CHAPTER 3

THE TRANSITION ECONOMIES

3.1 Introduction

(i)   Expectations and outcomes

The overall trends of economic activity in the ECE transition economies were abruptly reversed towards the middle of 1998 by the impact of a strong external demand shock, the negative effects of which dominated the second half of the year. The Asian and the Russian crises caused a considerable weakening of economic activity in many parts of the world, including western Europe. The combined real effect of these factors – the collapse of Russian imports, the drop in global demand for primary and intermediate products, and – in the second half of the year – a weakening of west European import demand – had an unexpectedly strong negative impact on economic performance in the transition economies.

Virtually all of them, including those that are more advanced in the reform process, were negatively affected (albeit to varying degrees) by the fall in external demand. Thus, although most of the central European countries weathered the global financial turmoil relatively successfully and proved to be less susceptible than feared to direct contagion from the crisis in other emerging markets, they nevertheless turned out to be rather vulnerable to real demand shocks. This underlines the concern that was raised in last year's *Survey*, namely, the risks to stability when growth is predominantly export led. It was argued that a high degree of external dependence, coupled with a substantial divergence between the composition of domestic output and domestic demand (which is a feature of a fast-growing, immature market economy),[156] is an inherent source of fragility and vulnerability and that, as a result, a fall in export demand is likely to develop into a full-scale negative demand shock. Developments in 1998 appear to confirm these fears.

The speed at which the economic situation deteriorated in the second half of the year presents a serious challenge to policy makers in the transition economies, especially those in the more advanced reformers, where the external shock was preceded by a period of relatively robust economic growth and improving macroeconomic fundamentals. Although a number of policy corrections were made in some countries in the course of the year, in general inertia prevailed: on average, policy adjustments were not sufficient to counterbalance the negative implications of the external shock. However, the magnitude of the disturbance was such that it is questionable whether domestic policies were even in a position to cope with it in a comprehensive manner.

At the start of the year it was widely expected that the relatively high rates of economic growth which had emerged in eastern Europe and the Baltic region in the second half of 1997 would continue and even strengthen in 1998. In fact, in almost all countries (with the exception of Hungary and to some extent Slovenia and Bulgaria) the actual outcomes were below the *ex-ante* forecasts (table 3.1.1). In virtually all the east European and Baltic transition economies (again, with the possible exception of Hungary), the second half of the year was marked by a considerable deterioration in the growth of output.

The rate of growth of aggregate GDP in eastern Europe in 1998 (2 per cent) was a mere half of what had been expected and below the average for 1997 (2.8 per cent). While the modest 1997 growth figure was mostly due to the poor performance in three crisis-hit economies (Albania, Bulgaria and Romania), the aggregate rate of growth in 1997 reflects a general weakening of economic activity throughout most of eastern Europe. Thus, in 1998, the aggregate GDP growth rate in the Baltic states dropped by some 3 percentage points from the impressive 7.6 per cent in 1997. In addition, the deep recession continued in Romania in 1998 for a second consecutive year and – rather unexpectedly – the Czech economy also slipped into a recession driven by mounting domestic and external problems.

A closer look at the patterns of output performance in the east European transition economies in 1998 provides further support for the vulnerability conjecture outlined above. While the manufacturing sector had been the principal engine of recovery and growth in recent years in many transition economies (especially when the conditions on foreign markets were favourable), it was also the first to face the demand shock when external conditions deteriorated. Industrial output (particularly manufacturing) turned out to be the most vulnerable and bore the brunt of shrinking external demand.

---

[156] This compositional mismatch is related to the nature and scale of the required change in economic structure. While the process of economic restructuring and reindustrialization generates highly diversified demand (in particular, for sophisticated hi-tech goods that are not produced locally), exports in this phase of development are usually rather narrowly based. As a result, there may be little or no room for the substitution of domestic sales for lost export markets, even when, overall, there is excessive domestic demand. This makes such an economy especially vulnerable to external demand shocks. UN/ECE, *Economic Survey of Europe, 1998 No. 1*, pp. 9-10.

TABLE 3.1.1

Basic economic indicators for the ECE transition economies, 1996-1999
(Rates of change and shares, per cent)

