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NOTE

The present *Survey* is the fifty-seventh in a series of annual reports prepared by the secretariat of the United Nations Economic Commission for Europe to serve the needs of the Commission and of the United Nations in reporting on and analysing world economic conditions.

The Survey is published on the sole responsibility of the Executive Secretary of the ECE and the views expressed in it should not be attributed to the Commission or to its participating governments.

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CONTENTS

	<i>Page</i>
<i>Explanatory notes</i>	<i>vi</i>
<i>Abbreviations</i>	<i>vii</i>
<i>Foreword</i>	<i>ix</i>
Chapter 1 THE ECE ECONOMIES AT MID-2004	1
1.1 The global context	1
1.2 Recent economic developments in the ECE region	6
(i) Output and demand	6
(ii) Costs and prices	17
(iii) Labour markets	24
(iv) Merchandise trade, current accounts and capital flows in eastern Europe and the CIS ...	29
(v) Macroeconomic policy	37
1.3 The short-term outlook	44
Chapter 2 THE COMPETITIVENESS OF NATIONS: ECONOMIC GROWTH IN THE ECE REGION ...	51
2.1 Introduction	51
2.2 A synthetic framework	52
2.3 The competitiveness of the countries of the ECE region 1993-2001: the “stylized facts”	54
(i) Technology competitiveness	56
(ii) Capacity competitiveness	57
(iii) Price competitiveness	57
(iv) Demand competitiveness	59
2.4 The dynamics of the competitiveness of the countries of the ECE region	60
2.5 Conclusions	62
Annex: data and sources	63
STATISTICAL APPENDIX	67

