)		Merchandise imports (growth rates)		Trade balance (per cent of GDP)	
	2001	2002 ^a	2001	2002 ^a	2001	2002 ^a
Eastern Europe	10.7	9.6	8.6	8.7	-10.0	-9.2
Albania.....	17.6	-2.5	24.3	15.0	-24.6	-24.2
Bosnia and Herzegovina ...	18.5	-13.9	2.2	10.6	-33.4	-50.7
Bulgaria.....	6.0	5.2	11.6	1.9	-15.8	-12.5
Croatia.....	5.1	3.6	14.7	13.6	-22.4	-25.2
Czech Republic ^b	14.9	13.7	13.4	9.7	-5.5	-2.6
Estonia.....	4.1	-3.1	0.8	6.0	-17.8	-21.0
Hungary.....	8.6	10.0	5.0	7.8	-6.1	-4.6
Latvia.....	7.3	10.7	10.0	13.3	-19.9	-20.1
Lithuania.....	20.3	10.5	16.4	19.9	-14.8	-16.5
Poland.....	14.0	7.9	2.7	5.8	-8.0	-7.7
Romania.....	9.8	15.1	19.1	12.0	-10.5	-8.9
Slovakia.....	6.6	8.7	16.0	7.4	-9.7	-7.0
Slovenia.....	6.0	8.9	0.3	4.2	-4.8	-2.0
The former Yugoslav						
Republic of Macedonia.....	-12.4	-7.0	-19.0	16.0	-15.2	-21.0
Yugoslavia.....	10.0	15.0	30.0	21.0	-28.4	-26.9
CIS^c	-0.2	0.8	15.6	6.7	14.9	13.3
Armenia.....	12.6	46.0	-1.8	8.1	-25.0	-20.7
Azerbaijan.....	32.6	-2.1	22.1	22.7	15.6	9.1
Belarus.....	1.3	4.0	-6.1	7.0	-5.1	-4.1
Georgia.....	-3.0	-5.9	5.1	0.1	-11.4	-11.8
Kazakhstan.....	-5.2	3.7	26.0	1.4	10.3	11.2
Kyrgyzstan.....	-5.6	-0.8	-15.7	30.1	0.6	-6.0
Republic of Moldova.....	21.0	13.6	15.5	15.4	-22.1	-23.4
Russian Federation.....	-2.1	-0.5	22.1	10.6	19.2	16.9
Tajikistan.....	-16.9	9.3	1.9	0.8	-3.4	-0.8
Turkmenistan.....	8.0	0.7	26.4	-26.0	7.5	6.7
Ukraine.....	11.6	6.3	13.0	6.0	1.3	2.4
Uzbekistan.....	-3.7	-10.6	6.0	-13.9	0.8	1.3
Total above	5.3	5.5	10.6	8.1	2.0	1.7
<i>Memorandum items:</i>						
Baltic states	11.7	5.9	9.7	13.9	-17.0	-18.6
Central Europe	11.4	10.2	6.9	7.3	-7.2	-5.8
South-east Europe	7.3	8.6	14.8	11.8	-17.5	-18.3
CIS without Russian						
Federation	4.7	3.6	9.7	2.8	2.2	2.9
Caucasian CIS	25.1	3.2	10.2	12.6	-0.1	-2.8
Central Asian CIS	-3.5	0.5	17.2	-6.3	6.6	7.4
Three European CIS	8.4	5.7	6.1	6.6	-0.9	-

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.

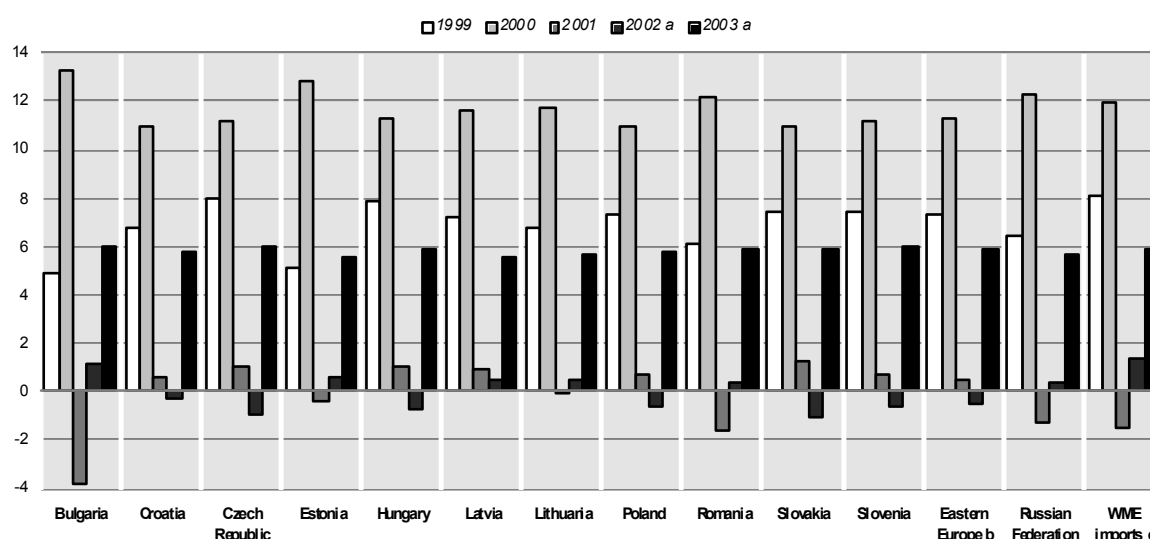
^a January-September over same period of 2001.

^b Including revisions of July-September 2002 data.

^c Including intra-CIS trade.

In Slovakia too, exports to the EU increased by nearly 9 per cent, despite those to the major EU market – Germany – being nearly flat in January-September 2002. In contrast, there were large increases in Slovak exports to less traditional EU markets (Denmark, Finland, Spain and Sweden), generally on the basis of a limited range of

CHART 3.5.1
Specific western demand for selected east European and CIS economies' exports, 1999-2003
(Annual percentage change in volume)



Source: UNECE secretariat calculations; estimates for 2002 and forecasts for 2003 from *OECD Economic Outlook*, No. 72 (Paris), December 2002 and European Commission, *Economic Forecasts*, No. 5 (Brussels), 2002.

Note: Aggregation of the import volume growth rates of individual western countries weighted by their share in the exports of each east European country. The data for the volume of western imports refer to goods and services on a national accounts basis.

^a Preliminary estimates for 2002 and forecasts for 2003.

^b Eleven countries shown.

^c Western market economies (WME) include western Europe, North America, Turkey and Japan.

manufactured goods and foods. Polish and Slovene exports were strongly supported by expansion to their eastern neighbours – the CIS (up some 15 to 17 per cent in dollar value), their CEFTA partners (11 to 17 per cent), and to some south-east European countries; exports to the EU grew somewhat less, by 4 to 7 per cent in dollar value.

According to EU data, the Czech Republic, Hungary and Poland were among the 10 major extra-EU partners, accounting together for 8.1 per cent of total extra-EU imports in January-September 2002, a gain of 0.8 percentage points from the same period in 2001. The increased presence of central European producers on western markets in spite of sluggish demand and, in many cases, appreciating domestic currencies, was partly due to strong intra-firm sales of multinational companies,¹⁸⁶ but also to developments in particular industries.¹⁸⁷

Among the south-east European countries, Romania's exports were also surprisingly strong in the second and third quarters of 2002: their dollar value grew by 17 per cent and 27 per cent, respectively, year-on-year, thanks to considerably increased sales to western and developing markets, while exports to the CIS and some east European countries (Bulgaria and Poland, in particular) fell. Sales of apparel and footwear to the EU, mainly under OPT arrangements, increased sharply, generating nearly half of Romania's exports to the EU in January-September 2002. Yugoslavia, too, reported a double-digit growth in the value of its exports in January-September 2002, the most rapid growth being in sales to the CEFTA countries (up by more than one third) and to the EU (up 13 per cent).

In Bulgaria and Croatia export growth was less vigorous, although it also strengthened considerably after the second quarter. The destination of exports, was quite different for these two countries: Bulgaria's exports to the CIS declined sharply, but there were large increases to the

¹⁸⁶ According to a survey data of 1,050 investment projects in eastern Europe carried out by 420 German multinationals during the 1990s, intra-firm exports to the parent company ranged from above 80 per cent of the subsidiary's total sales in the case of Slovakia, 64 per cent in the Baltic states, to 15 to 30 per cent in the Czech Republic, Hungary and Poland, and accounted for 46 per cent of manufactured goods (SITC 6), and 38 per cent of the machinery and equipment (SITC 7). D. Marin, A. Lorentowicz and A. Raubold, *Ownership, Capital or Outsourcing: What Drives German Investment to Eastern Europe?*, CEPR Discussion Paper, No. 3515 (London), July 2002.

¹⁸⁷ For instance, in January-September 2002, Hungarian exports to Sweden grew nearly six-fold, by \$936 million, due almost entirely to mobile

phone shipments within the Elcoteq company's network, while the \$388 million increase in exports to Germany in the first half of the year was dominated by Microsoft's Xbox game console, production of which stopped in June 2002 owing to its relocation to China, and to a lesser extent by Audi cars and engines. The Audi Hungaria Motor Kft. reported an increase of nearly 15 per cent in its external revenues in the first half of 2002 thanks to a 6 per cent increase in engine production and a larger number of assembled Audi cars in the Győr plant (29,258 in January-June 2002 against 55,296 in the whole of 2001). For more details see *Audi: 2002 Interim Report* [www.audi.com].

TABLE 3.5.3
Foreign trade of eastern Europe and the CIS by direction, 2000-2002
(Value in billion dollars, growth rates in per cent)^a

Country or country group ^b	Exports				Imports			
	Value 2001	Growth rates			Value 2001	Growth rates		
		2000	2001	2002 ^c		2000	2001	2002 ^c
Baltic states, to and from:								
World	9.9	24.4	11.7	5.9	14.2	15.0	9.7	13.9
Eastern Europe and CIS	3.1	18.6	22.6	6.4	4.8	23.2	9.3	7.2
CIS	1.3	1.0	38.8	22.4	2.9	36.7	4.5	-0.9
Baltic states	1.3	27.9	10.0	-0.8	0.9	7.8	15.5	24.0
Central and south-east Europe	0.5	44.9	24.0	-13.1	1.0	4.3	19.0	15.8
Developed market economies	6.4	26.0	5.1	5.7	8.1	9.0	5.5	20.2
European Union	5.7	26.6	4.7	4.5	7.1	9.9	5.5	19.3
Developing economies	0.5	47.2	55.7	5.5	1.2	37.2	50.1	1.4
Central Europe, to and from:								
World	121.9	12.2	11.4	9.5	145.3	10.2	6.9	7.3
Eastern Europe and CIS	25.0	11.3	15.6	11.0	29.9	29.3	5.2	0.6
CIS	4.9	17.4	17.5	15.5	13.4	56.2	-0.7	-6.2
Baltic states	1.5	15.7	26.4	15.6	0.5	51.0	-3.1	-15.8
Central and south-east Europe	18.6	9.6	14.4	9.4	16.1	11.0	11.0	7.2
Developed market economies	91.2	11.7	10.5	8.8	99.8	5.3	5.6	5.6
European Union	84.0	10.9	10.9	8.6	86.8	3.5	6.6	5.8
Developing economies	5.7	25.9	8.1	16.5	15.6	11.7	19.2	34.5
South-east Europe, to and from:								
World	25.3	16.0	7.3	8.6	42.0	13.4	14.8	11.8
Eastern Europe and CIS	5.0	15.7	-4.9	4.3	11.6	24.5	6.2	5.4
CIS	0.7	4.0	-15.6	-17.3	5.2	41.5	4.0	-4.1
Baltic states	-	-1.9	23.0	7.1	-	44.7	-11.9	47.2
Central and south-east Europe	4.2	18.3	-3.0	8.1	6.4	12.9	8.0	14.7
Developed market economies	17.0	14.8	12.9	10.2	25.3	9.1	17.7	13.2
European Union	15.2	16.3	14.1	11.4	22.5	7.8	19.1	15.0
Developing economies	3.4	22.1	0.9	14.0	5.1	9.9	23.3	19.4
Russian Federation, to and from:								
World	99.2	41.4	-3.8	-0.5	41.5	11.9	22.6	10.6
Intra-CIS	14.5	29.1	4.7	2.6	11.1	39.1	-4.0	-14.6
Non-CIS countries	84.7	43.6	-5.1	-1.0	30.4	1.5	36.5	20.8
Eastern Europe	16.4	61.2	-8.0	-12.6	3.1	15.6	25.4	24.6
Baltic states	3.8	73.9	-22.8	-2.5	0.4	12.2	28.5	27.6
Central and south-east Europe	12.6	56.9	-2.3	-15.6	2.6	16.2	24.9	24.1
Developed market economies	46.8	38.1	-5.7	-0.9	20.5	3.0	33.1	17.6
European Union	36.6	49.1	-0.8	-3.9	15.3	-0.3	37.2	23.1
Developing economies	21.5	43.6	-1.3	8.0	6.8	-9.2	54.5	28.6
CIS countries (CIS-11), to and from:								
World	42.8	34.2	4.7	3.6	40.5	19.1	9.7	2.8
Intra-CIS	15.4	37.3	2.7	-10.3	21.7	30.8	6.3	-1.2
Non-CIS countries	27.4	32.4	5.9	11.8	18.8	7.2	13.8	7.7
Eastern Europe and CIS, to and from:								
World	299.1	25.2	4.6	5.1	283.5	12.3	10.6	8.1

Source: National statistics and direct communications from national statistical offices to UNECE secretariat; for the Russian Federation, State Customs Committee data; for other CIS economies, CIS Interstate Statistical Committee data.

Note: The recent (16 January 2003) revision of the Czech foreign trade data for 2002 is not included in the central European aggregate. For 2002, data for Bosnia and Herzegovina are reflected in the growth rate for totals but not by partner-groups for south-east Europe. In 2000, Estonia switched its basic trade statistics to a "special trade" reporting system; this change is reflected in the Baltic states aggregate growth rates starting in 2000.

^a Growth rates are calculated on values expressed in dollars.

^b For country groups see table 1.1.3.

^c January-September 2002 over same period of 2001.

developing countries and to western Europe, while in the case of Croatia a substantial fall in exports to developing countries partly offset a rapid growth to the CIS and eastern Europe. Exports from the other south-east

European countries – Albania, Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia – were in decline as these economies were still struggling to restore their industrial infrastructures.