	GDP (growth rates)					Industrial output (growth rates)			Inflation (per cent change, Dec./Dec.)			Unemployment rate (end of period, per cent)		
			1998		1999									
			Ex-ante official forecast	Actual outcome	official forecast									
	1996	1997				1996	1997	1998	1996	1997	1998	1996	1997	1998
Eastern Europe	4.1	2.8	4.3	2	2.9	6.0	5.6	1.4	..	..	..	11.7	11.9	12.6
Albania	9.1	-7.0	10	8*	8	13.6	-5.6	10*	17.4	42.0	7.8	12.3	14.9	17.6
Bosnia and Herzegovina [a]	..	..	..	..	..	87.6	35.7	23.8	3.2	12.2	2.2	..	39*	..
Bulgaria	-10.1	-6.9	3.0	3*	3.7	3.8[b]	-10.2	-9.4	311.1	578.7	0.9	12.5	13.7	12.2
Croatia	6.0	6.5	7.5	3*	1.5-2	3.1	6.8	3.7	3.5	4.0	5.6	15.9	17.6	18.6
Czech Republic	3.9	1.0	1.4-2.6	-2.7	-0.8	2.0	4.5	1.6	8.7	9.9	6.7	3.5	5.2	7.5
Hungary	1.3	4.6	4.0	5	5	3.4	11.1	12.6	20.0	18.4	10.4	10.5	10.4	9.1
Poland	6.0	6.9	5.6-5.8	4.8	4.5	8.3	11.5	4.7	18.7	13.2	8.5	13.2	10.3	10.4
Romania	3.9	-6.9	–	-7.3	-2	6.3	-7.2	-17.0	56.8	151.7	40.7	6.6	8.8	10.3
Slovakia	6.6	6.5	5.0	4.4	3	2.5	1.7	4.6	5.5	6.5	5.5	12.8	12.5	15.6
Slovenia	3.5	4.6	3.5-4	4	4	1.0	1.0	3.7	9.0	8.8	6.6	14.4	14.8	14.6
The former Yugoslav Republic of Macedonia	0.8	1.5	5.0	2.9	6	3.2	1.6	4.5	0.3	4.5	-1.0	39.8	42.5	..
Yugoslavia [c]	5.9	7.4	10.0	2.6	7	7.5	9.5	3.6	59.9	10.3	45.7	26.1	25.6	27.2
Baltic states	4.1	7.6	6.3	4¼	4.5	4.6	9.4	3.6	..	..	..	6.4	6.3	7.4
Estonia	4.0	11.4	5.5-6	4.2	4	2.9	13.4	0.8	15.0	12.3	6.8	5.6	4.6	5.1
Latvia	3.3	6.5	5-6	4*	4	5.5	13.8	2.0	13.2	7.0	2.8	7.2	6.7	9.2
Lithuania	4.7	6.1	7.0	4.5	5	5.0	3.3	7.0	13.1	8.5	2.4	6.2	6.7	6.9
CIS	-3.4	1.1	1.2	-2¾	-1.1	-3.0	2.6	-2.3	..	..	..	6.6	7.6	8.5
Armenia	5.9	3.1	5-6	7.2	4	1.4	0.9	-2.5	5.6	21.8	-1.2	9.7	11.0	8.9
Azerbaijan	1.3	5.8	..	10.0	9	-6.7	0.3	2.2	6.8	0.3	-7.6	1.1	1.3	1.4
Belarus	2.8	11.4	7-8	8.3	4-6	3.5	18.8	11.0	39.1	63.4	181.6	4.0	2.8	2.3
Georgia	11.0	11.3	11-13	2.9	8	6.8	8.2	-2.7	13.6	7.3	11.0	3.2	8.0	4.2
Kazakhstan	0.5	1.7	3.5	-2.5	1.5	0.3	4.0	-2.1	28.6	11.3	1.9	4.1	3.9	3.7
Kyrgyzstan	7.1	9.9	3.6	1.8	2.8	8.8	50.4	4.6	35.0	14.7	18.3	4.5	3.1	3.1
Republic of Moldova [d]	-7.8	1.6	3-3.5	-8.6	-3	-6.5	–	-11.0	15.1	11.1	18.3	1.5	1.7	1.9
Russian Federation	-3.5	0.8	0-0.5	-4.6	-2.5	-4.0	2.0	-5.2	21.8	11.0	84.5	10.0	11.2	12.4
Tajikistan	-16.7	1.7	..	5.3	..	-23.9	-2.0	8.1	40.6	159.9	2.7	2.4	2.8	2.9
Turkmenistan	6.7	-11.4	..	5.0	..	19.7	-32.3	0.2	445.8	21.5	19.8	..	..	..
Ukraine	-10.0	-3.2	0.5	-1.7	-1	-5.1	-0.3	-1.5	39.7	10.1	20.0	1.5	2.8	4.3
Uzbekistan	1.7	5.2	6.0	4.4	4.4	2.6	4.1	5.8	80.0	27.5	..	0.3	0.3	0.4
Total above	-0.4	2.0	2.6	-½	0.7	0.1	3.8	-0.9	..	..	..	8.1	8.8	9.6
Memorandum items:														
CETE-5	5.0	5.5	4.7	3.6	3.6	6.1	9.4	5.0	..	..	..	11.2	9.8	10.2
SETE-7	2.1	-3.1	3.3	-1.9	1.3	5.7	-3.9	-9.2	..	..	..	12.5	14.3	15.4
Former GDR	3.2	1.7	..	2.0	..	3.3	5.8	7.5	..	..	..	17.0	20.8	18.6

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE secretariat (IMF and World Bank data for Albania).

Note: Aggregates are UN/ECE secretariat calculations, based on previous period weights at 1992 prices. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index except for Croatia and The former Yugoslav Republic of Macedonia for which retail price index is used. Unemployment generally refers to registered unemployment at the end of the period (with the exception of the Russian Federation, where it is the Goskomstat estimate of the ILO definition and Estonia where it refers to job seekers (see section 3.5(ii) for details)). Aggregates shown are: *Eastern Europe* (the 12 countries below that line), with sub-aggregates *CETE-5* (central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and *SETE-7* (south European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and Yugoslavia); *Baltic states* (Estonia, Latvia, Lithuania); *CIS* (12 member countries of the Commonwealth of Independent States); and *total transition economies*.

[a] Data reported by the Statistical Office of the Federation; these exclude the area of Republika Srpska.

[b] Bulgarian industrial output indices were recently recalculated according to a new methodology and the old series reportedly have been revised back to 1991. Here and in appendix table B.4 industrial output now includes the gross output of all activities of industrial enterprises (and not just the gross output of "pure" industry, as previously published). The figure for industrial output growth in 1996 according to the new methodology (3.8 per cent) differs significantly from the figure for the rate of change of gross industrial output (-9.1 per cent) reported in the national accounts for the same year.

[c] Gross material product instead of GDP.

[d] Excluding Transdniestria.

After a notable recovery in many transition economies during 1996-1997, industrial output growth decelerated rapidly in the course of 1998 and in the fourth quarter it actually declined in most of them (chart 3.4.1). Indeed, the weighted average annual rate of growth of industrial output in eastern Europe in 1998 (1.4 per cent) was the lowest since 1993 (appendix table B.4). The deterioration of industrial output had negative repercussions on economic activity across the board, and eventually led to a deceleration of the overall rate of economic growth.

There was also a considerable deterioration in 1998 in the Commonwealth of Independent States (CIS). While the official *ex-ante* forecasts were for positive growth in all the CIS countries, the outcome was actually negative in four of them: Kazakhstan, the Republic of Moldova, the Russian Federation and Ukraine (table 3.1.1). In three of the other CIS countries for which *ex-ante* forecasts were available (Georgia, Kyrgyzstan and Uzbekistan), actual performance was below expectations, albeit growth was still positive. In aggregate, the GDP of the CIS fell sharply (by 2¾ per cent), nullifying the gains of the modest 1.1 per cent recovery in 1997.