LIST OF TABLES

<i>Table</i>	<i>Page</i>
1.1.1 International commodity prices, 2002-2004	6
1.2.1 Changes in quarterly real GDP in major economies, 2003-2004	7
1.2.2 Changes in real GDP and main expenditure items in the United States, 2003-2004	7
1.2.3 Changes in real GDP and main expenditure items in the euro area, 2003-2004	8
1.2.4 Quarterly real GDP and industrial output in the new EU member countries, 2003-2004	10
1.2.5 Components of real demand in the new EU member countries, 2002-2004	13
1.2.6 Quarterly real GDP and industrial output in south-east Europe and the CIS, 2003-2004	14
1.2.7 Components of real demand in selected south-east European and CIS economies, 2002-2004	16
1.2.8 Volume of retail trade in south-east Europe and the CIS, 2002-2004	17
1.2.9 Real investment outlays in selected CIS economies, 2002-2004	17
1.2.10 Consumer price indices in Europe, North America and Japan, 2002-2004	20
1.2.11 Inflation in south-east Europe and the CIS, 2002-2004	22
1.2.12 Wages and unit labour costs in industry in the new EU member countries, 2003-2004	23
1.2.13 Wages and unit labour costs in industry in south-east Europe and the CIS, 2003-2004	24
1.2.14 Unemployment in Europe, North America and Japan, 2002-2004	25
1.2.15 Employment in Europe, North America and Japan, 2002-2004	26
1.2.16 Registered and labour force survey unemployment in south-east Europe and the CIS, 2003-2004	28
1.2.17 International trade and external balances of the east European and CIS economies, 2002-2004	31
1.2.18 International trade of eastern Europe and the Russian Federation by direction, 2002-2004	33
1.2.19 International trade of the CIS, 2002-2004	36
1.2.20 Convergence targets in selected new EU member countries, 2003-2008	41
1.3.1 Annual changes in real GDP in Europe, North America and Japan, 2002-2005	45
1.3.2 Annual changes in real GDP in south-east Europe and the CIS, 2002-2005	47
2.4.1 Results of OLS regression analysis, 1993-2001	61
2.4.2 Actual and estimated differences in growth vis-à-vis the world average, 1993-2001	61
A.1 Real GDP in Europe, North America and Japan, 1989-2003	69
A.2 Real private consumption expenditure in Europe, North America and Japan, 1989-2003	70
A.3 Real general government consumption expenditure in Europe, North America and Japan, 1989-2003	71
A.4 Real gross domestic fixed capital formation in Europe, North America and Japan, 1989-2003	72
A.5 Real total domestic expenditures in Europe, North America and Japan, 1989-2003	73
A.6 Real exports of goods and services in Europe, North America and Japan, 1989-2003	74
A.7 Real imports of goods and services in Europe, North America and Japan, 1989-2003	75
A.8 Industrial output in Europe, North America and Japan, 1989-2003	76
A.9 Total employment in Europe, North America and Japan, 1989-2003	77
A.10 Standardized unemployment rates in Europe, North America and Japan, 1989-2003	78
A.11 Consumer prices in Europe, North America and Japan, 1989-2003	79
B.1 Real GDP/NMP in eastern Europe and the CIS, 1980, 1989, 1991-2003	80
B.2 Real total consumption expenditure in eastern Europe and the CIS, 1989-2003	81
B.3 Real gross fixed capital formation in eastern Europe and the CIS, 1989-2003	81
B.4 Real gross industrial output in eastern Europe and the CIS, 1980, 1989, 1991-2003	82
B.5 Total employment in eastern Europe and the CIS, 1980, 1989-2003	83
B.6 Employment in industry in eastern Europe and the CIS, 1990, 1992-2003	84
B.7 Registered unemployment in eastern Europe and the CIS, 1990-2003	85
B.8 Consumer price indices in eastern Europe and the CIS, 1990-2003	86
B.9 Producer price indices in eastern Europe and the CIS, 1990-2003	87
B.10 Nominal gross wages in industry in eastern Europe and the CIS, 1990, 1992-2003	88
B.11 Merchandise exports of eastern Europe and the CIS, 1993-2003	89
B.12 Merchandise imports of eastern Europe and the CIS, 1993-2003	90
B.13 Balance of merchandise trade of eastern Europe and the CIS, 1993-2003	91
B.14 Merchandise trade of eastern Europe and the Russian Federation, by direction, 1980, 1990, 1992-2003	92
B.15 Exchange rates of eastern Europe and the CIS, 1990, 1992-2003	93
B.16 Current account balances of eastern Europe and the CIS, 1990, 1992-2003	94
B.17 Inflows of foreign direct investment in eastern Europe and the CIS, 1990, 1992-2002	95

LIST OF CHARTS

<i>Chart</i>	<i>Page</i>
1.1.1 Quarterly changes in real GDP in the euro area and the G7 economies, 1998-2004	2
1.1.2 Bilateral exchange rates of the dollar, January 1999-June 2004	3
1.1.3 International commodity prices, January 2000-May 2004	4
1.2.1 Quarterly growth in real GDP and contribution of major expenditure items in the United States, 2000-2004	7
1.2.2 Consumer confidence and quarterly business confidence in the United States, January 2000-May 2004	8
1.2.3 Consumer confidence and industrial confidence in the euro area, January 2000-May 2004	9
1.2.4 Quarterly growth in real GDP and contribution of major expenditure items in the euro area, 2000-2004	9
1.2.5 Economic sentiment in the new EU economies, January 2000-May 2004	11
1.2.6 Contribution of final demand components to annual change in real GDP in new EU economies, 2000-2003	12
1.2.7 Contribution of final demand components to annual changes in real GDP in selected south-east and CIS economies, 2000-2003	15
1.2.8 Consumer prices in the United States, January 2002-May 2004	18
1.2.9 Unit labour costs and main components in the United States, 2000-2004	18
1.2.10 Consumer prices in the euro area, January 2002-May 2004	19
1.2.11 Unit labour costs and main components in the euro area, 2000-2003	21
1.2.12 Youth unemployment in the new EU member countries, 2002 and 2003	27
1.2.13 Long-term unemployment in the new EU member countries, 2002 and 2003	27
1.2.14 Merchandise trade flows and balances in the new EU member countries and south-east Europe, January 2001-April 2004	32
1.2.15 Real effective exchange rates in selected east European economies, 2000-2004	34
1.2.16 Nominal short-term and long-term interest rates, January 2000-June 2004	38
1.2.17 Real effective exchange rates of major currencies, January 1999-May 2004	39
1.2.18 Monetary conditions index for the euro area, January 2000-May 2004	39
1.2.19 The rouble's real exchange rate against the dollar, January 1995-April 2004	43
2.3.1 Overall competitiveness, 1993-2001	56
2.3.2 Overall and technology competitiveness, 1993-2001	56
2.3.3 Technology competitiveness, 1993-2001	58
2.3.4 Overall and capacity competitiveness, 1993-2001	58
2.3.5 Capacity competitiveness, 1993-2001	58
2.3.6 Technology and capacity competitiveness, 1993-2001	58
2.3.7 Overall and price competitiveness, 1993-2001	59
2.3.8 Overall and price competitiveness, 1993 and 2001	59
2.3.9 Overall and demand competitiveness, 1993-2001	60
2.5.1 Contribution to change of technology and capacity competitiveness, 1993-2001	62