In the Baltic states, there was also substantial export growth after the first quarter of 2002. In January-September, exports were some 10 per cent higher than a year earlier in Latvia and Lithuania, while in Estonia they remained below the level of 2001.¹⁸⁸ According to preliminary data for the first nine months of 2002, Lithuanian exporters improved their position in the country's major markets, with a 27 per cent rise in exports to the CIS and a 14 per cent increase to the EU. Exports to Russia, in which road vehicles occupy a major share (47 per cent), rose by nearly 50 per cent.¹⁸⁹ In fact, these exports account for most of the large increase in the exports of "machinery and equipment" in chart 3.5.2. The rapid growth of Latvian exports was largely based on a 10 per cent increase in sales to the CIS and a more than doubling of exports to North America, exports to the EU growing relatively less.

After an initial slump in the first quarter of 2002, merchandise imports also gained momentum throughout the region in the second and third quarters, but in the Baltic states and in several south-east European countries the pick-up was especially strong in both value and volume (tables 3.5.2 and 3.5.4). The appreciation of domestic currencies provided an impetus for import growth. But the primary influence was booming domestic demand, in particular, private consumption, and in some cases (the Baltic states and Croatia) rapidly increasing investment (see section 3.2 above). This is reflected in large increases in imports of consumer and certain capital goods (chart 3.5.2).¹⁹⁰

On the other hand, since imports tend to be highly correlated with exports in many east European countries (because of the high import content of their exports and their engagement in OPT), imports also moved in line with manufacturing activity (for the relative growth rates of industrial sectors, see table 3.2.4 above). However, the lower dollar prices of raw materials and fuels on world

markets, together with cheaper components, often priced in dollars, substantially dampened the growth of these imports in terms of value. Owing to its specific industrial structure, this had the most impact on Bulgaria, which recorded the lowest rate of import growth in eastern Europe even though its domestic demand rose strongly. Sluggish imports of inputs were also in part behind the slower import growth in the Czech Republic, Romania and Slovakia, although in these countries it was consistent with the slowing of domestic demand.

In central and south-eastern Europe, and also in Latvia and Lithuania the strong demand for consumer goods and in some cases for intermediate components, encouraged at least in part by the cheaper dollar, led to significantly increased imports from developing countries.¹⁹¹ Imports from western Europe grew more modestly in many central and south-east European countries, often reflecting increased imports of capital goods. The latter were also behind the large increase of Baltic imports from western Europe.

The only falls in imports into eastern Europe by source were those from the CIS, which consist mainly of raw materials, fuels and some intermediate products. These were affected by the factors mentioned earlier (lower world market prices and reduced demand for inputs by resource-intensive industries).

In central Europe and in a few other east European countries, a more diversified commodity structure and a greater flexibility of exporters in searching for specific niches and new markets (thanks in part to their integration into the multinational corporation (MNC) networks), appear to have helped them to limit the adverse effects of weaker western demand. In other countries, such as Bulgaria and Romania, competitiveness based on their low wage costs has helped to maintain a steady rate of growth of sales to the west. However, the preliminary data for October-November 2002 point to some deceleration in the exports of a number of these countries (most noticeably Bulgaria and Hungary), and the continuing weakness of domestic demand in western markets in late 2002 does not bode well for exports in early 2003. If the expected upturn in western markets (chart 3.5.1) materializes in the second half of 2003, its initial impact is likely to be a rise in western demand to replenish stocks of intermediate goods. East European exports of such goods fared rather poorly in 2002 (chart 3.5.2). The prospects for continuing growth of import demand in the CIS, and in particular in Russia, also seem to be promising and

¹⁸⁸ During the first half of 2001, Elkoteq – a major exporter in 2000 – closed down its production operations in Estonia (UNECE, *Economic Survey of Europe, 2001 No. 2*, p. 22). This generated a high base-year effect that began to fade in the second half of the year. Already in the third quarter exports had increased by more than 25 per cent in dollar value, and the average rate of export growth for 2002 as a whole is likely to be positive.

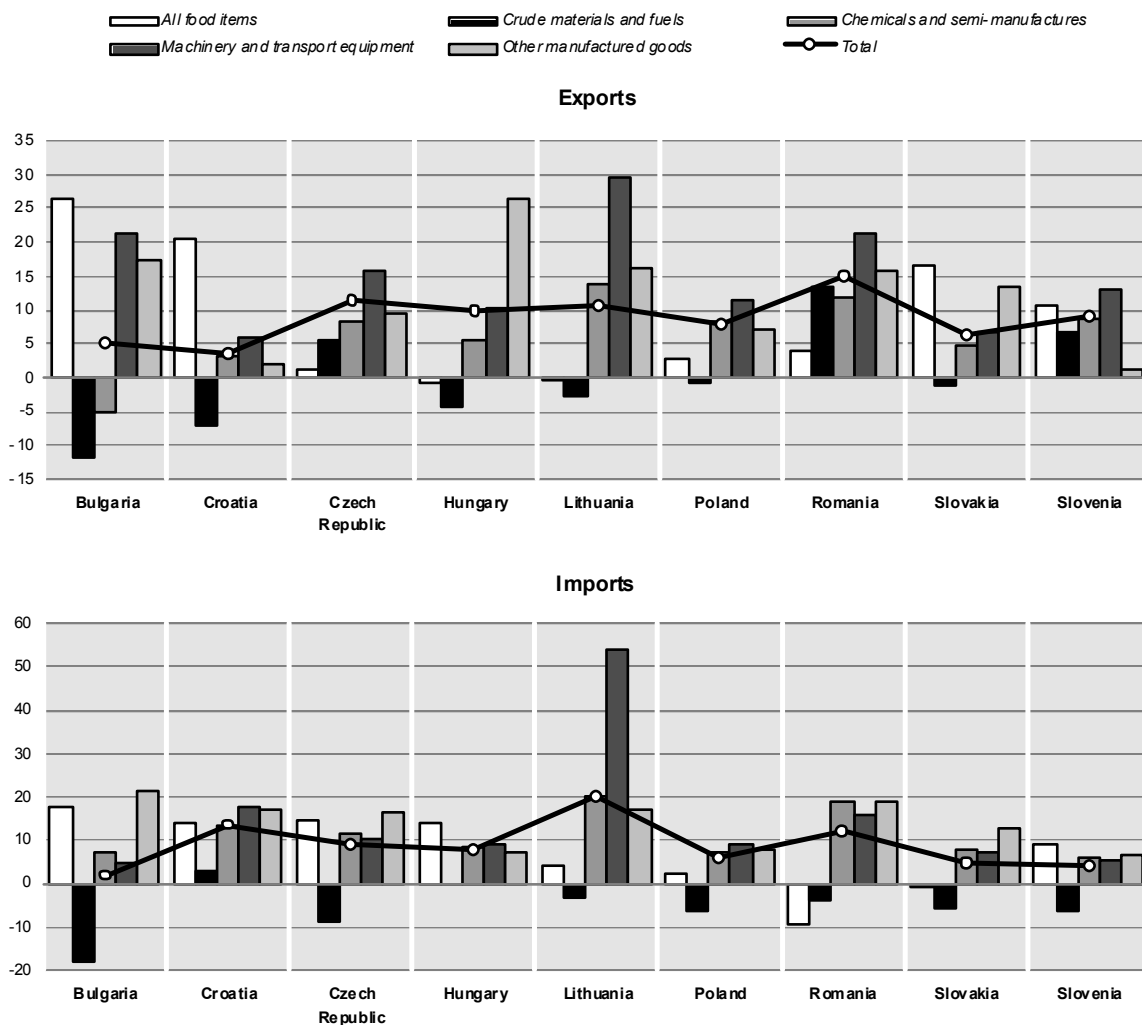
¹⁸⁹ Exports of road vehicles to Russia rose some 70 per cent in dollar value, year-on-year, and accounted for more than two thirds of total Lithuanian exports in this category. Passenger vehicles, mainly second-hand, accounted for the bulk of these exports. A strong incentive for this largely re-export activity was the Russian decision to introduce higher customs duties on imported cars older than seven years from October 2002; thus it can be expected that these exports will have slowed down in the fourth quarter.

¹⁹⁰ In chart 3.5.2 consumer goods are represented broadly by foods and other manufactured goods, while machinery and equipment stand for capital goods. The unprecedentedly large increase (54 per cent) in Lithuanian imports of "machinery and transport equipment" was due in large part to the value of imported ships, aircrafts and passenger vehicles (mainly for re-export to Russia); excluding those three categories, imports in this group rose some 20 per cent year-on-year. The near doubling (from the previous year) of FDI in January-September 2002 was partly behind this rise.

¹⁹¹ Estonian imports from the developing countries, however, remained considerably below their value of the previous year in January-September 2002: the cessation of mobile phone production by Elkoteq in the second half of 2001 disrupted its imports of inputs from China, which had accounted for nearly 13 per cent of total Estonian imports. This high base year effect is wearing out, however, and Estonia seems to be catching up with the general trend: its imports from the developing world in the third quarter of 2002 increased by 60 per cent (year-on-year) in dollar value.

CHART 3.5.2

Growth of exports and imports by major commodity groups in selected east European countries, January-September 2002^a
(Per cent)



Source: National statistics.

Note: Foreign trade growth is measured in current dollar values. 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).

^a Over January-September 2001.

governments and the business community in several east European countries have recently made efforts to strengthen their presence on these markets.¹⁹² Some additional impetus might also come from the continued strong growth in China and some other Asian countries, although these trade relationships are often developed within MNC intra-firm exchanges and are generally much stronger on the import side.

¹⁹² The Polish government, for example, prepared a "Program to Regain Eastern Markets", which involves export insurance and guarantee facilities, action to lower barriers to imports from Poland, international Polish exhibitions, etc. The programme aims to increase exports towards the European CIS and Kazakhstan and Uzbekistan and is to be launched in January 2003. *Interfax Poland Weekly Business Report*, 30 December 2002 (as quoted by *Reuters*).

The recent slowdown in the west does not appear to have been accompanied by increased protectionist pressures, at least so far as the east European economies are concerned. In fact, the overall trend has been the opposite, as freer market access has been offered by the EU to some south-east European countries within the Stabilization and Association framework, and during the final negotiations on agricultural trade between the EU and acceding countries, where the EU agreed to further mutual concessions on farm trade with Poland to take effect from April 2003.¹⁹³ During 2002 or from January

¹⁹³ The agreement with Poland should enhance the existing bilateral trade arrangements and involves additional duty free coverage for about €170 million of imports from Poland. *Reuters News*, 7 January 2003.

TABLE 3.5.4
Changes in the volume of foreign trade in selected east European and CIS economies, 1999-2002
(Per cent)

	Exports						Imports					
	1999	2000	2001	2002 ^a			1999	2000	2001	2002 ^a		
				Jan.-Mar.	Jan.-Jun.	Jan.-Sep.				Jan.-Mar.	Jan.-Jun.	Jan.-Sep.
Eastern Europe	6.5	20.5	10.0	1.5	4.3	5.0	5.2	14.7	7.7	2.7	4.7	5.5
Bulgaria .....	..	..	11.4	1.1	3.0	8.1	..	..	16.4	0.4	0.8	2.1
Croatia	-2.7	-1.3	7.2	-4.9	0.4	-0.1	-4.2	3.7	15.6	5.6	3.6	9.7
Czech Republic	9.4	18.7	12.7	3.7	5.3	3.9	5.1	19.9	13.4	1.3	3.4	4.6
Estonia ^b	0.9	41.2	-19.2	-34.9	-19.8	-8.5	-9.0	34.9	3.3	-10.7	-3.7	3.1
Hungary	15.9	21.7	7.7	4.7	6.2	6.6	14.3	20.8	4.0	2.6	3.1	4.4
Eastern Europe and European CIS.....	-9.3	22.5	16.1	3.7	4.1	3.4	6.0	17.1	1.8	6.1	8.0	10.0
European Union	20.6	21.3	6.9	0.7	4.7	6.0	14.6	14.4	2.5	-4.0	-1.5	0.1
Latvia	-2.1	13.6	8.2	1.4	3.2	7.7	-3.2	5.1	11.9	3.6	6.9	7.2
Lithuania	-16.3	19.2	23.6	10.8	11.4	15.9	-13.0	7.4	20.4	14.6	18.8	18.9
Poland	2.0	25.3	11.8	0.2	4.0	4.6	4.4	10.8	3.2	3.5	6.9	5.9
Eastern Europe and European CIS.....	-9.3	25.1	18.8	13.4	14.2	11.3	7.8	16.7	4.4	3.7	4.1	3.1
European Union	5.4	26.8	10.8	-1.5	2.4	3.2	4.1	10.5	2.6	1.7	5.4	4.7
Slovenia	3.7	11.4	5.3	0.5	3.0	4.4	9.2	4.1	0.6	0.8	1.2	1.8
The former Yugoslav Republic of Macedonia	-7.4	15.3	..	..	..	..	-5.1	14.9	..	..	..	..
Russian Federation	9.4	10.2	2.8	6.6	9.7	9.7	-15.6	29.2	29.8	23.0	17.6	21.7
Non-CIS	11.3	9.9	1.8	3.5	7.2	7.4	-19.4	28.6	43.9	37.3	30.8	31.2
CIS	1.5	12.5	9.5	25.5	25.5	23.1	-4.8	30.6	2.8	-7.4	-10.8	0.3
<i>Memorandum item:</i>												
Baltic states	-7.7	25.4	6.2	-6.4	-0.7	6.1	-9.4	15.2	13.1	4.2	9.0	11.2
Central Europe ^c	8.3	21.1	10.4	2.6	4.9	4.9	7.5	15.4	6.1	3.0	4.5	4.8

Source: UNECE secretariat calculations, based on national foreign trade statistics.

Note: The dollar values of exports and imports in 2001 are used as weights in calculating aggregate growth rates.

^a Over the same period of 2001.

^b Volume growth rates for Estonia are calculated on the basis of export and import values under the special trade reporting system.

^c Czech Republic, Hungary, Poland and Slovenia.

2003, several bilateral free trade agreements among east European countries came into force,¹⁹⁴ and these should at least enhance trade with and among the south-east European economies – although some of these are doomed to be short-lived due to the EU enlargement foreseen for May 2004.

(b) CIS

CIS trade (in current dollars) was relatively sluggish in January-September 2002, exports remaining roughly unchanged and imports rising only moderately. However, these figures conceal a continuing growth in the volume of Russia's trade. The total volume of exports of many other CIS countries is also likely to have been more dynamic than the value since the prices of their chief exports, mostly commodities, generally weakened. The

year 2002 was also characterized by a resumption of the trends of growing trade with non-CIS partners and a contraction of trade among the CIS themselves (see chapter 6.2).