The shock waves from the Russian crisis reached all the ECE transition economies but their repercussions were especially damaging in the neighbouring CIS countries. Apart from the negative impact on trade and output, these countries were very strongly affected by the devaluation of the Russian rouble which triggered a series of currency crises among these countries. The CIS economies (and especially those in Europe), are still very closely linked to the Russian economy and their ties sometimes go much beyond what might be expected from simply looking at the official trade figures. Apart from geographic proximity and traditional business relations, there exist a number of additional, sometimes informal, economic ties and links which make the actual interdependence of these economies even stronger.[157] In fact, the very heavy fallout from the Russian crisis on some of the CIS countries suggests that these economies are still very closely integrated.

The unexpected weakening of output was detrimental for the situation on the labour markets in the ECE transition economies. Labour markets in these countries are still undergoing substantial structural changes and there have been major shifts in the composition of the labour force. These often lag behind the changes in the structure of output due to the inherent rigidities in labour markets. The increase in total employment in recent years represents a positive balance between job creation (thanks to economic recovery – in particular, the start-up and growth of new business – in the more advanced reform countries) and job destruction (due to the continuing process of labour shedding caused by microeconomic restructuring). This delicate balance apparently suffered a blow in 1998 in a number of transition economies.[158]

The deterioration of the situation on the labour markets became especially pronounced in the second half of the year when unemployment started to increase rapidly throughout the whole region: between June and December the average rates of unemployment in eastern Europe increased from 11.6 to 12.6 per cent; in the Baltic states from 5.9 to 7.3 per cent and in the CIS as a whole from 7.7 to 8.5 per cent (table 3.5.2).

Several major factors affected prices in the ECE transition economies in 1998 resulting in divergent inflation trends among countries. In general, disinflation not only prevailed in eastern Europe, in the Baltic region and in some CIS countries (table 3.1.1), but in many countries the year-on-year inflation turned out to be much lower than was expected *ex ante*.[159] While disinflation does reflect the positive results of lasting policy efforts in the transition economies, this specific outcome in 1998 was also largely induced by negative import price pressures resulting from the considerable drop in commodity prices (as well as of the prices of other tradeables) in 1998 (for details see chapter 2.1 and sections 3.2(ii) and 3.4).

At the same time, contagion from the global financial turmoil in 1998, and especially from the Russian crisis, resulted in growing financial and macroeconomic turbulence in a number of transition economies. The most visible result of this financial disturbance was a series of exchange rate crisis leading to sizeable (in some cases manifold) depreciation of the exchange rates (discussed in more detail in section 3.2(ii)). As a consequence, strong inflationary pressures re-emerged in a number of transition economies, especially in the second half of the year. Due to the lags in transmission mechanisms, the actual 1998 price statistics do not reflect in full the actual inflationary potential of the devaluations; however, the continuing weakening of the currencies of a number of transition economies suggests that the inflationary pressures are likely to remain high in these countries for some time to come.

---

[157] One extremely important channel of interdependence (and of dependence on Russia) is the inherited common energy infrastructure and distribution networks of the Soviet Union. Anecdotal evidence suggests that a substantial proportion of Russian energy deliveries (in particular of gas and electricity) are not being paid for by the recipient countries and that Russian suppliers are often subject to strong political pressure to accept payment arrears (which amounts to politically motivated capital transfers to other CIS countries). In turn, the existence of such arrears is likely to become a lever for exerting political influence on the recipient CIS countries as they become hostage to their own economic problems.

[158] For example, while in 1996-1997 total employment in eastern Europe increased both in 1996 and in 1997 (table 3.5.1), this trend was reversed in 1998 and the decline in total employment resumed. At the same time, however, employment continued to increase in some east European transition economies (notably Hungary which was relatively less affected by the demand shock and Poland).

[159] In some countries (The former Yugoslav Republic of Macedonia, Armenia and Azerbaijan) year-on-year CPI was even negative (table 3.1.1). The deflationary trend was even more widespread as regards year-on-year changes in PPI (table 3.4.3).

This macroeconomic turbulence was another factor that adversely affected economic activity in some transition economies. The erosion of real incomes (provoked by currency depreciation and the subsequent surge in inflation) and, in many cases the austerity measures undertaken to restore macroeconomic equilibrium, resulted in a dampening of domestic demand and this, in turn, also had a negative impact on output.

It should be noted that the changes in external demand in 1998 were highly differentiated both by type of products (the shock affected most severely the demand for primary commodities and semi-processed goods) and by the direction of the flows (at first South-East Asia, subsequently Russia and, towards the end of the year, western Europe). Due to this specificity, their actual impact does not always show up clearly in the 1998 trade performance data. Thus, the most affected transition economies were those which were relatively more dependent on the affected export markets or products.[160] Other types of export flows from the transition economies – such as final consumption goods destined for western Europe or products marketed through the distribution network of multinational companies – were not affected to the same extent by weak external demand. On the contrary, these exports (mostly from central Europe and the Baltic states) tended to grow quite strongly during 1998.

On balance, the value of the foreign trade of the east European countries increased by some 8-9 per cent in 1998, more than the 6 per cent increase in 1998 (table 3.6.1). The higher rates of growth in most cases, however, were mainly due to developments during the early months of the year, whereas trade performance weakened considerably in the second half. Despite the apparently strong aggregate export performance for the region as a whole, there were substantial declines in both the value and volume of exports in many individual countries. The growth of trade in the Baltic states in 1998 decelerated substantially from previous years: the value of their exports and imports increased on average by some 3 and 7 per cent, respectively (table 3.6.1), way below the annual rates of 20 to 30 cent between 1995 and 1997. The main factor behind this slowdown was the weakening of import demand in the CIS countries, principally in Russia, again primarily in the second half of the year (table 3.1.2). There was some redirection of exports by the transition economies, mainly to western Europe, but this was not sufficient to offset the fall in exports to Russia.