LIST OF BOXES

<i>Box</i>	<i>Page</i>
1.1.1 The macroeconomic impact of higher oil prices	5

EXPLANATORY NOTES

The following symbols have been used throughout this *Survey*:

- .. = not available or not pertinent
- = nil or negligible
- * = estimate by the secretariat of the Economic Commission for Europe
- | = break in series

In referring to a combination of years, the use of an oblique stroke (e.g. 1998/99) signifies a 12-month period (say, from 1 July 1998 to 30 June 1999). The use of a hyphen (e.g. 1999-2001) normally signifies either an average of, or a total for, the full period of calendar years covered (including the end-years indicated).

Unless the contrary is stated, the standard unit of weight used throughout is the metric ton. The definition of “billion” used throughout is a thousand million. The definition of “trillion” used throughout is a thousand billion. Minor discrepancies in totals and percentages are due to rounding.

References to dollars (\$) are to United States dollars unless otherwise specified.

The membership of the United Nations Economic Commission for Europe (UNECE) consists of all the states of western Europe, eastern Europe, the Commonwealth of Independent States (CIS), North America and Israel.

The term EU-15 refers to the aggregate of the following 15 member states of the European Union: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom.

EU-25 refers to the 15 above-mentioned member states plus the 10 countries which have joined the European Union in May 2004, i.e. Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

WECEE comprises the EU-25 plus the countries of Iceland, Norway and Switzerland.

CEBS-8 (central Europe and Baltic states) includes the new member states listed above excluding Cyprus and Malta.

For the convenience in presentation, the countries of eastern Europe and the CIS are sometimes grouped into subregions based on geographical proximity.

The group of countries denoted as Eastern Europe comprises the following subregions:

- Baltic states (BS-3): Estonia, Latvia and Lithuania;
- Central Europe (CE-5): Czech Republic, Hungary, Poland, Slovakia and Slovenia;
- South-east Europe (SEE-7): Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia and Montenegro and The former Yugoslav Republic of Macedonia.

The Commonwealth of Independent States comprises the Russian Federation and the following subregions:

- Caucasian CIS (CCIS-3): Armenia, Azerbaijan and Georgia;
- Central Asian CIS (CACIS-5): Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan;
- European CIS, excluding Russia (ECIS-3): Belarus, Republic of Moldova and Ukraine.