Total trade of the CIS

In the first nine months of 2002, the dollar value of total merchandise exports from the CIS countries increased slightly, by 1 per cent year-on-year (table 3.5.2 and 3.5.5). This flat performance in export earnings represented a consolidation of gains after a considerable turnaround in 2000 following the period of low commodity prices in 1999. About half of the CIS countries increased their total exports, the increases ranging from 1 per cent in Turkmenistan to almost 50 per cent in Armenia, but there were also falls in Azerbaijan, Georgia, Kyrgyzstan and Uzbekistan. In Russia the volume of exports continued to rise (by 10 per cent in January-September, table 3.5.4), but there was little change in their current dollar value.

Most CIS countries continue to rely on sales of primary commodities and so their export revenues are closely related to global commodity prices. In the first nine months of 2002, commodity prices were relatively weak and affected the export revenues of individual CIS

¹⁹⁴ For example, in mid-October 2002, Latvia signed a free trade agreement with Bulgaria, while Estonia completed free trade agreement negotiations with the Czech Republic later in the year. Croatia is set to join CEFTA in January 2003 after securing bilateral free trade agreements with all its member countries; the country also has free trade agreements with Bosnia and Herzegovina, The Former Yugoslav Republic of Macedonia and, since March 2002, with Turkey; Croatia's free trade agreement with Yugoslavia, signed at the end of 2002, has still to be ratified. In February 2003, a free trade agreement is to be signed between Bulgaria and Yugoslavia.

countries to varying degrees.¹⁹⁵ In those countries dependent on sales of crude oil and refined products such as Azerbaijan, Kazakhstan and Russia, export volumes increased by 10 to 20 per cent in comparison with the same period in 2001. These increases, however, did not offset the fall in commodity prices and the deterioration in other export sectors in Azerbaijan and Russia.¹⁹⁶ In Kazakhstan shipments of metals were mixed (exports of steel products increased while those of base metals were flat or falling), but increased exports of crude oil contributed to the higher value of the country's total exports in the first nine months of 2002. In Tajikistan, the export volumes of both aluminium and cotton contributed to a 9 per cent increase in the value of total exports. Other commodity exporters such as Turkmenistan and Ukraine registered modest increases (1 and 6 per cent, respectively) in the value of total exports: in Turkmenistan these were due to increased sales of natural gas while the increases were across the board in Ukraine (except in the chemicals sector).

In the foreign exchange markets, in the first three quarters of 2002, the domestic currencies of Armenia, Azerbaijan, Georgia, the Republic of Moldova and Tajikistan depreciated by between 1 and 5 per cent in real terms against the dollar (year-on-year). In Kazakhstan and Ukraine, exchange rates were unchanged, while they appreciated in Belarus, Kyrgyzstan and Russia by between 3 and 9 per cent in real terms against the dollar. The movements of CIS currencies against the euro in real terms followed roughly similar paths with all currencies depreciating against the euro except those of Belarus and Russia, which increased by 6 and 3 per cent, respectively. The movement of CIS currencies against the dollar and the euro is important for non-CIS trade. As regards intra-CIS trade, and especially Russia's trade with the other members, the currencies of virtually all CIS countries continued to depreciate in real terms against the Russian rouble in 2002 (chart 3.1.3).

In contrast to flat exports, the dollar value of total CIS imports increased by 7 per cent. Only in two countries – Turkmenistan and Uzbekistan – did total imports decline (by 26 and 14 per cent, respectively). The value of total imports in the remaining CIS countries increased by up to 30 per cent in the first nine months of 2002, year-on-year. The gains varied between about 10 per cent in Armenia and

¹⁹⁵ World crude oil prices fell by 6 per cent, year-on-year, while export prices for Russia's natural gas decreased by about 12 per cent. Metal prices were also weak with aluminium falling by 9 per cent and copper by 5 per cent. In contrast, nickel prices increased by 7 per cent. The price of cotton – a major export earner in central Asia – declined by a fifth. The price of gold rose by almost 20 per cent, partly responding to global political uncertainties. See charts 2.1.5 and 2.1.6 for more information on commodity pricing in 2002.

¹⁹⁶ In the January-September 2002 period, average export prices of crude in Azerbaijan, Kazakhstan and Russia were respectively 8, 10 and 5 per cent lower than in the corresponding period of 2001. With crude oil prices about one third higher in the fourth quarter of 2002, year-on-year, these oil exporters can expect noticeably better export revenues in the near future.

TABLE 3.5.5

CIS countries' trade with CIS and non-CIS countries, 2000-2002
(Value in million dollars, growth rates in per cent)

	Export growth		Import growth		Trade balances		
	2001	2002 ^a	2001	2002 ^a	2000	2001	2002 ^a
Armenia.....	12.6	46.0	-1.8	8.1	-584	-30	-319
Non-CIS.....	10.8	62.0	-7.9	2.2	-484	-403	-194
CIS.....	18.4	3.0	23.1	26.3	-100	-127	-125
Azerbaijan.....	32.6	-2.1	22.1	22.7	573	883	376
Non-CIS.....	38.5	-2.1	23.7	11.5	713	1 106	675
CIS.....	-5.2	-1.5	18.6	43.9	140	-222	-299
Belarus.....	1.3	4.0	-6.1	7.0	-1244	-621	-426
Non-CIS.....	1.0	17.2	-4.2	9.1	376	513	763
CIS.....	1.6	-4.9	-6.9	6.1	-1 619	-1 134	-1 189
Georgia.....	-3.0	-5.9	5.1	0.1	-321	-364	-284
Non-CIS.....	-11.1	-12.7	2.3	-5.2	-226	-258	-195
CIS.....	9.1	2.4	10.3	9.4	-95	-107	-89
Kazakhstan.....	-5.2	3.7	26.0	1.4	4 075	2 284	2 020
Non-CIS.....	-10.9	14.8	33.2	19.2	4 456	2 958	2 589
CIS.....	10.8	-20.9	19.9	-14.1	-381	-674	-568
Kyrgyzstan.....	-5.6	-0.8	-15.7	30.1	-50	9	-70
Non-CIS.....	3.5	8.1	-17.7	27.9	42	97	45
CIS.....	-18.7	-15.1	-13.9	32.0	-91	-88	-115
Republic of Moldova.....	21.0	13.6	15.5	15.4	-305	-327	-268
Non-CIS.....	14.4	27.7	7.7	14.7	-321	-333	-255
CIS.....	25.6	4.7	31.0	16.5	16	6	-13
Tajikistan.....	-16.9	9.3	1.9	0.8	109	-36	-6
Non-CIS.....	7.2	23.2	29.8	15.9	295	290	255
CIS.....	-43.4	-15.5	-3.9	-3.2	-186	-326	-261
Turkmenistan.....	8.0	0.7	26.4	-26.0	720	450	619
Non-CIS.....	8.3	-14.3	27.3	-26.4	100	-100	-41
CIS.....	7.7	13.7	25.0	-25.4	620	550	660
Ukraine.....	11.6	6.3	13.0	6.0	617	490	713
Non-CIS.....	15.0	14.8	17.4	15.5	4 159	4 646	4 039
CIS.....	4.0	-13.6	9.9	-1.2	4 675	-4 157	-3 326
Uzbekistan.....	-3.7	-10.6	6.0	-13.9	380	90	90
Non-CIS.....	-1.9	-0.7	6.7	-13.4	290	130	245
CIS.....	-7.0	-29.2	4.8	-14.7	90	-40	-155
Total above.....	4.7	3.6	9.7	2.8	3 971	2 329	2 446
Non-CIS.....	5.9	11.8	13.8	7.7	9 400	8 647	7 927
CIS.....	2.7	-10.3	6.3	-1.2	-5 429	-6 318	-5 481
Russian Federation.....	-2.1	-0.5	22.1	10.6	69 214	57 670	42 722
Non-CIS.....	-5.1	-1.0	36.5	20.8	66 995	54 325	39 062
CIS.....	4.7	2.6	-4.0	-14.6	2 220	3 345	3 660
CIS total.....	-1.4	0.8	15.8	6.7	73 185	59 998	45 168
Non-CIS.....	-2.6	2.0	26.8	15.7	76 394	62 971	46 989
CIS.....	3.7	-4.2	2.6	-5.8	-3 209	-2 973	-1 821

Source: CIS Statistical Committee data (Moscow); UNECE secretariat estimates for Turkmenistan and Uzbekistan.

^a January-September.

Belarus, and some 15 to 30 per cent in Azerbaijan, Kyrgyzstan and the Republic of Moldova. In Russia the dollar value of imports rose by 11 per cent, but their volume growth was around 22 per cent (table 3.5.5).

Increases in imports reflected the growth of output (except in Kyrgyzstan) and, in Russia and Belarus,¹⁹⁷ real

¹⁹⁷ In Russia, for example, it is estimated that one half of the increase in imports can be attributed to the combined effect of GDP growth and the real appreciation of the rouble. EIU, *Country Report Russia* (London), December 2002, p. 37.

exchange appreciation against the dollar and the euro. Imports of investment goods were strong throughout the CIS, a function of increased investment outlays (except in Kyrgyzstan). In particular, in Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, the Republic of Moldova and Russia imports of machinery, equipment and transportation vehicles increased between 8 and 23 per cent in the January-September 2002 period, year-on-year. The increased demand for imported consumer goods was driven by the continuing rise in consumer demand (section 3.2 above) in most CIS countries.

The region's aggregate merchandise trade surplus fell by \$3 billion to \$45 billion mainly because of falling surpluses in Azerbaijan and Russia. In both cases this was due to lower crude oil prices and the increased value of imports.

Trade with non-CIS countries

In the first three quarters of 2002, the value of exports from the CIS countries to the rest of the world increased by 2 per cent (table 3.5.5). In almost half of the CIS countries the dollar value of their exports fell between 1-2 per cent (Azerbaijan, Russia and Uzbekistan) and 14 per cent (Turkmenistan). In the others, exports to the non-CIS area increased from 8 per cent in Kyrgyzstan (despite the stoppage of gold production in the third quarter) to 62 per cent in Armenia. In the latter (which became the latest member of the WTO in December 2002), exports of goods – dominated by sales of precious stones and metals to Belgium and Israel – were driven by jewellery sales. There were also large increases in exports from Belarus, Kazakhstan, the Republic of Moldova, Tajikistan and Ukraine (15 to 23 per cent). In Kazakhstan, a one-third increase in shipments of crude oil was the dominant factor behind the 15 per cent increase in the value of exports to non-CIS countries. The Republic of Moldova continued to expand exports of agricultural products and textiles (up 13 per cent) destined mostly for EU markets. Moreover, its sales of steel and base metals also rose considerably. Tajikistan's exports to non-CIS countries rose on the strength of a doubling in the volume of cotton exports and a one-third increase in shipments of aluminium. Russian exports to non-CIS markets fell slightly in value (1 per cent) but the increase in volume remained at over 7 per cent.¹⁹⁸ The value of Russia's non-CIS exports of machinery and transport equipment (including arms and military equipment) was unchanged. In other CIS countries such as Azerbaijan and Belarus the increased export volumes of crude oil and refined products were related to production increases and, to a much lesser extent, shifts in the sales of these products away from CIS markets.

¹⁹⁸ The volume of Russian exports of crude oil and oil products to non-CIS markets rose by 8 and 17 per cent, respectively, in the January-September 2002 period, year-on-year. Natural gas exports increased by 3 per cent in volume terms while metal sales were mixed: exports of steel products and nickel rose while copper and aluminium were down, year-on-year.

In January-September 2002, the value of CIS imports from non-CIS countries rose by 16 per cent, largely due to the fast-growing CIS economies. However, they fell in Georgia, Turkmenistan and Uzbekistan. In general, the CIS countries buy machinery and equipment as well as foodstuffs from the non-CIS. In the first three quarters of 2002, the value of Russian imports from non-CIS countries continued to increase (up by 21 per cent) and their volume by much more (up by 31 per cent). The dollar value of Russian imports of machinery and equipment (including cars) increased by one third,¹⁹⁹ as did imports of foodstuffs and consumer durables such as meat, alcohol and furniture. Large increases in imports of machinery and equipment were also evident in many other rapidly growing CIS economies. In Belarus, Kazakhstan and the Republic of Moldova their value rose by about 25 per cent. Even in Kyrgyzstan, where GDP shrank in the first three quarters of 2002, imports of machinery and equipment from the non-CIS were almost 50 per cent higher than in the corresponding period of 2001.

Intra-CIS trade

In the first nine months of 2002, the dollar value of intraregional trade declined by 4 to 6 per cent but there were large differences between Russia and the other CIS countries. Russia's trade with other CIS countries is a major determinant of total intraregional trade and is crucial for many individual CIS countries. Despite the growth of the Russian economy and the real appreciation of the Russian rouble against other regional currencies, the value of Russian imports from other CIS members fell by 15 per cent.²⁰⁰ Kyrgyzstan's exports to Russia rose by 13 per cent and those of Armenia and Belarus were unchanged, but for all the remaining CIS countries there were falls of between 22 and 65 per cent.

The value of Russia's imports of machinery and equipment from the CIS – representing about a third of total imports from the CIS – declined by 4 per cent to just over \$2 billion, while steel products fell by a half. Most of Russia's imports of consumer products and foodstuffs, such as grain, cotton and clothes, also declined.

In the third quarter of 2002, a 20 per cent increase in the volume of Russia's CIS imports (offsetting the losses in the first half of the year) was reflected in a surge in the other CIS countries' exports to Russia. This may be a statistical effect, however, related to the switch in Russia to a VAT regime based on country of destination

¹⁹⁹ The volume of imports of machinery and equipment from non-CIS countries rose by an estimated 50 per cent during the January-September 2002 period.

²⁰⁰ The decline in value reflected lower average prices as, according to Russian data, the import volume was unchanged for the first three quarters of 2002. In the first three quarters of 2002, year-on-year, the Russian rouble appreciated in real terms against all the other CIS currencies. The increases ranged between 4 per cent against the Ukrainian hryvnia to 14 to 16 per cent against the currencies of Armenia, Azerbaijan and Georgia (chart 3.1.3)

(where exports are zero-rated while imports are taxable).²⁰¹ The value of Russia's exports to CIS countries increased slightly (by 2 per cent) in the first nine months of 2002, but the volume surged by about a quarter. Russia shipped greater quantities of natural gas, crude oil and refined products, but the value of its exports of machinery and equipment to the CIS area declined by 7 per cent.