The value of the foreign trade of the CIS taken as a whole declined in 1998: during the first three quarters of the year, the dollar value of total CIS exports declined by some 14 per cent, while the value of total CIS imports fell by 5 per cent (table 3.6.6). All CIS countries are heavily specialized in the exports of primary commodities and

these significant falls in value reflect to a large extent the collapse of world commodity prices. As discussed in section 3.6, export performance in volume terms was mixed, but even the increased export volumes of certain commodities were insufficient to offset the effect of lower prices.

One specific consequence of the deterioration in export and output performance in 1998 was the widespread re-emergence of trade protectionism. This affected both bilateral trade relations among the transition economies themselves as well as their exports to some of their major trading partners among the western market economies (for details see section 3.6).

The changes in the external environment have had in general a detrimental impact on the external position of the transition economies, but individual countries were affected in different ways. Thus the external (trade and current account) balances in the first three quarters of 1998 do not show any uniform pattern: they worsened in some countries but improved in others (table 3.1.2). The differences, especially as regards trade balances, reflect both the general downward pressure on import prices (resulting in lower import values due to the falls in world market prices) and the fact that some countries were forced to adjust their external positions due to balance of payments constraints. However, as discussed in section 3.7, there appears to have been a considerable worsening of the current account balances in a number of transition economies in the fourth quarter.[161] The external balances of most of the CIS countries, however, had already deteriorated in the first three quarters of the year (table 3.1.2).

The escalation of global financial turmoil in 1997-1998 has raised renewed concerns about the sustainability of current account deficits in the transition economies which – as shown in table 3.1.2 – have been quite high in recent years in some countries (this issue is discussed in more detail in section 3.7). On the one hand, a current account deficit is a normal feature of a restructuring economy, especially when it is growing fast. On the other hand, the deficit can be a source of vulnerability and macroeconomic instability, especially when financed by short-term capital flows. Maintaining current account deficits within sustainable limits thus requires a continuous monitoring of the delicate balance between stability and growth (which may change over time as a result of varying external conditions) which in turn calls for close policy coordination and policy flexibility.

One of the negative consequences of the global financial crisis for the transition economies was a general deterioration of borrowing conditions on the international financial markets. Immediately after the Russian default in August access to these markets was practically denied to most transition economies; in the months that

_____

[160] The components of the demand shock and its sequencing are discussed in sect. 3.3(ii).

[161] Only partial and preliminary current account data for the fourth quarter were available at the time of writing this *Survey*.

TABLE 3.1.2

International trade and external balances of the ECE transition economies, 1996-1998
(Rates of change and shares, per cent)

	Merchandise exports in dollars (growth rates)			Merchandise imports in dollars (growth rates)			Trade balances (per cent of GDP)			Current account (per cent of GDP)		
	1996	*1997*	*1998[a]*	*1996*	*1997*	*1998[a]*	*1996*	*1997*	*1998[a]*	*1996*	*1997*	*1998[a]*
Eastern Europe	3.0	5.9	9.8	14.5	6.5	8.6	-9.6	-10.6	-9.5	-3.7	-4.3	-3.7
Albania	5.3	-33.5	..	40.5	-32.1	..	-26.0	-21.1	–	-4.0	-12.0	-0.9
Bosnia and Herzegovina	141.6	87.4	22.2	129.9	29.2	-32.0	-41.3	-43.3	..	..	..	..
Bulgaria	-8.5	0.5	-12.6	-10.0	-3.7	2.2	-1.9	0.3	-4.0	0.2	4.2	-1.0
Croatia	-2.6	-7.6	6.6	3.7	16.9	-2.0	-16.5	-24.5	-18.1	-4.3	-12.1	-5.4
Czech Republic	4.3	2.7	17.0	10.5	-1.3	5.0	-10.2	-9.2	-3.6	-7.6	-6.2	-1.2
Hungary	2.2	21.6	21.3	4.8	17.0	21.3	-5.4	-4.7	-5.7	-3.7	-2.1	-3.7
Poland	6.8	5.4	6.3	27.9	13.9	11.4	-8.9	-11.6	-12.5	-0.9	-3.0	-3.4
Romania	2.2	4.3	-3.3	11.3	-1.4	7.4	-9.5	-8.2	-8.9	-7.3	-6.7	-6.8
Slovakia	2.8	0.2	8.2	26.6	-8.0	6.5	-12.2	-10.5	-10.2	-11.2	-6.9	-10.1
Slovenia	-0.1	0.8	7.3	-0.7	-0.7	5.5	-5.9	-5.4	-5.0	0.2	0.2	0.4
The former Yugoslav Republic of Macedonia	-4.7	2.8	12.8	-5.4	7.8	9.6	-10.8	-15.5	-14.0	-6.5	-7.4	-6.3
Yugoslavia	20.6	28.7	6.7	54.3	16.7	1.3	-14.2	-13.4	..	..	-7.2	..
Baltic states	17.6	23.0	8.3	26.3	26.7	14.1	-18.6	-22.0	-22.6	-8.2	-9.5	-11.3
Estonia	13.2	40.9	13.0	27.2	37.5	15.0	-26.4	-32.4	-32.7	-9.7	-12.0	-9.7
Latvia	10.7	15.9	12.9	27.6	17.4	22.3	-17.1	-19.0	-20.4	-5.4	-6.2	-9.7
Lithuania	24.0	15.1	2.7	24.9	23.8	9.5	-15.3	-18.6	-19.1	-9.2	-10.2	-13.0
CIS	10.2	1.8	-13.6	5.9	18.7	-0.6	7.0	5.4	4.7	1.2	-0.5	-3.9
Armenia	55.4	-12.2	8.9	67.1	4.5	18.4	-25.8	-28.1	-27.3	-18.3	-18.8	-21.1
Azerbaijan	-3.1	18.1	-40.1	41.4	-28.6	46.3	-8.8	-1.0	-9.3	-29.2	-23.7	-30.6
Belarus	6.3	1.8	-7.4	25.6	21.2	13.2	-3.5	-7.1	-9.0	-3.8	-6.0	-7.4
Georgia	23.3	45.1	-16.4	78.7	44.1	10.2	-8.2	-10.0	-11.7	-6.6	-7.0	-7.0
Kazakhstan	15.7	28.4	-3.4	12.3	51.9	13.6	6.9	7.0	5.3	-3.6	-4.1	-4.1
Kyrgyzstan	-20.0	154.5	4.7	107.6	-21.9	59.4	-13.4	0.6	-6.3	-23.7	-7.8	-19.1
Republic of Moldova	-9.7	6.0	-14.0	54.5	35.0	20.5	-9.9	-15.6	-29.9	-11.1	-13.9	-23.3
Russian Federation	8.7	-1.2	-14.9	-4.9	23.3	-0.2	8.8	6.7	7.1	2.8	0.8	-2.7
Tajikistan	-11.6	7.7	-16.2	-13.9	-6.2	-7.4	14.6	22.2	6.5	-7.0	-5.4	-4.6
Turkmenistan	-42.1	-45.5	-29.7	49.3	-42.5	-15.7	-17.3	-8.6	-9.7	2.0	-22.2	-25.4
Ukraine	13.4	23.6	-8.0	17.1	12.7	-6.2	1.3	2.8	2.6	-2.7	-2.7	-4.1
Uzbekistan	94.0	-4.4	-13.6	96.0	1.9	-31.5	0.9	-0.5	0.3	-7.1	-3.9	-3.4
Total above	6.7	4.7	-0.2	12.7	10.6	6.5	-0.1	-1.4	-2.7	-0.9	-2.2	-4.0
Memorandum items:												
CETE-5	4.0	6.8	12.7	15.6	6.7	10.7	-8.6	-9.5	-9.1	-3.3	-3.5	-3.3
SETE-7	-0.6	2.5	-1.4	8.7	4.8	3.1	-11.2	-12.4	-11.1	-5.3	-6.8	-5.4