ABBREVIATIONS

c.i.f.	cost, insurance, freight
CIS	Commonwealth of Independent States
CMEA	(former) Council for Mutual Economic Assistance
CPI	consumer price index
DIW	Deutsches Institut für Wirtschaftsforschung (German Institute for Economic Research)
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECE	Economic Commission for Europe
EMU	Economic and Monetary Union
EPO	European Patent Office
ERM-2	Exchange Rate Mechanism-2 (of the EU)
EU	European Union
EURIBOR	euro interbank offered rate
FDI	foreign direct investment
FOMC	Federal Open Market Committee
G-7	Group of Seven
GDP	gross domestic product
GDR	(former) German Democratic Republic
GERD	gross domestic expenditure on R&D
HICP	Harmonized Index of Consumer Prices
HWWA	Hamburgisches Welt-Wirtschafts-Archiv (Hamburg Institute of International Economics)
ICT	information and communication technologies
IEA	International Energy Agency
ILO	International Labour Office
IMF	International Monetary Fund
ISCED	International Standard Classification of Education
ISI	Institute for Scientific Information Citation Indexes
ITU	International Telecommunication Union
LFS	labour force survey
mb/d	million barrels per day
NIC	newly industrializing country
NMP	net material product
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
OPEC	Organization of the Petroleum Exporting Countries
OPT	outward processing trade
p/b	price per barrel
PPI	producer price index
PPP	purchasing power parity
R&D	research and development
S&T	science and technology
SAAR	seasonally adjusted annual rates
SARS	severe acute respiratory syndrome

SGP	Stability and Growth Pact
SITC	Standard International Trade Classification
ULC	unit labour costs
UNCTAD	United Nations Conference on Trade and Development
UNECE	United Nations Economic Commission for Europe
UNESCO	United Nations Educational, Scientific and Cultural Organization
USAID	United States Agency for International Development
USPTO	United States Patent and Trademark Office
USSR	(former) Union of Soviet Socialist Republics
VAT	value added tax
WTO	World Trade Organization

FOREWORD

The world economy strengthened in the first half of 2004 and the consensus of current forecasts is for the global recovery to continue in the second half of this year and into 2005. There remain important risks and uncertainties, however, that could trigger a cyclical setback. Higher oil prices have so far had little if any noticeable impact on the pace of the global growth, but any further large increases – as a result, for example, of continuing or intensified geopolitical uncertainties – could very well jeopardize the recovery. Another important downside risk is whether the rapid closing of the global output gap will lead to stronger than expected inflationary pressures which could result in a more pronounced tightening of monetary policy than is currently anticipated. The possibility of disruptions in the pattern of capital flows and exchange rates arising from abrupt changes in market sentiment and investor confidence about the sustainability of the twin deficits of the United States also remains a major downside risk.

Against this background, macroeconomic policy makers are faced with important challenges. The surge in global liquidity resulting from the considerable easing of monetary policy in recent years in the major industrialized countries carries risks of higher rates of inflation and the creation or intensification of asset price bubbles. The difficult task is to return to a broadly neutral monetary policy stance without endangering the sustainability of the global recovery. The decision of the Federal Reserve to raise its key interest rate in late June 2004 is a key turning point for monetary policy in both the United States and the rest of the world. But the expected further tightening of monetary policy will need to be accompanied by a more prudent fiscal policy to restore the internal and external balance of the United States economy.

In the euro area, the strength of the recovery remains relatively moderate, relying largely on the stimulus from foreign demand. In view of moderate rates of inflation, monetary policy can remain on hold until the recovery is more broadly based. This requires a sustained strengthening of domestic demand. Due to the recent deterioration of public finances, however, the scope for fiscal policy to stimulate economic activity in the three largest member states of the euro area has been reduced to the operation of automatic stabilizers, as is now also the case in the United States. This is partly the price being paid for not having pursued fiscal consolidation when the economic situation was more favourable. A major challenge is therefore to design consolidation strategies that will ensure fiscal sustainability in the medium and longer term without limiting the operation of the built-in stabilizers in the short run. This underlines the important role of monetary policy in contributing to a supportive policy mix that will keep the European economy on a sustained and, eventually, more dynamic growth path.