Intraregional exports and imports of the rest of the CIS countries fell in dollar value in the first three quarters of 2002, year-on-year. Exports fell by 10 per cent in aggregate with seven CIS countries reporting falls of between 2 per cent in Azerbaijan to about one third in Uzbekistan. In the remaining countries such as Armenia, Georgia and the Republic of Moldova the value of exports increased slightly (2 to 5 per cent), although Turkmenistan's exports to its regional partners increased by 14 per cent. A multitude of factors were behind these outcomes. Large increases in the volume of sales of oil products, which account for almost half of Azerbaijan's regional exports (offset to a limited extent by lower prices) helped to keep the value of CIS exports roughly unchanged from 2001. In Georgia, exports to Russia declined by more than one fifth in value, but they were offset by sales of aircraft and parts to Azerbaijan. Kazakhstan's CIS exports fell by 21 per cent, grain and coal exports decreasing by a half and the value of crude oil exports by almost a third. Kyrgyzstan – a supplier of electricity to central Asia – exported 60 per cent less of it in the first nine months of 2002, year-on-year. Tajikistan – facing lower prices for its three main commodity exports (electricity, cotton and aluminium) – shipped about 20 per cent more cotton but less energy and aluminium to its regional partners. Turkmenistan has continued to supply natural gas to Russia and Ukraine, reportedly at slightly higher prices, thus contributing to the increase in the value of its CIS exports in the first three quarters of 2002. The volume of natural gas shipped from Turkmenistan has increased since the signing of a transit agreement with Russia in 2000. In contrast, Uzbekistan, which sells electricity, natural gas and crude oil to other CIS countries, reported a one-third decline in the value of these exports.

(iii) External financing and FDI

There was a marked upturn in net capital and financial flows into *eastern Europe* in the first three quarters of 2002 (tables 3.5.6 and 3.5.7), in spite of the

unfavourable global economic environment and a generally heightened aversion to risk among investors.²⁰² While part of the increase is due to a few large-scale privatizations, other factors such as the progress towards macroeconomic stabilization, continuing structural reforms, comfortable (or improving) foreign currency positions and the approaching membership in the EU for eight countries, have helped to reduce international investors' perception of risk in this part of the world. This, together with the willingness of investors to differentiate among countries, has contributed to the improving credit worthiness of many countries (including some of the CIS – see below and subsection iv) and the lowering of borrowing costs in the past two years. Moreover, the east European economies largely avoided financial contagion in 2002 (from Brazil and Turkey) and some of the advanced reformers even emerged as safe havens for investors during periods of market turbulence. However, the situation varies considerably across countries, with conditions in most of the CIS and some south-east European countries tending to discourage private (and in some cases even official) inflows.

The increase in financial flows into eastern Europe in 2002 reflects, above all, a renewed surge in short-term capital flows (a \$10 billion reversal), which brings to a halt the significant outflows reported in 1999-2001 (table 3.5.7). The recent inflows, including the return of deposits from abroad, were relatively more important and widespread in south-east Europe than in central Europe. FDI rose sharply and remained the leading source of finance, but its growth was concentrated in the Czech Republic, Slovakia and Slovenia where it also raised total financial inflows. Net portfolio investment declined due to the sell-off in the equity markets of several countries, although this was partly offset by the stronger demand for local bonds and an increase in new international bond issues. In the latter part of 2002, the stock markets of the Czech Republic, Hungary and Poland were among the best performing in the world, thanks in part to foreign investment. Net borrowing of medium- and long-term funds, however, has remained subdued. In general, financial inflows exceeded current account deficits and most countries continued to accumulate official reserves (tables 3.5.6 and 3.5.8), which in several cases had placed substantial upward pressure on the exchange rate. On average, the official reserves of the east European countries cover five months' worth of imports of goods and services and in most countries they exceed the generally recommended three months of coverage. Hungary was an exception in 2002, reporting weaker financial flows (in part because of the fall in net FDI) and a sharp reduction in foreign exchange reserves.

²⁰¹ Anticipation of the change in the VAT regime (in July 2001) prompted increased imports in the first half of 2001 followed by a sharp decline in the third quarter. Subsequent to the third quarter of 2002, the declining trend in dollar value appears to have resumed. For the January-November 2002 period, year-on-year, Russia's imports from the CIS fell by 11 per cent. Only Armenia and Kyrgyzstan shipped more to Russia in value terms (about 15 per cent), imports from Azerbaijan and Belarus were flat, while for all other countries there were declines of at least 20 per cent. During the same period, Russian exports to the CIS area were 6 per cent greater in value, with a 14 per cent decrease in exports to Kazakhstan and slightly lower exports to Tajikistan and Turkmenistan.

²⁰² The IIF has estimated that capital flows to a selection of emerging market economies stagnated at some \$140 billion in 2002, which reflects a further decline in private capital flows. IIF, *Capital Flows to Emerging Market Economies* (Washington, D.C.), 18 September 2002.

TABLE 3.5.6
Net financial flows into east European and CIS economies, 2000-2002
 (Million dollars, per cent)

	Capital and financial account flows ^a								Changes in official reserves ^b (million dollars)		Changes in reserves/GDP ^b (per cent)	
	Million dollars				Capital flows/GDP				Jan.-Sep.		Jan.-Sep.	
	2000	2001	Jan.-Sep.		2000	2001	Jan.-Sep.		2001	2002	2001	2002
			2001	2002			2001	2002				
Eastern Europe	27 050	28 094	18 725	29 954	6.6	6.2	5.7	8.3	7 942	13 613	1.8	3.8
Albania	288	363	293	355	7.7	8.8	9.5	10.2	145	37	3.5	1.1
Bosnia and Herzegovina.....	1 000	1 892	950*	1 010*	22.5	41.0	27.5	27.1*	766	10	16.6	0.3
Bulgaria	1 111	1 117	134	396	8.8	8.2	1.4	3.6	275	336	2.0	3.0
Croatia	1 021	1 930	1 141	1 170	5.5	9.9	7.8	7.1	1 313	646	6.7	3.9
Czech Republic	3 536	4 390	2 617	8 886	6.9	7.7	6.3	17.8	1 765	6 350	3.1	12.7
Estonia	416	293	49	570	8.1	5.3	1.2	12.1	-47	25	-0.8	0.5
Hungary ^c	2 388	1 008	1 411	756	5.1	1.9	3.8	1.7	-97	-1 537	-0.2	-3.4
Latvia	486	1 037	431	407	6.8	13.7	7.8	6.8	305	5	4.0	0.1
Lithuania.....	806	899	510	656	7.1	7.5	5.8	6.6	325	291	2.7	2.9
Poland	10 573	6 726	6 261	5 916	6.5	3.7	4.7	4.4	-440	1 057	-0.2	0.8
Romania	2 283	3 707	2 391	2 392	6.2	9.3	8.8	7.9	1 484	1 435	3.7	4.7
Slovakia	1 525	1 899	844	3 988	7.7	9.3	5.5	23.3	143	2 778	0.7	16.3
Slovenia	726	1 254	591	731	4.0	6.7	4.2	4.7	1 285	1 101	6.8	7.1
The former Yugoslav Republic of Macedonia	326	318	257	194	9.1	9.3	10.0	7.1	82	-18	2.4	-0.6
Yugoslavia	566	1 261	847	2 527	8.1	12.2	10.9	24.7	637	1 098	6.2	10.7
CIS^d	-30 674	-23 290	-17 209	-13 647	-8.7	-5.6	-5.7	-4.0	10 544	11 218	2.5	3.3
Armenia	298	216	132	..	15.6	10.2	9.4	..	20	..	0.9	..
Azerbaijan	442	317	92	..	8.4	5.6	2.3	..	266	..	4.7	..
Belarus	399	270	-76	-13	3.8	2.2	-0.8	-0.1	-5	-52	-	-0.5
Georgia	242	258	171	180*	7.9	8.1	7.3	7.5	47	20	1.5	0.8
Kazakhstan	-534	1 626	863	858	-2.9	7.3	5.2	4.8	385	614	1.7	3.4
Kyrgyzstan	101	35	-40	37	7.4	2.3	-3.5	3.2	16	27	1.1	2.3
Republic of Moldova	152	101	70	95	11.8	6.8	6.7	8.3	9	42	0.6	3.7
Russian Federation	-30 829	-26 630	-18 867	-14 159	-11.9	-8.6	-8.3	-5.6	8 212	9 825	2.6	3.9
Tajikistan	91	82	90	-10	9.2	7.9	13.0	-1.4	8	-7	0.8	-1.0
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine	-1 083	204	-51	-1 276	-3.5	0.5	-0.2	-4.3	1 606	809	4.2	2.7
Uzbekistan	-153	80*	136*	..	-1.1	0.7	1.6	..	130*	..	1.1	..
Total above^d	-3 624	4 804	1 516	16 307	-0.5	0.6	0.2	2.3	18 486	24 831	2.1	3.5
<i>Memorandum items:</i>												
Baltic states	1 708	2 229	990	1 633	7.2	8.9	5.4	7.9	583	321	2.3	1.6
Central Europe	18 749	15 277	11 724	20 277	6.3	4.6	4.9	7.7	2 657	9 749	0.8	3.7
South-east Europe	6 594	10 588	6 012	8 044	7.6	11.1	8.8	10.3	4 703	3 543	4.9	4.5
CIS without Russian Federation	155	3 340	1 658	512	0.2	3.2	2.2	0.6	2 332	1 393	2.2	1.6
Caucasian CIS^d	981	792	395	570	9.6	7.2	5.1	7.0	332	-40	3.0	-0.5
Central Asian CIS^d	-295	1 974	1 320	1 136	-0.8	4.7	4.2	3.2	389	634	0.9	1.8
Three European CIS	-532	575	-57	-1 194	-1.2	1.1	-0.2	-2.9	1 610	799	3.1	1.9
Russian Federation ^e	-21 673	-16 521	-11 468	-8 882	-8.4	-5.3	-5.1	-3.5	8 212	9 825	2.6	3.9

Source: UNECE secretariat calculations, based on national balance of payments statistics; IMF, *Staff Country Reports* (Washington, D.C.), for Bosnia and Herzegovina, Tajikistan and Uzbekistan [www.imf.org]; TACIS, *Azerbaijan Economic Trends* (Baku). No balance of payments data have been available for Turkmenistan since 1998.

^a Includes errors and omissions; excludes changes in official reserves.

^b A negative sign indicates a decrease in reserves.

^c Excludes reinvested profits (net inflow).

^d Totals include secretariat estimates for Armenia, Azerbaijan, Turkmenistan and Uzbekistan.

^e Excluding errors and omissions.

The fall in net capital outflows from *Russia* continued in 2002. Among other things, this reflects a reversal in the substantial build-up of residents' deposits abroad, a sharp slowdown in the repayment of medium-

term credits and a fall in unrecorded capital outflows (as reflected in the errors and omissions item of the balance of payments). Estimates of capital flight indicate that it slowed in January-June but quickened again in the third

TABLE 3.5.7
Net financial flows by type of capital into eastern Europe and the European CIS, 2000-2002
(Billion dollars)

	Eastern Europe ^a				Baltic states				Three European CIS ^b			
	2000	2001	Jan.-Sep.		2000	2001	Jan.-Sep.		2000	2001	Jan.-Sep.	
			2001	2002			2001	2002			2001	2002
Capital and financial account	24.5	22.6	16.5	31.4	1.6	2.0	1.0	1.5	-0.6	0.9	0.3	-0.7
Capital and financial account ^c	27.1	28.1	18.7	30.0	1.7	2.2	1.0	1.6	-0.5	0.6	-0.1	-1.2
of which:												
FDI	20.9	20.8	13.3	17.7	1.1	0.9	0.8	1.0	0.9	1.0	0.8	0.6
Portfolio investment	2.3	4.8	4.6	3.7	0.1	0.5	0.2	-	-0.1	-0.9	-0.6	-1.2
Medium-, long-term funds	5.5	0.8	0.6	1.9	-	0.2	-	-0.1	-1.2	0.6	0.2	0.3
Short-term funds	-5.2	-5.0	-2.9	7.4	0.4	0.4	-0.1	0.6	-0.3	0.1	-0.2	-0.4
Errors and omissions	2.5	5.5	2.3	-1.4	0.1	0.2	-	0.1	0.1	-0.3	-0.3	-0.5

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

^a Includes the Baltic states.

^b Belarus, Republic of Moldova and Ukraine.

^c Including errors and omissions.

quarter.²⁰³ The better-than-expected current account surplus and the slowing of net financial outflows raised official reserves by some \$12 billion to \$44.5 billion (excluding gold), almost six months of import cover. This, and various provisions in the draft budget for 2003, have boosted confidence that Russia will meet its higher debt servicing obligations in 2003 and beyond.

The *three European CIS* countries have generally attracted little capital, and this was again the case in 2002, each obtaining only modest amounts of FDI and officially-backed medium-term loans. Such funds and Ukraine's current account surplus have financed an outflow of portfolio investment and made possible further additions to official reserves. All three countries show signs of capital flight, which in Belarus and Ukraine contributed to a net outflow on the financial account, and in Belarus to a fall in official reserves as well. Although reserves rose in the Republic of Moldova they remain relatively low. Financial data are available for only a few of the *Asian CIS*. In Azerbaijan and Kazakhstan, FDI, presumably in the petroleum sector, has provided the bulk of new financing. FDI was also dominant in Armenia, but it was virtually absent in Kyrgyzstan where new loans prevailed. It is difficult to generalize about this group of countries because of the large differences in the magnitude and composition of capital flows. Moreover, progress towards raising the level of official reserves to the recommended equivalent of three months of imports has been far from uniform.

²⁰³ Estimates by JP Morgan show capital flight increasing from \$11.4 billion in January-June to \$17 billion in the third quarter of 2002 (both estimates on an annualized basis). These figures reflect a favourable shift to positive net foreign cash purchases and net foreign currency deposits balances; but outflows, including unrepatriated overdue export proceeds, unexecuted import advances and errors and omissions, increased sharply in the third quarter. JP Morgan, *Emerging Europe, Middle East and Africa Weekly* (London), 18 January 2003.