Source: National statistics, CIS Statistical Committee and direct communications from national statistical offices to UN/ECE secretariat; UN/ECE secretariat computations.

Note: Foreign trade growth is measured in current dollar values. Trade and current account balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. Trade values include the "new trade" among the successor states of former Czechoslovakia and the former SFR of Yugoslavia, but not intra-CIS trade. Current-price GDP values are in some cases estimated from reported real growth rates and consumer price indices. On regional aggregates, see the note to table 3.1.1.

[a] January-September.

followed, the conditions eased somewhat[162] but the costs of borrowing in general remained much worse than they had been before the crisis. As a consequence (as discussed in section 3.7), a number of transition economies started to face serious balance of payments constraints already in 1998; others may well be facing them in the near future. On the other hand, there has also been a growing differentiation among the transition economies in their access to the international capital markets. It is noteworthy that some of the most advanced

reform countries did not apparently have problems in financing their current account deficits; the inflow of FDI to these countries in 1998 was also unaffected by the financial turmoil.

The painful experience of a number of recent transformation crises (Romania is a case in point – see section 3.2(iii)) point once again to the enormous difficulties that policy makers and the population at large are still facing in a number of transition economies. Moreover, the unexpected general economic downturn in 1998 – coupled in some cases with financial turmoil – revealed once again the inherent fragility and vulnerability of the transition economies to setbacks and, especially to those caused by external shocks. In this

_____

[162] In the last quarter of 1998 and in the beginning of 1999 several ECE transition economies were able to borrow again on international markets.

context, chronic economic weaknesses – if left unchecked – may set the stage for a full-scale financial and economic crisis. One of the main lessons from this recent experience is thus related to the dangers of complacency: a deliberate, consistent and long-term policy effort – combining prudence and a dedication to reform – is the major prerequisite for successful transformation; otherwise recovery and macroeconomic stabilization may be easily reversed.

(ii) Short-term outlook

Due to the considerable volatility of output in the second half of 1998, the short-term outlook for the ECE transition economies is very uncertain. At the moment of writing this *Survey* it was not clear how much deeper the current downturn might go and how much longer it would last. However, if the deterioration in west European economic performance continues in 1999, as well it might, then a number of transition economies, including some of those that have grown rapidly in recent years, could even move into recession. The rising uncertainties (and the increased downside risks) are a serious handicap in attempting to quantify even the short-term outlook and this, in itself, presents a serious challenge to economic policy in the transition economies.

Most of the official government forecasts reported in table 3.1.1 are those associated with the formulation of the 1999 budgets. Although the budget procedures and their timing vary widely among countries, in the majority of cases the 1999 budgets were prepared before the worsening of output became clear, when expectations about 1999 in general were much more optimistic.[163] Since that time some governments have lowered their growth forecasts for 1999 and some of these revisions are reflected in table 3.1.1. However, on average, most of the forecasts in table 3.1.1 still appear to be somewhat optimistic, especially in view of the possible further weakening of west European demand and the continuing volatility of output in some transition economies in the first few months of 1999.[164]

According to the available official forecasts, governments in all the east European and Baltic countries (with the exception of the Czech Republic and Romania) still expect positive economic growth in 1999. Among the central European transition economies, the growth projections underlying the budgets were highest in Hungary and in Poland where some 5 per cent GDP

growth is envisaged in 1999. However, in recent statements government officials in both countries have warned that these targets were unlikely to be met.[165] The Czech budget was drafted under the assumption of 1.5 per cent GDP growth in 1999, but with the dramatic worsening of output in the fourth quarter of 1998, when quarterly GDP fell year-on-year by 4.1 per cent, this forecast has been lowered and it is likely that recession will continue in 1999.[166] The 1999 budget adopted by the new Slovak government assumes a considerable slowdown in economic activity but positive GDP growth (of 3 per cent) is still expected in 1999. However, given the scale of the required adjustment effort in Slovakia, even this reduced growth rate may turn out to be optimistic. Official expectations were also cut substantially in Croatia: preliminary estimates of some 5 per cent GDP growth in 1999 were first lowered to some 3 per cent and at the beginning of the year the central bank reduced it further, to 1.5-2 per cent.[167] Recession is likely to continue in Romania in 1999 but its depth remains uncertain. The government forecast of a 2 per cent decline in GDP is conditional on renewed financial support from the IMF which is still under negotiation. In the absence of IMF finance Romania may face a serious balance of payments constraint due to the problem of servicing its foreign debt and in this case, the actual decline in GDP may be even worse.