A better balance of macroeconomic policies needs to be complemented by structural reforms if the improvement is to be sustainable. The “conventional wisdom” is that there is a need for more structural reforms in labour markets and further deregulation in product markets if the growth potential of the European economy is to be increased. But the reform agenda is often too narrowly conceived in terms of making it easier for firms to hire and fire employees: it should comprise much more than that, including reforms in the sectors providing services of general interest as well as education and training, research and development, and health care. There is also the need to improve labour market flexibility by raising labour skills and matching them more closely to the changing requirements of the economy. Improving the incentives to work, particularly on the part of older workers, can also contribute to meeting the challenge of coping with the adjustment pressures created by population ageing and the associated problems of financing retirement pensions in the medium to longer term.

Structural reforms frequently involve adjustment costs, which generally appear before the benefits of the reform; the population naturally tends to resist such adjustments in times of cyclical weakness and crisis. Such adjustment costs can be more easily absorbed in a context of sustained economic growth, supported by adequate macroeconomic policies. It is therefore important that policy makers better exploit the opportunity for structural reforms and fiscal consolidation provided by a growing economy and expanding employment. This is a lesson that applies equally to the countries of eastern Europe and the CIS, all of which are still facing difficult structural adjustment problems.

For the eastern European countries that joined the EU at the beginning of May 2004 an immediate policy challenge is to develop a coherent strategy for achieving the nominal convergence targets (the Maastricht criteria), without at the same time jeopardizing further progress in real convergence. The timing of the obligatory entry into the EMU is a key element in such a strategy. An important intermediate step is the decision as to when to join the new European Exchange Rate Mechanism (ERM-2), which is the antechamber to the EMU. The precise timing will have to reflect the specific economic circumstances in the individual countries. Three economies – Estonia, Lithuania and Slovenia – joined the ERM-2 after only two months of EU membership. For those countries that have not yet followed a fixed exchange rate regime – Estonia and Lithuania have maintained their currency boards – joining ERM-2 will reduce the scope for using monetary policy as an instrument of macroeconomic policy. Given the potential conflicts between the EMU targets for inflation and exchange rate stability that may arise in the process of economic catch-up, this will require skilful management. In the presence of volatile and often speculative capital flows, there is an increased risk of currency crises that should not be underestimated.

Another major preoccupation of governments in many of the new EU member states is the fiscal adjustment required by the rules of the EU's fiscal policy framework. Many of the new member states have budget deficits that are significantly above the threshold of 3 per cent of national GDP. These countries face major structural adjustments, including the urgent need to rehabilitate and enhance their infrastructures, which, for reasons of intergenerational equity and political feasibility, will have to be financed by government borrowing. This is a transitory process but it will require a flexible interpretation of the Stability and Growth Pact (SGP), in order to avoid a counterproductive fiscal tightening. The crisis of the SGP in 2003 has, in any case, accentuated the need for a more flexible interpretation of the fiscal rules. The recent proposals made by the European Commission go in the right direction, but any modifications should explicitly take into account the specific circumstances of the new member states.

In oil-exporting CIS countries, especially Russia, the sharp rise in oil prices has led to a large and progressive real appreciation of their national currencies in the past few years, with adverse effects on their domestic manufacturing sectors. One of the current policy challenges for these economies is thus to prevent a possible overshooting of the real exchange rate. If the increased oil revenues, however, are used efficiently to enhance productive capacities and promote economic diversification, the growth potential of these economies can be increased and their dependence on natural resources reduced.

All of the UNECE economies continue to face increasing pressures from the forces of globalization and technological progress. In order to ensure that these forces are exploited to enhance rather than diminish the welfare of their populations it is up to governments to design policies and institutions that create an environment that will encourage both the necessary structural changes in the patterns of specialization and ensure that the costs and benefits of such change are equitably distributed.

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