The favourable international credit ratings acquired by many countries in the region have facilitated foreign borrowing including especially the issuance of new external bonds. As of early 2003, 10 east European and CIS countries (the eight EU accession countries, Croatia and Kazakhstan) have been rated investment grade risks and five countries are rated sub-investment grade.²⁰⁴ Kazakhstan reached this milestone in September 2002 when Moody's upgraded it by two notches to Baa3, the lowest investment grade rating.²⁰⁵ Moody's and Standard and Poor's upgraded Russia again in December 2002 (to Ba2 and BB, respectively), as a result of its growth performance and the continuing improvement in its financial position.²⁰⁶ During the past two years the yield on the country's sovereign debt has fallen dramatically, by 200 basis points in 2002 alone. In November, Moody's raised the foreign debt ratings of the eight EU accession countries to eliminate the gap between the foreign and the (higher) rated domestic debt.²⁰⁷ The justification for this move was that the process of economic and financial integration of these countries with the EU is now virtually irreversible. Although agreement with this move was not universal, it is clear that the recent credit upgrades are a continuation of a long-term trend that reflects the increasing

²⁰⁴ Azerbaijan, Bulgaria, Romania, Russia and Ukraine. In November, Standard and Poor's lowered Ukraine's outlook from stable to negative, due, *inter alia*, to concern about the country's fiscal position, which had been weakened by shortfalls in privatization revenues. Also see subsect. iv below.

²⁰⁵ In addition to increased oil exports expected in the medium term (due to the construction of a new oil pipeline), Moody's cited key accomplishments such as the creation of an oil stabilization fund, a stable banking sector with a deposit insurance scheme and the implementation of a pension scheme, as justification for the upgrade.

²⁰⁶ Both agencies upgraded Russia by one notch in December 2002.

²⁰⁷ Moody's raised the Czech Republic's sovereign bond rating to A1 from Baa1, Estonia A1 (Baa1), Hungary A1 (A3), Latvia A2 (Baa2), Lithuania Baa1 (Ba1), Poland A2 (Baa1), Slovakia A3 (Baa3), and Slovenia Aa3 (A2).

TABLE 3.5.8
Selected external financial indicators for eastern Europe and the CIS, 1999, 2000 and 2002
(Million dollars, per cent)

	Gross debt, World Bank data (million dollars)		Gross debt, national data (million dollars)		Gross debt/exports (per cent) ^a			Gross debt/GDP (per cent)		Official reserves			
	2000		2000	2002 ^c	1999	2000	2002 ^c	2000	2002 ^c	Million dollars		Months of imports ^a	
	Gross	Present value ^b								2001	2002	2001	2002
Eastern Europe.....	..	..	201 168	232 723	119	112	109	49	46	79 546	100 299	4.1	4.8
Albania.....	784	485	1 130	1 090*	170	138	98	30	23	363	411	2.4	2.2
Bosnia and Herzegovina....	2 828	2 286	2 870	2 500*	186	168	159	64	49	1 221	1 165	4.9	4.3
Bulgaria.....	10 026	9 617	11 202	10 553	180	153	126	89	67	3 291	4 204	4.3	5.4
Croatia.....	12 120	12 114	11 002	13 675	118	122	125	60	62	4 703	5 852	4.9	5.4
Czech Republic.....	21 299	21 419	21 608	23 824	65	57	51	42	35	14 341	22 456	3.8	5.4
Estonia.....	3 280	3 054	3 007	4 160	70	61	75	59	66	820	923	1.7	1.7
Hungary.....	29 415	27 841	30 742	38 222	104	93	95	66	61	10 727	9 694	3.4	2.7
Latvia.....	3 379	3 332	4 701	6 391	124	135	160	66	77	1 149	1 115	3.1	2.6
Lithuania.....	4 855	4 772	4 857	6 000*	104	92	81	43	43	1 618	2 146	2.7	3.1
Poland.....	63 561	58 144	69 465	78 735	162	143	142	42	42	25 648	28 184	6.1	6.7
Romania.....	10 224	10 006	10 658	14 705	92	86	94	29	33	5 442	7 049	3.8	4.4
Slovakia.....	9 462	9 071	10 804	11 881	84	75	71	55	51	4 141	8 422	2.9	5.4
Slovenia.....	..	..	6 217	7 988	49	56	62	34	38	4 330	5 969	4.4	5.7
The former Yugoslav													
Republic of Macedonia.....	1 465	1 252	1 488	1 527	99	88	114	41	41	745	793	4.4	4.4
Yugoslavia.....	11 960	12 007	11 418	11 472	491	439	376	164	85	1 007	1 916	2.3	3.4
CIS^d.....	..	..	211 849	205 954	176	125	118	60	44	42 060	55 554	3.6	4.5
Armenia.....	898	598	860	1 020*	179	156	130	45	44	321	388	3.8	4.2
Azerbaijan.....	1 184	991	1 170	1 410*	74	54	60	22	23	897	692	4.2	2.8
Belarus.....	851	804	2 299	2 210*	37	30	25	22	15	391	362	0.5	0.5
Georgia ^e	1 633	1 271	1 610	1 700*	225	191	184	53	51	160	197	1.4	1.8
Kazakhstan ^f	6 664	6 689	12 685	17 377	172	120	160	69	71	1 997	2 448	2.0	2.5
Kyrgyzstan.....	1 829	1 405	1 704	1 730	306	292	273	124	108	264	281	4.9	4.4
Republic of Moldova ^f	1 233	1 138	1 547	1 590	204	190	138	120	100	229	264	2.2	2.2
Russian Federation.....	160 300	148 076	171 800	160 000*	210	144	134	66	46	32 542	44 470	4.7	5.9
Tajikistan.....	1 170	940	1 226	1 017*	174	148	133	124	85	96	88	1.4	1.2
Turkmenistan.....	..	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine ^{eg}	12 166	11 500	10 348	10 700*	72	53	47	33	27	2 955	4 165	1.7	2.2
Uzbekistan ^g	4 340	4 245	4 300	4 800*	120	128	164	31	49	1 208	..	4.3	..
Total above^d.....	..	..	413 017	438 677	145	118	113	54	45	606	155 854	3.9	4.7
Memorandum items:													
Baltic states	11 514	11 158	12 565	16 551	97	92	98	53	58	3 587	4 184	2.5	2.5
Central Europe.....	..	..	138 836	160 650	113	107	104	46	44	59 188	74 726	4.3	5.1
South-east Europe	49 407	47 767	49 768	55 522	152	140	132	57	51	16 772	21 390	4.0	4.6
CIS without Russian													
Federation^d.....	..	..	40 049	45 954	102	80	83	44	39	9 518	11 085	2.0	2.3
Caucasian CIS	3 715	2 860	3 640	4 130	138	102	102	36	35	1 378	1 277	3.4	2.8
Central Asian CIS^d.....	..	..	22 215	27 324	160	122	147	57	55	4 565	5 017	2.7	3.0
Three European CIS	14 250	13 442	14 194	14 500	67	50	45	33	26	3 575	4 791	1.4	1.7

Source: National statistics; IMF, *International Financial Statistics*, January 2003 and *Staff Country Reports*, various issues (Washington, D.C.); press reports; UNECE secretariat estimates. Debt ratios reflect the latest available debt data, available as of mid-January 2003. World Bank, *Global Development Finance 2002* (Washington, D.C.), 2002 is the source for World Bank data for gross debt and the present value of debt servicing.

^a Exports of merchandise and services, and income receipts. Total imports of merchandise and services, and income payments.

^b For its classification of countries by indebtedness, the World Bank relies on estimates of the present value of total debt service (PV) in a particular year rather than using gross external debt. PV is lower than gross debt for those (mostly low-income) countries that benefit from some kind of concessional financing. See also section 3.5(iv) and table 3.5.11.

^c Gross debt at end September or latest available data.

^d Totals include UNECE secretariat estimates for Turkmenistan.

^e Gross debt excludes cross-border inter-enterprise arrears.

^f Gross debt includes cross-border inter-enterprise arrears.

^g Government and government guaranteed debt only.

credit worthiness of many countries in the area, especially those in the forefront of economic reform (subsection iv).²⁰⁸ These ratings and the closer association with the EU have helped to insulate these countries from bouts of turbulence in the international financial markets. During the summer of 2002, when there was mounting concern about the situation in Brazil, spreads on the bonds of several countries, rated as sub-investment grade, widened temporarily. However, investment grade bonds of central European countries were hardly affected.

Bond issuance by eastern Europe and the CIS picked up from \$6.3 billion in 2001 to over \$11 billion in 2002 (table 3.5.9). Russian businesses, mainly oil companies, raised about \$3.4 billion.²⁰⁹ Poland was the largest sovereign borrower raising about \$3.1 billion, partly because of the need to finance a fiscal gap (Poland followed with a €1.5 billion bond in January 2003). Bulgaria swapped \$1.3 billion of Brady Bonds for eurobonds, an operation that resulted in a small reduction in external debt. In November-December, Ukraine managed to add \$400 million to an existing bond (maturing in 2007), but at the cost of a high yield (the coupon was almost 11 per cent). This was more than the \$350 million that the authorities had planned in the first such operation since Ukraine's financial crisis in 1998. Overall governments and government agencies issued bonds worth \$7 billion while business, mostly in Russia, accounted for the \$4 billion balance.

Despite the generally unfavourable international climate for FDI,²¹⁰ inflows into eastern Europe rose sharply in the first three quarters of 2002 (table 3.5.10). The Czech Republic led the way with record investments – estimated at almost \$8 billion for the whole year – thanks largely to the €4 billion privatization of Transgas, the Czech natural gas monopoly. The sale of SPP, the local natural gas monopoly, for \$2.7 billion accounts for most of the record FDI in Slovakia. Slovakia appears to be increasingly attractive to foreign investors having recently won the competition for a new Peugeot-Citroen plant.²¹¹ In Slovenia FDI was also at a record, a second consecutive rise in 2002 following a change in policy toward FDI. Delays in various privatization plans partially explain the decline in FDI in Poland and Hungary (although there is little left to privatize in

²⁰⁸ Credit upgrades between the beginning of 2000 and early 2002 are discussed in UNECE, *Economic Survey of Europe, 2002 No. 1*, chap. 3.5(iv).

²⁰⁹ Despite the reduced costs of borrowing, the Russian government did not issue any international bonds in 2002, and so far it does not have any plans to do so in 2003, provided that oil prices do not collapse.

²¹⁰ The IIF has estimated that net direct investment in the emerging markets fell in 2002 because of the weak global economy, concerns about prospects for profitability, limited privatizations and perceptions of a greater risk of investing in emerging markets. IIF, op. cit.

²¹¹ The deal is worth \$740 million, making it the largest greenfield investment in Slovakia. The Czech Republic, Hungary and Poland were also in the running for the plant. *Financial Times*, 16 January 2003.

TABLE 3.5.9

Eurobond issues of east European and CIS countries, 2000-2002
(Million dollars)

	2000	2001	2002
Eastern Europe	4 169	5 419	6 863
Bulgaria.....	–	223	1 303
Croatia.....	490	670	575
Czech Republic.....	–	233	350
Estonia.....	196	–	295
Hungary.....	196	853	–
Latvia.....	–	178	–
Lithuania.....	319	222	380
Poland.....	1 316	1 387	3 149
Romania.....	147	1 161	665
Slovakia.....	1 114	–	146
Slovenia.....	392	494	–
CIS	350	927	4 170
Kazakhstan.....	350	150	420
Russian Federation.....	–	777	3 350
Ukraine.....	–	–	400
Total above	4 519	6 345	11 032

Source: *International Insider and Financial Times*, various issues.

Hungary).²¹² In south-east Europe, inflows of FDI have lagged those in central Europe and the Baltic states, and in 2002 they even appear to have lost some of the momentum generated by earlier privatizations. Only Bosnia and Herzegovina and Yugoslavia, two countries that first started to receive FDI in the late 1990s, reported increases. A recent study attributed the generally low level of FDI in the area to delays in implementing economic reforms that would be favourable to investment.²¹³

In most CIS countries the long-standing perception of a poor investment climate appears to have deterred foreign investment, despite several consecutive years of economic growth. However, in Azerbaijan and Kazakhstan the oil sector continues to attract relatively large inflows. Russia, a major oil producer, has received only about \$2-\$3 billion annually in recent years, less than its annual FDI abroad. In the low-income CIS countries, the results with FDI have been mixed with Georgia and the Republic of Moldova receiving quite a bit more than Kyrgyzstan and, presumably, Tajikistan and Uzbekistan.

²¹² In September it was estimated that Poland was likely to collect only about one third of the privatization revenues for which it had budgeted. JP Morgan, *Emerging Europe, Middle East and Africa Weekly* (London), 27 September 2002.

²¹³ *Financial Times*, 14 November 2002, based on OECD and Stability Pact Country Economic Teams, "Progress in policy reform in south-east Europe: monitoring instruments", September 2002. Of the 587 reforms planned since the start of 2000, only some 280 have been implemented. According to the study, Albania, Bulgaria, and Croatia have led in the implementation of reforms with The former Yugoslav Republic of Macedonia lagging behind. The OECD also examined Yugoslavia and found that Serbia ranked first in the whole sample and Montenegro last.

TABLE 3.5.10

Foreign direct investment in eastern Europe and the CIS, 2001-2002
(Million dollars, per cent)

	Inflows ^a (million dollars)			Inflows/GDP (per cent)		
	Jan.-Sep.			Jan.-Sep.		
	2001	2001	2002	2001	2001	2002
Eastern Europe	21 784	14 201	18 494	4.8	4.3	5.1
Albania.....	207	156	95	5.0	5.0	2.7
Bosnia and Herzegovina.....	130	98	180*	2.8	2.8	4.8
Bulgaria.....	694	494	289	5.1	5.0	2.6
Croatia.....	1 512	868	653	7.7	5.9	4.0
Czech Republic.....	4 916	3 186	7 068	8.7	7.7	14.1
Estonia.....	542	408	223	9.8	9.9	4.7
Hungary ^b	2 443	1 877	834	4.7	5.0	1.8
Latvia.....	154	246	349	2.0	4.5	5.8
Lithuania.....	446	346	577	3.7	3.9	5.8
Poland (cash basis).....	6 995	4 149	2 612	3.8	3.1	1.9
Romania.....	1 157	743	741	2.9	2.7	2.4
Slovakia.....	1 475	859	3 391	7.2	5.6	19.8
Slovenia.....	503	289	1 105	2.7	2.1	7.1
The former Yugoslav						
Republic of Macedonia.....	443	402	67	12.9	15.7	2.5
Yugoslavia.....	165	80	310	1.6	1.0	3.0
CIS ^c	6 915	5 203	5 528	1.7	1.7	1.6
Armenia.....	70	58	60*	3.3	4.2	3.9
Azerbaijan.....	227	110	900*	4.0	2.8	21.7
Belarus.....	111	64	111	0.9	0.7	1.1
Georgia.....	110	81	100	3.4	3.5	4.2
Kazakhstan.....	2 748	1 900	1 852	12.4	11.5	10.3
Kyrgyzstan.....	4	18	2	0.3	1.6	0.1
Republic of Moldova.....	160	134	49	10.8	12.8	4.3
Russian Federation.....	2 469	2 021	1 829	0.8	0.9	0.7
Tajikistan.....	9	8	13	0.9	1.2	1.8
Turkmenistan.....	..	..	..	..	..	..
Ukraine.....	792	639	392	2.1	2.3	1.3
Uzbekistan.....	71*	55	100*	0.6	0.6	1.5
Total above ^c	28 699	19 404	24 022	3.3	3.1	3.5
<i>Memorandum items:</i>						
Baltic states	1 143	1 000	1 148	4.6	5.4	5.6
Central Europe	16 333	10 360	15 011	4.9	4.3	5.7
South-east Europe	4 309	2 841	2 335	4.5	4.1	3.0
CIS without Russian						
Federation ^c	4 446	3 182	3 699	4.2	4.2	4.4
Caucasian CIS	406	249	1 060	3.7	3.2	13.1
Central Asian CIS ^c	2 977	2 096	2 087	7.1	6.7	5.8
Three European CIS	1 063	837	552	2.1	2.2	1.3

Source: UNECE secretariat calculations, based on national balance of payments statistics; IMF, *Staff Country Reports* (Washington, D.C.) for Bosnia and Herzegovina, Yugoslavia, Tajikistan and Uzbekistan [www.imf.org]; TACIS, *Azerbaijan Economic Trends* (Baku).