As output kept decelerating in 1998 in the Baltic states, so did the official forecasts for 1999. In October 1998, the official forecasts for the three Baltic countries still envisaged that GDP growth in 1999 would be in the range of 5-7 per cent.[168] Since then, the forecasts have been lowered in all three countries, and in mid-March their GDP, on average, was expected to grow by 4.5 per cent (table 3.1.1), some 1.5 percentage points below the expectations of five months ago.[169]

---

[163] The actual deterioration in output performance became evident only towards the end of 1998 and in the beginning of 1999.

[164] These difficulties are also reflected in private sector forecasts as well, but a clear downward trend of expectations can be traced in the most recent forecasts. For example, between September 1998 and March 1999, the mean of available private forecasts of 1999 GDP growth in the Czech Republic decreased by almost 2 percentage points to -0.4 per cent; in the case of Hungary it was lowered by 0.5 percentage point to 3.8 per cent; in Poland it was reduced by 1.6 percentage points to 3.7 per cent. Consensus Economics Inc., *Eastern Europe Consensus Forecasts*, March 1998.

[165] In the case of Poland, Prime Minister Jerzy Busek stated in March that he expected GDP to grow by 4.5 per cent in 1999. Oxford Analytica, "Poland: slowdown response", *Oxford Analytica Brief*, 15 March 1999. The National Bank of Poland has also lowered its 1999 growth forecast to 4-5 per cent (statement by Central Bank Governor Hanna Gronkiewicz-Waltz as reported by *Reuters News Service,* 2 March 1999). In Hungary, the Economics Minister Attila Chikan stated, also in March, that GDP growth would not reach 5 per cent in 1999 and that the Ministry of Economics was preparing a revised forecast envisaging growth in the range of 3-4 per cent (*Reuters News Service*, 17 March 1999).

[166] Both the Ministry of Finance and the Central Statistical Office in the Czech Republic prepare independent forecasts. At the beginning of February the Central Statistical Office had already revised its 1999 GDP forecast to a 0.8 per cent decline. The forecast of the Ministry of Finance was also revised downwards but as of February it still envisaged some 1 per cent GDP growth in 1999 (*Reuters News Service*, 3 February 1999).

[167] Statement by Central Bank Governor Marko Skreb, as reported by *Reuters News Service*, 12 February 1999.

[168] UN/ECE, *Economic Survey of Europe, 1998 No. 3*, p. 49.

[169] The downward revision of forecasts has since continued. On 18 March Lithuania's Ministry of Economics announced a reduction in its 1999 GDP forecast to 3.7-4.1 per cent. *Reuters News Service*, 18 March 1999.

Official forecasts envisage falling GDP in 1999 in three of the CIS countries – the Republic of Moldova, the Russian Federation and Ukraine (table 3.1.1). Moderate but still positive GDP growth is projected for Kazakhstan and Kyrgyzstan, whereas in the rest of the CIS countries for which official forecasts were available relatively high rates of GDP growth are envisaged. While the reliability of many of these forecasts remain questionable, one feature is common to all of them: economic prospects in the CIS as a whole by and large depend on the performance of the Russian economy. However, at the beginning of 1999, numerous uncertainties surround the economic prospects of Russia. Among them, the unsettled issue of servicing of the foreign debt is probably the most acute problem facing the Russian economy in 1999. These uncertainties are reflected in the different forecasts for the Russian Federation: as late as March, the official forecasts for the decline in GDP in 1999 ranged between -2 and -10 per cent.[170] But whatever course the Russian economy takes in 1999 will determine to a large extent the growth path in many of the other CIS countries as well.

As regards inflation, the short-term outlook varies considerably among the transition economies. The better than expected 1998 inflation performance in a number of transition economies was largely determined by external factors, in the first place, the considerable fall in world commodity prices. In the short run there does not appear to be much room for further falls in these prices, but on the other hand an abrupt upward reversal also seems unlikely. Under these circumstances price developments in the transition economies in 1999 are likely to be determined mostly by domestic factors. Hence, while it can be expected that the medium-term trend of disinflation will continue in the more advanced economies, price developments in 1999 on average will probably not match the disinflation record of 1998. On the other hand, the series of currency crises in 1998 resulted in currency devaluations in a large group of transition economies (for details see section 3.2(ii)), and a renewed upsurge of inflation in these can probably be expected in 1999.

Another issue that is likely to have an important bearing on economic performance in 1999 is the level of current account deficits and their financing. Despite some easing in borrowing conditions, at least for some borrowers, it can be expected that international financial markets will in general remain tight, and that borrowing will be more limited and relatively more expensive than it

_____

[170] The latest available forecast by the Russian Ministry of Economics was drafted in February and it assumed that GDP would fall by 2.5 per cent in 1999 (*Interfax News Agency*, 12 February 1999). Subsequently, the Analytical Department of the Duma published a report in March ("On the forecast of socioeconomic development in Russia for 1999") which contained three basic scenarios: according to the first (which was in agreement with that of the Ministry of Economics) GDP would decline by 2-3 per cent in 1999; in the second scenario the fall in GDP amounted to 5-6 per cent; and in the third GDP declined by 9-10 per cent. WPS Inc., *Banks and Exchanges Weekly*, 9 March 1999.

was before the global financial crisis. Given the increasing divergence in the performance of individual transition economies, the accessibility of financial markets is also likely to remain highly differentiated: while some countries will probably continue to enjoy a privileged status, others will find it increasingly difficult to borrow. Thus, balance of payments constraints may emerge in some cases as the dominant factor in determining the performance of individual economies. The tightening of balance of payments constraints in some transition economies that previously were able to finance relatively large external imbalances may force them to make unwelcome macroeconomic adjustments and thus dampen further their rates of economic growth.

3.2 Issues in transformation policy

(i) Policy challenges in the current stage of transition

The transition from plan to market posed a double challenge for policy makers in the transition economies. On the one hand, the process of economic transformation was unprecedented in terms of both the nature of the policy issues involved and the severity of the problems to be solved. On the other hand, due to their decades of isolation and adherence to central planning dogmas, policy makers in these countries had little, if any, experience with modern economic policy-making. The policy-making background was also rather weak: with the exception of a small number of (mainly central European) countries, there were actually very few trained economists and there was a general deficiency of administrative know-how and skills. Transition was thus also a "learning-by-doing" process for policy makers in these countries and, inevitably, one characterized by "trial-and-error".

Almost a decade after the start of economic transformation, the policy scene in many of these countries now looks rather different. Many of the transition economies have made remarkable progress in the policy process in terms of developing both its conceptual basis and the actual policy mechanisms and instruments required for effective implementation. However, as with many other aspects of the transition process, there are also growing disparities among countries in the general stance of economic policy. The "leading" reform countries, in terms of institutional and structural questions, are often also ahead as regards the depth and sophistication of their policy process. In most of the central European and Baltic countries, the cardinal regime changes which were typical of the initial stages of the transition – and which as a rule involved some macroeconomic turbulence – have already been implemented, albeit with varying degrees of success. It is sometimes asserted that these countries have more or less completed the "first phase" of the transformation process and have now entered a new one where the policy issues and problems are of a rather different nature.

For example, in this second phase the macroeconomic policy process is turning towards fine-tuning and is becoming more routine, combining longer-term objectives with current day-to-day management. This requires continuous policy coordination, especially between fiscal and monetary policy, and although this does not always work smoothly, the accompanying policy debate has contributed to improving the quality of the policy process. Painful setbacks can still occur within this group of transition economies (as indicated by the recent experience of the Czech Republic); however, these disturbances are starting to resemble cyclical downturns in mature market economies. The composition of the macroeconomic policy mix in the more advanced reform countries has also changed significantly. The apparent eclecticism in defining the nature of macroeconomic policy and its components which marked the early stages of the transition has gradually diminished and even disappeared altogether. In particular, a clearer distinction has developed between the policy issues addressed by monetary and fiscal policy; there has also been growing emphasis on creating automatic countercyclical mechanisms and increasing the flexibility of the available macroeconomic policy tools.[171]

It is worth stressing that the aspiration for reintegration in the European economy – and ultimately for future EU membership – has been a very strong driving force for the positive changes in the economic policy process in these countries. The necessary legislative harmonization and policy synchronization with the EU – in itself a formidable policy challenge – is not only an essential element of the preparations for EU accession but has also been a strong stimulus for upgrading the policy process and the functioning of the public administration in these countries. Moreover, the more energetic has been the effort to achieve the medium-term objective of harmonization with the EU, the stronger has been the positive externality of policy-specific administrative knowledge and skills being diffused towards the aspirant countries.

Despite the progress in reforms and the refinement of the policy process, policy makers still face numerous challenges even in the more advanced transition economies. Within the principal macroeconomic policy mix, the dualism of monetary and fiscal policy in general probably calls for a better balance between the macroeconomic policy goals pursued through the instruments of monetary and fiscal policy. At the start of economic transformation the monetary-fiscal dualism was somewhat disproportionately biased towards monetary policy: the main macroeconomic policy objectives were primarily pursued through monetary policy tools while fiscal policy apparently lagged behind, especially as regards its role in demand management. Indeed, as mentioned above, in recent years the policy

process has improved considerably (notably, in this direction) in the advanced reformers; however many transition economies still have a long way to go.

The background of this policy imbalance was both conceptual and technical in nature. Conceptually it was a reflection of the philosophy of the transformation paradigm embodied in the reform packages, especially those applied in the early phases of transition. These were in many cases strongly influenced by the "Washington Consensus" (see chapter 1) which in principle assigns higher priority to monetary policy than demand management. Technically, it was a consequence of the fact that it takes relatively much less time, resources and effort to constitute an operating monetary authority, capable of pursuing well defined monetary objectives than to establish a similar policy infrastructure for the pursuit of (macroeconomic) fiscal policy goals.

As discussed in section 3.2(ii), the monetary authorities in a number of transition economies have made considerable progress in this respect: they are capable of setting a wide range of monetary objectives and have developed the policy instruments to pursue such objectives. This notwithstanding, the central banks in the transition economies often face difficult policy dilemmas in implementing their agenda and in the day-to-day conduct of monetary policy. In addition to that, the underdeveloped money and capital markets and the still limited arsenal of available policy tools at the disposal of central banks, may limit the efficiency of monetary policy. Thus – as argued in section 3.2(ii) – when faced with conflicting policy objectives (as appears to have been the case in 1998), the monetary authorities may sometimes be forced to revert to "second best" policy decisions. In part, this conflict may also be a consequence of the imbalance between the monetary and fiscal policy noted above: due to this imbalance monetary policy may sometimes turn out to be overburdened with macroeconomic policy objectives, some of which may in principle be possible to pursue (and probably to pursue more efficiently) through other policy means, in particular through fiscal policy.

In fact, through a large part of the 1990s, and especially in the first phase of transition, fiscal policy in many transition economies has predominantly concentrated on the containment of endemic fiscal crises, largely stemming from the legacies of the communist past and the transformational recession.[172] At the extreme (which however was not uncommon in this period), this one-sided notion of fiscal policy was merely reduced to the pursuit of quantified budget deficit targets. Regrettably, such a simplistic approach fails to take into account the fact that not only the deficit position but any

_____

[171] See, for example, National Bank of Hungary, *Monetary Policy Guidelines 1999* (Budapest), pp. 5-7.