^a Inflows into the reporting countries.

^b Excludes reinvested profits.

^c Totals include UNECE secretariat estimates for Turkmenistan.

On average, net FDI inflows through January-September 2002 exceeded the current account deficits of the central European countries (table 3.5.1), although Hungary was an exception. This structure of financing suggests a relatively low vulnerability of the current account to potential disruptions in the international capital markets. In general the ratio of net FDI to the current account deficit has been most favourable in central Europe.

(iv) Foreign indebtedness in eastern Europe and the CIS

The recent evolution of external debt divides the east European and CIS countries into roughly two groups: for the majority of the east European countries their debt performance has contributed to favourable international credit ratings; but for the CIS and south-east European countries, although some of them face heavy debt burdens, they nearly all have difficulties in attracting private capital. Concerns about the financial situations of several CIS countries were exacerbated by the rouble crisis in 1998 and in some cases by regional and ethnic conflicts. As a result, those most affected by these events, including five countries classified by the IMF and World Bank as "low-income" (Armenia, Georgia, Kyrgyzstan, Republic of Moldova and Tajikistan), have attracted increased attention from the international community. This subsection provides an overview of the debt situation in eastern Europe and the CIS. It also looks briefly at the implications of the emergence of large fiscal deficits in several east European countries and at the relationship between FDI and debt accumulation.

(a) Sources of indebtedness

The growth of gross external debt is a normal feature of the process of economic development.²¹⁴ Typically, countries catching up in terms of income levels seek investment resources beyond those that can be mobilized domestically, either because of low savings and/or underdeveloped systems of financial intermediation. These needs can be met by foreign resources, reflected in net imports of goods and services (a current account deficit) and in their counterpart, a surplus on the financial account of the balance of payments. Sizeable current account deficits have been a hallmark of many east European and CIS countries since the start of the transition (appendix table B.16). They have resulted in the build-up of external debt in the form of debt securities and foreign loans arranged by various domestic entities, namely:

- Governments, to finance, for example, infrastructure projects and budget deficits. The possible sources of funds are private investors, international financial institutions, agencies of other governments, etc.;
- Local commercial banks, to invest on their own account or for on-lending to local businesses;

²¹⁴ Gross external debt as used here is consistent with the definition adopted by the IMF, *Balance of Payments Manual*, Fifth Edition (Washington, D.C.), 1993. It is the amount, at any given time, of disbursed and outstanding contractual liabilities of residents of a country to non-residents to repay principal, with or without interest, or to pay interest, with or without principal. Debt differs from liabilities in the international investment position by its exclusion of equity securities (portfolio investment) and direct investment equity capital, including reinvested earnings. The stress on debt in risk analysis derives from the contractual obligations to service debt, which are not present in the case of equities.

- Resident business, to finance capital investment. Businesses may borrow abroad from commercial banks or issue bonds. Subsidiaries of multinationals often borrow from the parent firm (inter-company loans).²¹⁵

The scope for such debt creating operations varies considerably among the transition economies, depending on the credit worthiness of their governments (reflected in their sovereign credit ratings) and of their local companies and banks, and on the development of the domestic debt markets. Among other things, financial inflows are determined by the domestic demand for capital and the differential between local and international interest rates.²¹⁶

Current account deficits may also be financed by portfolio or direct equity investment, neither of which are debt creating.²¹⁷ In recent years, the current account deficits of many east European countries have been largely or fully covered by FDI (see subsection iii above), which reflects the use of equity by the subsidiaries of multinational corporations to finance the import of goods and services for their local operations.²¹⁸ Consequently, the external debt of these economies has risen less than their cumulative current account deficits. Moreover, existing debt burdens are reduced if FDI spurs the growth of exports and GDP. For these reasons, FDI is the preferred mode of current account financing (although it too can eventually add to financing pressures).²¹⁹ Nonetheless, as noted above, there are reasons why external debt may increase even if FDI inflows equal or exceed a country's current account deficits.

Whether foreign borrowing results in a permanently higher debt burden depends on the overall performance of the economy. If debt-creating flows (and any FDI) are channelled into new capacities that raise output and exports, the debt burden can be kept in check and even reduced.²²⁰ In fact good economic performance has

enabled quite a few countries to "grow out" of their debt problems despite further increases in their debt stock.

The debt burden here is measured by the debt/exports²²¹ and debt/GDP ratios, which are presented for the period 1993 to 2002 (chart 3.5.3 and table 3.5.8). Both are indicators of debt sustainability and are commonly used to assess country risk. The accumulation of official reserves, which reduces net debt (i.e. gross debt minus official reserves, see table 3.5.8), is mentioned here only when there has been a major positive impact on a country's financial situation. On the whole, the east European and CIS countries have boosted official reserves considerably in recent years, often to the point of covering more than five months of imports of goods and services (subsection iii). This has improved their short-term debt servicing capacity, helped to insulate them from market turbulence and reduced the risk of default. Reserves have grown for a variety of reasons including foreign direct investment associated with privatization, current account surpluses (e.g. in Russia and Ukraine) and foreign borrowing.

(b) Country experiences with debt

Most of the east European and CIS countries are currently "less and moderately indebted", according to the World Bank's debt classification criteria, but a few of them are "severely indebted" (table 3.5.11).²²² A ranking of countries by credit worthiness²²³ gives a somewhat different picture (which underlines the fact that there is more to credit worthiness than the degree of indebtedness). On this ranking almost half of the east European and CIS countries rank in the upper half of the 151-country sample and virtually all the east European economies rank above the CIS. Nearly all the countries of the region saw their credit worthiness and world ranking improve in the six months to September 2002.

In general, the debt stock of the east European and the CIS countries rose in the 1990s, with several countries reporting substantial increases in 2002 (although a part of the rise was due to the depreciation of the dollar).²²⁴ However, debt burdens have risen by less, due to the resumption of output and export growth in the second half of the 1990s. However, this generalization conceals considerable differences between countries in the region (chart 3.5.3), including setbacks due to economic distress.

²¹⁵ Inter-company loans is IMF terminology.

²¹⁶ Typically businesses and governments borrow abroad if foreign interest rates are lower and/or there are expectations of real exchange rate appreciation (which lowers the burden of servicing foreign debt).

²¹⁷ The inter-company loans mentioned above are a form of FDI, which does create debt. It should be noted that while FDI does not create debt it does increase a country's liabilities.

²¹⁸ FDI is also associated with the privatization of state owned assets, which involves a cash payment to the host government (not linked to imports of goods and services) that can be used to reduce debt and/or increase official reserves.

²¹⁹ FDI can adversely affect the current account when companies repatriate and/or reinvest profits, both transactions counting as outflows. This is not an issue if a country's FDI stock is low, as it was at the beginning of the transition, but such outflows can grow as FDI accumulates and companies become profitable. However, unlike debt there is no obligation for companies to pay dividends to foreign equity holders and, of course, there is no principal to repay. In several countries, including the Czech Republic and Hungary, the repatriation and reinvestment of profits has reached substantial levels (see subsect. i).

²²⁰ Needless to say this applies to government borrowing for infrastructure, education, R&D and other investments that contribute to economic growth.

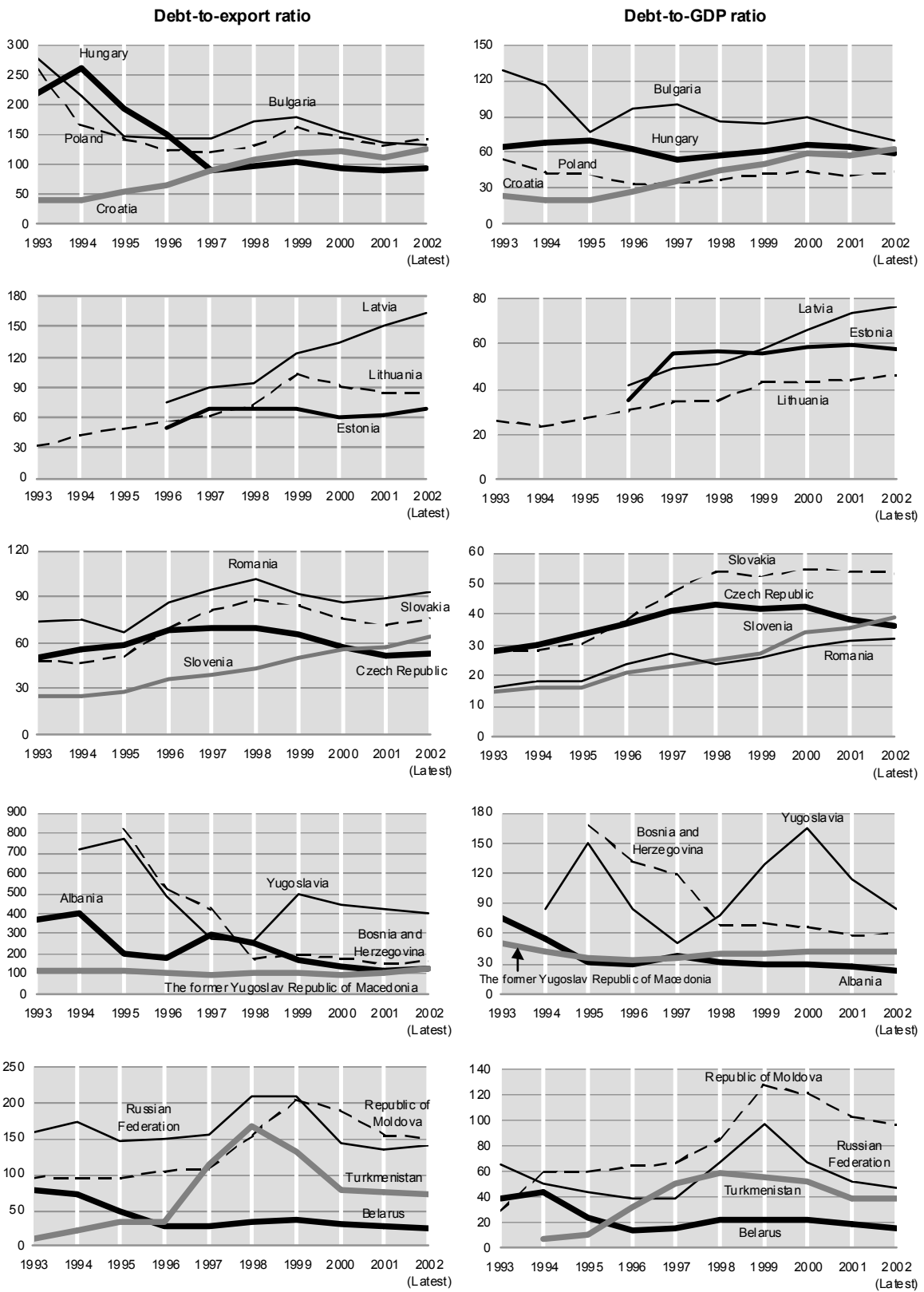
²²¹ Exports include goods, services and income. It does not include private transfers, which have become an important source of foreign exchange for some east European and CIS economies.

²²² It should be noted that classifications of several countries in table 3.5.11 differ from those in the World Bank's *Global Development Finance* (which rated countries on the basis of data to 2000). The differences are due to subsequent changes in debt indicators or differences in the underlying data. The ECE secretariat's calculations are based on national statistics, which in some cases differ from those used by the World Bank (e.g. see debt data in table 3.5.8).

²²³ *Institutional Investor*, September 2002. The *Institutional Investor* ranks 151 countries by its measure of credit worthiness.

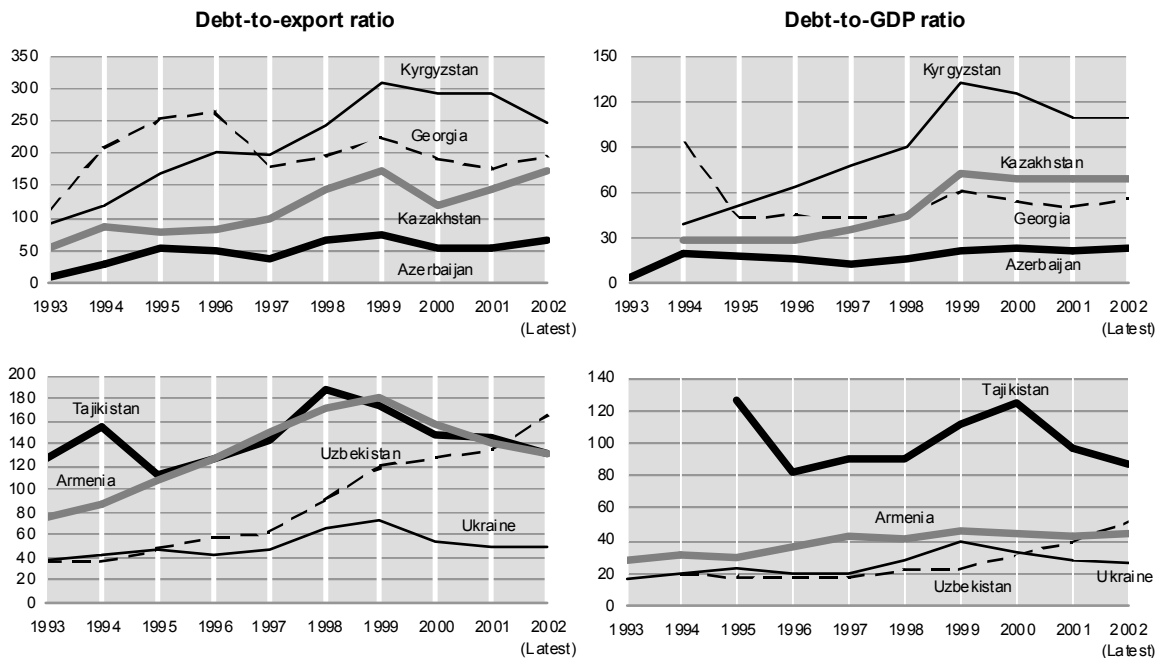
²²⁴ External debt is generally measured in dollars, but countries have also contracted liabilities denominated in other currencies. Thus, dollar depreciation raises the dollar value of the non-dollar component of debt.

CHART 3.5.3
 Foreign debt indicators for eastern Europe and the CIS, 1993-2002
 (Per cent)



(For source see end of chart.)

CHART 3.5.3 (concluded)
 Foreign debt indicators for eastern Europe and the CIS, 1993-2002
 (Per cent)



Source: UNECE secretariat calculations, based on national balance of payments, external debt and GDP data.

Note: Debt here refers to gross debt based on national data as indicated in columns 3 and 4 of table 3.5.8.

Eastern Europe

The eight central European and Baltic countries acceding to the EU in 2004 are all lightly to moderately indebted and they have been given investment grade credit ratings by the international rating agencies. Most of them have been successful in attracting foreign direct investment. The Czech Republic has traditionally been a low-debt country (which was also the case for the former Czechoslovakia), and its debt indicators and official reserves have improved considerably in the past few years. Slovakia was also lightly indebted until a surge in external debt moved it into the “moderately-indebted” category. However, the debt/GDP ratio appears to have stabilized and the debt/export ratio is very favourable.²²⁵ Slovenia inherited part of the debt of the former SFR of Yugoslavia (see below) but it quickly achieved international credit worthiness. It remains lightly indebted despite the long-term deterioration in both indicators. At the beginning of the transition Hungary and Poland were classified by the World Bank as moderately- and severely-indebted countries, respectively, but both have made substantial progress reducing their debt burdens. The nominal debt of Hungary was roughly constant until the upturn in the late 1990s. Although the growth of exports of goods (associated with FDI) and services led

to a dramatic decline in the debt/export ratio, the more modest improvement in the debt/GDP ratio has kept the country in the ranks of the moderately indebted. In the first half of the 1990s Poland benefited from debt write-offs in conjunction with the restructuring of its London and Paris Club obligations,²²⁶ but its debt was also lowered by the repayment of principal. External debt grew in the second half of the 1990s, but good economic performance has kept the debt/GDP ratio low. However, the debt/export ratio has tended to rise, moving the country into the “moderately-indebted” group. Poland’s financial position benefits from the largest reserves in central Europe. The Baltic countries began the transition with virtually no foreign debt (as was the case of the other states of the former Soviet Union, see below). Lithuania has remained lightly indebted, having recently checked the growth of its external liabilities. Increases in the debt burden have recently resulted in Latvia becoming a moderately indebted country. This classification does not change even when its position as a regional banking centre is taken into account (foreign currency and deposit liabilities are relatively large, accounting for over 30 per cent of external debt, but they are fully covered by bank assets). Estonia is also a moderately-indebted country whose debt indicators appear to have stabilized.

²²⁵ The debt export ratios of countries with open economies and rapid export growth – Estonia, Hungary, Latvia and Slovakia – have declined to low levels, but their debt/GDP ratios have not developed as favourably.

²²⁶ The debt write-off amounted to a 45 per cent reduction in the net present value of the eligible debt.

TABLE 3.5.11

Debt classifications and creditworthiness of eastern Europe and the CIS, 2002

Eastern Europe		CIS	
Less indebted			
Albania	(126+)	America.....	(na)
Czech Republic	(34+)	Azerbaijan	(93+)
Lithuania	(56+)	Belarus	(139+)
The former Yugoslav Republic of Macedonia	(108+)	Ukraine.....	(99+)
Romania	(79)		
Slovenia	(26+)		
Moderately indebted			
Bosnia and Herzegovina.....	(na)	Georgia	(132-)*
Bulgaria	(68+)	Kazakhstan.....	(71+)*
Croatia	(57+)	Russian Federation	(70+)
Estonia	(38+)	Tajikistan	(115+)
Hungary	(30)	Uzbekistan.....	(119)
Latvia	(35+)*		
Poland	(37-)*		
Slovakia	(54-)*		
Severely indebted			
Yugoslavia	(124-)*	Kyrgyzstan.....	(123-)
		Republic of Moldova	(130+)*
		Tajikistan	(140+)

Source: UNECE secretariat calculations; World Bank, *Global Development Finance 2002* (Washington, D.C.), 2002.

Note: The numbers in parentheses are the *Institutional Investor's* credit rankings of a total of 151 countries as of September 2002. A "+" indicates that the world ranking of the country was raised in the previous six months, a "-" that it has fallen, and no sign that there has been no change.

An (*) indicates a difference in classification from that in the World Bank source which classifies countries on the basis of data available through 2000. In these cases, the UNECE classification is one category lower than that of the World Bank, except for Yugoslavia, which the Bank rates "less indebted". The World Bank has not classified Slovenia.

The World Bank debt classification criteria based on the present value of total debt service (PV – see note to table 3.5.8) are: less indebted countries – PV/XGS less than 131 per cent and PV/GNP less than 48 per cent; moderately indebted countries – PV/XGS less than 220 per cent but higher than 132 per cent or PV/GNP less than 80 per cent but higher than 48 per cent; severely indebted countries – PV/XGS higher than 220 per cent or PV/GNP higher than 80 per cent. The UNECE secretariat has taken differences in PV and gross external debt (table 3.5.8) into account in constructing this table. Also see text.

South-east Europe includes Bulgaria and Romania (which are to accede to the EU in 2007), Albania and the successor states of the former SFR of Yugoslavia (except for Slovenia, discussed above). These countries are about evenly split between the less- and moderately-indebted categories and all of them have had difficulty in attracting FDI. Only Croatia is rated as an investment grade risk – Bulgaria and Romania are sub-investment grade – and they have achieved various degrees of access to private finance. The others in this group, including those that are "less indebted", are limited largely to bilateral and multilateral finance. Early in the 1990s, Albania and Bulgaria were rated as severely indebted by the World Bank. However, this is no longer the case, thanks to Bulgaria's policy of limiting external borrowing and a period of economic growth. The experience of Albania has been similar although nominal debt increased since

its partial write-off in 1995.²²⁷ Despite its status as a less-indebted country, it does not have access to the international financial markets. Romania paid off most of its foreign debt in the 1980s and the country remains relatively lightly indebted, despite the subsequent rise in the debt stock.

The former SFR of Yugoslavia had been a highly-indebted country in the 1980s and underwent several reschedulings. Its dissolution in the early 1990s, subsequent armed conflicts and the collapse of output triggered financial distress in the successor states.²²⁸ However, the extent of their financial recovery has varied considerably. After Slovenia (see above), Croatia was the next to receive an investment grade credit rating that has facilitated increased borrowing and it is now classified as a moderately-indebted country. There was a notable rise in the debt burden in 2002 despite an increase in the exports of goods and services. The nominal debt of the former Yugoslav Republic of Macedonia (a less-indebted country) has been relatively stable, but its economy has been periodically disrupted by internal conflicts and the events in Kosovo. Support has come in the form of a Paris Club rescheduling and the privatization of the state telecommunications company in 2001 significantly boosted official reserves. The debt indicators of Bosnia and Herzegovina have improved dramatically as output and exports recovered in the post-conflict period, thanks in part to significant amounts of foreign aid attached to the Dayton Accord. In 1998 a \$1 billion debt write-off contributed to its reclassification as a "moderately-indebted" country. However, weak economic growth and falling foreign aid has slowed the alleviation of the debt burden. The decline in Yugoslavia's debt indicators was interrupted by the impact of the Kosovo crisis in 1999, and it has remained a severely-indebted country. The agreement with the Paris Club in 2001 includes a two-thirds reduction in official debt, but it does not appear to have been implemented yet.²²⁹ The official reserves of all these countries have recently improved. In several cases (e.g. Yugoslavia) this was associated with the exchange of deutsche marks for euros, at which time the population deposited part of their hoarded cash in commercial banks.

²²⁷ Throughout much of the 1990s economic activity in Albania was heavily supported by foreign aid, which was also used to buy back heavily discounted bank debt in 1995.

²²⁸ UNECE, "Postwar reconstruction and development in south-east Europe", *Economic Survey of Europe, 1999 No. 2*, chap. 1. The external debt of the former SFR of Yugoslavia was apportioned among the successor states, but foreign exchange reserves, controlled by the Belgrade authorities, disappeared. Consequently, all these countries were forced to rebuild reserves from scratch.

²²⁹ According to the agreement with the Paris Club concerning \$4.5 billion of bilateral debt, \$3 billion are to be written off in two stages. After an EFF is arranged with the IMF, 51 per cent of the debt (in net present value terms) is to be cancelled. A further 15 per cent reduction will be made after successful completion of the programme. Paris Club, *Press Release*, 19 November 2001 [www.clubdeparis.org].

CIS

Aside from Russia, the CIS countries were virtually debt-free²³⁰ after the dissolution of the Soviet Union. However, all have subsequently accumulated debt, generally consisting of multilateral and bilateral credits and, in many cases, payment arrears on official and commercial debt.²³¹ Only Kazakhstan has achieved an investment grade credit rating while Azerbaijan, Russia and Ukraine are considered sub-investment (speculative) risks.²³²

In the first half of the 1990s the debt indicators of the CIS reflect the collapse of output associated with the disintegration of the Soviet Union. Although debt increased in this period, GDP continued to fall (until the upturn in 1996-1997), both developments increasing the debt/GDP ratio. In contrast, the debt/export ratio developed more favourably because exports began to recover already in 1994-1995 (except in Azerbaijan and Turkmenistan). All the CIS countries were to different degrees adversely affected by the rouble crisis in August 1998 and by the following contraction of Russian import demand. The exports of all the CIS countries fell in 1998 (and in about half of them in 1999), current account deficits increased and debt continued to rise. Consequently, debt/export ratios rose, but debt/GDP ratios were less affected because output growth continued in 1998-1999, Kazakhstan, the Republic of Moldova and Ukraine being the exceptions.²³³ Since 2000 the continuation of GDP growth and the resumption of export growth have led to a general improvement in the debt indicators.

The debt burdens of the *fuel producing/exporting CIS economies* – Azerbaijan, Russia, Kazakhstan, and Turkmenistan – are sensitive to changes in fuel production and international fuel prices. The fall of oil prices in 1998 contributed to Russia's financial crisis and the resulting rouble depreciation and the collapse of output sharply increased the external debt burden. However, this deterioration was reversed by the rebound in oil prices (and export revenues) in 1999-2000, the resumption of economic growth and the reduction in nominal debt. The government has repaid principal, including prepayments to the IMF and a eurobond issue,

and no new public debt has been issued in the euromarkets. Large current account surpluses have considerably increased official reserves and contributed to a fall in net debt. Private investors have reacted by dramatically lowering the risk premium on Russian debt. The economies of Azerbaijan and Kazakhstan have benefited from FDI in the oil sector, but the external debt of both countries has risen steadily. As a result of rapidly increasing oil export revenues, Azerbaijan has remained a low-debt country (also see below), but Kazakhstan has become moderately indebted. According to data released several years ago, Turkmenistan is a moderately indebted country,²³⁴ but its debt servicing capacity depends on access to natural gas pipeline grids within the CIS.

Within Europe, Belarus and Ukraine have maintained low levels of indebtedness, at least in part because of their limited access to foreign finance.²³⁵ In recent years Ukraine has run a current account surplus enabling it to make repayments and reduced its debt slightly in 2000-2001,²³⁶ while increasing foreign currency reserves. Ukraine benefited from a rescheduling of commercial and Paris Club debt in July 2001.

Sometime ago the economic situation in seven *low-income CIS countries* – Armenia, Georgia, Kyrgyzstan, the Republic of Moldova and Tajikistan (CIS-5) and Azerbaijan and Uzbekistan (CIS-7) – began to receive increased attention from the international community.²³⁷ In particular concerns were raised about the debt and fiscal sustainability of the CIS-5.²³⁸ To different degrees, all were adversely affected by the Russian crisis, the Republic of Moldova, Kyrgyzstan and Tajikistan being hit particularly hard. A joint IMF-World Bank analysis

²³⁰ As a part of the normalization of its relations with foreign creditors, Russia agreed to the so-called "zero option" under which it took over all the foreign assets and liabilities of the former Soviet Union, essentially freeing the other successor states of external obligations.

²³¹ UNECE, "External financing and CIS debt issues", *Economic Survey of Europe, 2001 No. 1*, chap. 3.6(iii), table 3.6.14. For most countries, especially the low-income CIS, Russia was the largest bilateral creditor. Turkmenistan has also been a creditor but the amounts are smaller.

²³² The Republic of Moldova and Turkmenistan are rated as default grade.

²³³ Nevertheless their debt/GDP ratios tended to rise because the depreciation of CIS currencies against the dollar lowered the dollar value of GDP. The depreciation of the local currency increases pressures on debt servicing and fiscal budgets because it takes more local currency to meet a given dollar obligation.

²³⁴ For recent years the debt indicators for Turkmenistan used here are based on estimated data because official statistics have not been released, as is also the case for Tajikistan and Uzbekistan (subsect. iii). The World Bank classifies Turkmenistan as a moderately-indebted country, but no debt indicators are given.

²³⁵ Belarus and Ukraine have depended on bilateral sources and have failed to attract much FDI. Belarus has never concluded an IMF agreement and most of its private foreign borrowing has been short term, but Ukraine has periodically been able to access IMF funds. Ukraine had brief access to the capital markets prior to a currency crisis in 1998. It was able to add to an existing bond issue in December 2002, at unfavourable terms (subsect. iii).

²³⁶ In this study only the public debt of Ukraine is taken into account. The addition of private external debt (recently published) would not change the country's low-debt classification.

²³⁷ Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, the Republic of Moldova and Tajikistan have all qualified for the IMF Poverty Reduction and Growth Facility (PRGF) and for programmes of the World Bank's International Development Agency (IDA). Uzbekistan is also IDA-eligible. All of them have been included in a growth-promoting initiative launched by the international economic institutions. EBRD, "Initiative to assist low-income countries of the Commonwealth of Independent States", *Press Release*, 22 February 2002. CIS-5 and CIS-7 are acronyms adopted by the international financial organizations.

²³⁸ IMF and World Bank, "Armenia, Georgia, Kyrgyz Republic, the Republic of Moldova and Tajikistan: external debt and fiscal sustainability", 7 February 2001 and "Poverty reduction, growth and debt sustainability in low-income CIS countries" (Washington, D.C.), 4 February 2002.

of the CIS-5 published in early 2001 (and based largely on the situation in 1999)²³⁹ concluded that if a favourable external environment prevailed, the foreign debt (and fiscal) situation of four of the countries would be difficult, but manageable, during the next five years. To this end they were advised to seek rescheduling agreements with bilateral and certain other creditors, to deal with peak debt service burdens in 2001-2004. As regards Kyrgyzstan, however, it was felt that there was no clear prospect of sustainability, even with the recommended rescheduling.

In 2000-2002 the curbing (or even cessation) of debt growth, accelerating and/or high rates of GDP growth and somewhat mixed export performances generally lowered the debt burdens of the CIS-7. As a result of the doubling of exports from Armenia²⁴⁰ and Azerbaijan, the former has become a low-debt country (as Azerbaijan already is). Of the moderately- or severely-indebted countries, the debt indicators of Tajikistan (based on estimated data) have probably fallen to pre-crisis levels²⁴¹ but despite some progress this is still not the case for Georgia and the Republic of Moldova. The sluggish economic performance of Kyrgyzstan has resulted in only a modest alleviation of the debt burden. However, in Uzbekistan increases in debt, modest output growth and a contraction of exports have led to a rise of its debt indicators. The international community has responded to the debt servicing peaks of several low-income countries (projected for 2001-2004) with several restructuring agreements.²⁴²

(c) Changes in the structure of external debt

Section 3.1(ii) drew attention to the recent large fiscal deficits of Croatia, the Czech Republic, Hungary, Poland and Slovakia in 2001-2002. These have increased the government debt owed to foreigners (table 3.5.12) and contributed to the growth of total external debt (except in the Czech Republic). In Poland, which inherited a large public debt from the former Communist regime, the share of government debt fell until the upturn in 2002. Nevertheless, the level of the government's foreign obligations remains

²³⁹ Ibid.

²⁴⁰ In November 2001 Armenia arranged a \$98 million debt-for-equity swap with Russia, *Oxford Analytica*, 11 April 2002, but it does not yet appear to have been reflected in the available debt series.

²⁴¹ In early 2002, Tajikistan obtained a write-off of some of its obligations to Russia and Uzbekistan, *Oxford Analytica*, 25 September 2002.

²⁴² In August 2002, the Republic of Moldova managed to restructure a maturing \$75 million eurobond. Several countries have obtained debt relief from the Paris Club. Under the agreement with Georgia, the debt service due to club members in 2001-2002 was reduced from an initial amount of \$88 million to \$33 million, virtually all of which was interest due on outstanding loans. Paris Club, *Press Release*, 6 March 2001. Under the agreement with Kyrgyzstan in March 2002, debt service falling due in 2002-2004 is to be reduced from an initial amount of \$101 million to \$5.6 million. Paris Club, *Press Release*, 7 March 2002 [www.clubdeparis.org]. As of end-January 2003 no other south-east European or CIS country was scheduled to approach the Paris Club.

TABLE 3.5.12

External debt of selected east European countries and the Russian Federation, 1998-2002

(Shares, per cent of total, end of period)

	1998	1999	2000	2001	2002 ^a
Croatia					
Total debt (million dallas) ...	9 586	9 872	11 002	11 222	13 383
Total debt (per cent)	100.0	100.0	100.0	100.0	100.0
Monetary authorities	2.4	2.0	1.4	1.1	0.8
Government	35.4	40.2	43.6	44.7	43.0
Commercial banks	26.1	22.2	19.0	20.5	21.9
Other sectors	33.5	32.5	30.3	27.9	27.7
Intercompany loans	2.5	3.1	5.7	5.8	6.6
Czech Republic					
Total debt (million dallas) ...	24 348	22 861	21 608	21 696	23 824
Total debt (per cent)	100.0	100.0	100.0	100.0	100.0
Monetary authorities	1.5	1.5	0.0	0.0	0.0
Government	4.5	3.9	3.6	3.9	6.3
Commercial banks	18.3	15.6	11.7	11.2	11.9
Other sectors	37.0	39.4	41.4	43.5	45.3
<i>Memorandum item:</i>					
Intercompany loans	8.9	11.3	13.2	..	..
Hungary					
Total debt (million dallas) ...	27 265	29 193	30 807	33 329	36 828
Total debt (per cent)	100.0	100.0	100.0	100.0	100.0
Monetary authorities	42.8	33.6	27.7	19.8	14.5
Government	10.0	18.5	20.7	25.1	30.7
Commercial banks	20.0	19.0	18.6	18.5	18.5
Other sectors	17.9	18.9	22.7	20.8	19.1
Intercompany loans	9.3	10.0	10.3	15.9	17.2
Poland					
Total debt (million dallas) ...	59 135	65 365	69 465	71 048	78 367
Total debt (per cent)	100.0	100.0	100.0	100.0	100.0
Monetary authorities	1.6	2.8	0.6	0.6	0.3
Government	57.7	49.1	47.5	41.2	42.9
Commercial banks	8.7	10.0	8.8	9.3	9.2
Other sectors	32.1	38.0	43.1	49.0	47.7
<i>Memorandum item:</i>					
Intercompany loans	10.8	11.0	13.0	14.4	13.7
Slovakia					
Total debt (million dallas) ...	11 804	1 0518	10 804	11 043	11 881
Total debt (per cent)	100.0	100.0	100.0	100.0	100.0
Government ^b	21.3	26.8	31.3	31.3	31.2
Commercial banks	22.9	6.5	6.3	7.9	6.9
Other sectors	55.9	66.7	62.4	60.8	61.9
<i>Memorandum item:</i>					
Intercompany loans	6.7	9.1	8.7	..	..
Russian Federation					
Total debt (million dallas) ...	189 200	178 600	161 400	151 100	149 700
Total debt (per cent)	100.0	100.0	100.0	100.0	100.0
Government	82.1	81.9	79.0	75.1	71.1
Commercial banks	5.4	4.6	5.8	9.0	9.1
Other sectors	10.4	11.8	13.5	15.9	19.8
<i>Memorandum item:</i>					
Intercompany loans	1.6	2.1	3.3	4.4	4.9

Source: National statistics of central banks; IMF, *Balance of Payments Statistics Yearbook* (Washington, D.C.), 2001.

^a September for Croatia, Czech Republic, Poland, the Russian Federation and Slovakia; October for Hungary.

^b Includes monetary authorities.

below that of the previous decade. The external debt of the Czech government increased in 2000 but it is very small. In Croatia and Slovakia the share of public debt had already increased substantially in 1999-2000, and in

Croatia it now equals that of Poland. The government debt of Hungary has increased rapidly, but the debt of the central bank, part of which is also the obligation of the government, has declined. Although all these countries have room for further increases in total government debt, there is a risk that their fiscal deficits will continue to rise due to the additional spending required to comply with EU regulations (section 3.1(ii)). In Russia, however, the fiscal and current account surpluses have facilitated the servicing of external public debt, which has declined since 1998 in nominal terms and as a share of total debt. However, the foreign liabilities of Russian *bank and non-bank commercial enterprises* have increased (as has generally been the case in the other countries discussed here) slowing the decline in Russia's total debt. The share of non-bank enterprises in total external debt has risen (except in Croatia where government borrowing has dominated), suggesting that the debtor and creditor bases have grown. *Inter-enterprise loans*, associated with the growing presence of foreign direct investment, have generally increased and in most countries account for over 10 per cent of total external debt.

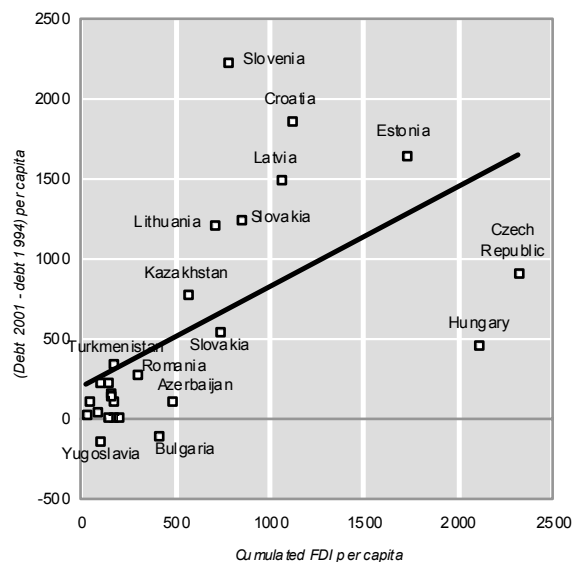
(d) FDI and external debt

Countries are often advised to finance their current account deficits by FDI as a means of curbing the growth of external debt and maintaining (or achieving) financial sustainability. This raises the question of whether countries that rely heavily on FDI flows have in fact had smaller increases in debt than other countries. Chart 3.5.4 suggests the opposite: economies with the largest amounts of FDI²⁴³ are also those with the largest increases in debt. This relationship is presumably explained by the confluence of a favourable investment climate, FDI inflows and good credit ratings, which facilitate further foreign borrowing. Moreover, FDI creates the potential for inter-company loans, which are a significant component of debt in many economies. The countries in the north-east section of chart 3.5.4 – i.e. those with large amounts of FDI and large debt increases – have favourable international credit ratings. Since they have generally been able to keep their external debt burdens in check, it is likely that FDI, by contributing to economic growth, makes it possible to support a larger amount of external debt. More generally, economic development in eastern Europe has been associated with access to a broad range of sources of external finance.

(e) Concluding remarks

Although temporal comparisons of the debt situation in eastern Europe and the CIS are limited by the dramatic changes in borders since 1990, it is nonetheless clear that this region can no longer be associated primarily with high debt and financial distress. Most of the 27 countries are now classified as predominantly low

CHART 3.5.4
Cumulated FDI and the increase in total foreign debt in eastern Europe and the CIS, 1994-2001
(Dollars)



Source: UNECE secretariat calculations, based on national balance of payments and external debt data.

to moderately indebted. Another feature of the region is the continuing, and in some respects widening gap between what are perceived as the most creditworthy countries (i.e. the EU accession countries, Croatia, and to a lesser extent Kazakhstan and Russia) and a second group with little or no access to international markets: Albania, Bosnia and Herzegovina and Yugoslavia in the Balkans; Belarus, the Republic of Moldova and Ukraine in Europe; and Armenia, Azerbaijan, Georgia, Krygyzstan, Turkmenistan and Uzbekistan in Asia. The first group enjoys high credit ratings, relatively large FDI inflows (except for Russia) and the greatest access to foreign finance (all the governments are able to issue international bonds (sovereign debt)). However, individual borrowing costs vary considerably, and local enterprises still rely primarily on bank loans, bond issues being limited to a few “blue chip” companies.

The second group, which is composed of low- to highly-indebted countries, still faces the more basic and longer-term challenge of gaining ready access to foreign private capital (and in some cases even to multilateral funds). Although the highly-indebted economies have made some progress, further reductions in debt burdens are necessary to raise their credit worthiness. To this end, they have made commitments to improve their debt management policies, including the imposition of controls on some types of new borrowing (especially non-concessional loans) and to use privatization proceeds to reduce debt. Several countries have obtained debt write-offs, in some cases lowering their obligations to levels deemed sustainable. Poland is instructive in this regard since the reduction of its debt in the mid-1990s,

²⁴³ There have been considerable differences among countries in their ability to attract FDI (table 6.1.7 and appendix table B.17).

together with the implementation of a broad programme of economic reform, led to a favourable international credit rating, greater capital inflows and better economic performance. While debt relief may be essential in some cases to remove a “debt overhang”, countries also require longer-term strategies to achieve high rates of sustainable output and export growth, so that they can “grow” out of their financial difficulties. There is broad agreement on the necessary policies: sound macroeconomic management (including in some cases strong fiscal adjustment), implementation of institutional and structural reforms, and increased domestic investment and R&D. Reforms in the CIS and some of the south-east European countries got off to a late start but in recent years many of them, including several poor CIS members, have made progress (chapter 5). In general the mobilization of domestic and foreign funds will require further improvements in the business climate and better financial institutions and infrastructure. This would also help them attract more FDI in sectors other than natural resources.

Many of these countries would have a better chance of achieving sustained growth and reducing their debt burdens if they could diversify their economies. Several of the CIS are heavily dependent on natural resource extraction and/or agriculture, which make them vulnerable to commodity price volatility, weather conditions and interruptions in key production facilities. Examples of such reliance are Kyrgyzstan (gold), Tajikistan (aluminium), Azerbaijan and Kazakhstan (petroleum), Turkmenistan (natural gas) and the Republic of Moldova (agricultural products). In the longer run economic diversification will require new investments and access to foreign markets.

The economic expansion of eastern Europe in the past decade owes much to the liberalization of trade (with the west and among themselves), which has contributed to export-led growth. Although it is doubtful that the CIS countries can replicate this performance, their growth prospects might be enhanced by a greater commitment to the promotion of trade. So far, there appears to have been little progress creating free trade areas among the CIS countries and a host of non-tariff obstacles remains in place (chapter 6.2). For example, the facilitation of transit and border procedures could immediately benefit the trade of several CIS countries. These are important issues for landlocked countries that often have few transport options. In the longer term, better infrastructure will be required to facilitate intra-trade and trade with non-CIS countries. Moreover, it should be borne in mind that a host of civil and ethnic conflicts and unresolved territorial disputes have closed several borders and otherwise impeded trade. Resolution of these matters and determined steps toward trade integration would make the CIS area more attractive for FDI and other foreign investment.

All the low-income ECE countries face the challenge of alleviating poverty and in some cases managing high levels of external debt. Given the constraints of low domestic saving rates and the need to consolidate fiscal balances, there are difficult choices to be made regarding the allocation of resources to poverty relief, economic growth and external debt servicing. The international community has helped with foreign aid and in several cases restructuring has significantly lowered near-term debt servicing obligations. In other cases debt servicing issues remain to be addressed.