[172] J. Campbell, "Reflections on the fiscal crisis of post-communist states," pp. 84-112, and S. Owsiak, "Financial crisis of the post-socialist state. The Polish case", pp. 149-167, in J. Hausner, B. Jessop and K. Neilsen (eds.), *Strategic Choice and Path-Dependency in Post-Socialism: Institutional Dynamics in the Transformation Process* (Aldershot, Edward Elgar, 1995).

fiscal action has macroeconomic implications – even if these are not explicitly spelled out or intended. Thus, sometimes (Russia is the most conspicuous example in this regard) the blind pursuit of deficit targets, disregarding complex causal relations and the actual factors (including microeconomic and institutional ones) that cause the fiscal deficit in fact did lead to perverse macroeconomic outcomes.[173]

More recently, and especially with the emergence of new, transition-specific imbalances, the scope of fiscal policy in some of the more advanced reformers has been broadened to incorporate some of the features of more conventional demand management. Thus, as discussed in section 3.3, when faced with unsustainable external or domestic imbalances, a number of transition economies have in recent year been compelled to restore equilibrium (or at least to reduce the imbalances) largely through the use of fiscal policy. However, so far, the widening of the scope of macroeconomic fiscal management has leaned almost exclusively towards its use in cutting expenditure.[174] Besides, there appears to be ample room for a more sophisticated use of fiscal policy through the differentiated management of the individual component of the fiscal accounts.

The unexpected slowdown of economic growth in the second half of 1998 poses further challenges for the conduct of fiscal policy. It is natural to expect larger fiscal deficits in the downward phase of a cycle and this should be borne in mind in designing the proper policy response. An excessive fiscal austerity in response to lower revenue and the desire to meet targeted fiscal deficits (planned under different conditions and assumptions) at any cost, may in fact have perverse effect: such policies may further dampen output and the end result may be even larger deficits. Thus the current downside risks in the economic outlook call for more policy flexibility and innovation as well as greater coherence and closer coordination of all elements in the macroeconomic policy mix to counterbalance these adverse effects.

In contrast to the notable progress in economic transformation in some (mostly central European and Baltic) countries, important reforms have been stalled or have suffered serious setbacks in a number of transition economies, especially in the Commonwealth of Independent States but also in south-eastern Europe. Policy makers in these countries are still faced with

problems that are typical of the first phase of transition, such as the existence of major macroeconomic disequilibria and, hence, persistent sources of macroeconomic instability. Indeed, some transition economies have been in a state of "permanent crisis" since the very start of the transformation process. While these problems are largely due to the considerable difficulties in the implementation of the transformation agenda, they also – at least partly – reflect gaps and flaws in the policy process itself: inconsistencies and incoherence in the policy mix; the absence of policy discipline; poor policy coordination; and a lack of public debate about the policy course, with the consequent failure to gain public support for difficult but necessary reforms.

Due to the lack of experience and expertise, the economic policy process in some transition economies is still embryonic and this adds to the overall fragility of their economies and their vulnerability to disturbances and shocks. It is not uncommon for important policy decisions to be taken in an ad hoc manner and without a coherent and consistent framework for policy and long-term objectives. In the absence of overall policy consistency and due to a myopic bias caused by a state of "permanent crisis", policy is often inefficient and sometimes produces unintended or perverse macroeconomic consequences. In turn, the lack of transparency in the policy process encourages corruption and rent-seeking behaviour which further reduces the efficiency of the policy-making process.

Ironically, it is this group of lagging countries, which is most in need of outside assistance for improving the policy-making process but which de facto has received less than the leading reformers. The international financial institutions (IFIs) have indeed been active in this region and maintain operations in most of the less advanced transition economies. However, the main problem is that when economic performance in these countries goes off-track (and it tends to do so more often in their fragile economic environment), the IFIs, due to the nature of their assignment and their terms of reference, tend to withdraw as well. Consequently, national policy makers are left on their own exactly at the moment when they are most in need of external assistance.

In addition, the less advanced transition economies tend to have less intensive relations with the EU and some of them in fact have not even been part of the debate on the future enlargement of the EU.[175] Despite the existence of some forms of EU financial assistance, the countries without association agreement have been left outside the accompanying policy discussions and, hence, have not benefited to the same extent from the infusion of policy-related know-how from the EU. The decision to start pre-accession negotiations with only five

---

[173] For example the mechanical sequestration of budgetary spending to meet deficit targets (in view of revenue shortfalls) had highly detrimental macroeconomic repercussions for the Russian economy. UN/ECE, *Economic Survey of Europe, 1998 No. 3*, pp. 31-41.

[174] A notable exception has been the use of fiscal policy to boost domestic demand, via public investment, in Slovakia. However, as argued in sect. 3.3, the policy wisdom of this experience is rather questionable: due to its unsustainable scale and because it was not designed in the framework of an overall consistent macroeconomic policy, this fiscal boost led to a dangerous escalation in the external and domestic imbalances.

[175] Only 10 ECE transition economies have association agreements with the EU and none of them are CIS countries.

of the 10 associated transition economies is also likely to add to the existing disparities. With the start of the pre-accession negotiations, the "fast track tier" of countries (which is anyway more advanced in the reform and policy process) will begin to receive a disproportionately large share of financial and technical assistance from the EU[176] while the flow of assistance to the countries left out of the negotiations at this stage (and which are less advanced in the reform process) will decline, at least in relative terms.

The unprecedented difficulties and policy challenges in the implementation of the transformation agenda are mirrored in the recent series of transformation crises in several ECE transition economies. Given the severity of these crises as well as their unprecedented nature and character, various issues of this *Survey* have been devoting special attention to them, in an attempt to identify their causes and the mechanisms through which they evolve and escalate.[177] Following this tradition, section 3.2(iii) contains an analytical assessment of the difficult transition process in Romania, focusing both on the underlying roots of the "permanent crisis" in Romania and on the causes of the recent acute deterioration of the economic situation in this country. The nature of many of the economic problems that Romania has been facing throughout the entire decade of the 1990s – as well as the roots of these problems – are not only confined to Romania; for the most part they are also characteristic of most transition economies. It is mainly the frequency and scale of the problems that differ from country to country and that define whether or not they have the potential to develop into a crisis.

As argued in chapter 1, the series of transformation crises poses a number of questions about the wisdom of the prevailing transformation paradigm (at least as regards its success in some transition economies) which was heavily influenced by the "Washington Consensus". This philosophy – underlying the transformation agenda in many transition economies (and especially in the programmes implemented in the first phase of transition) – presumed that sustainable macroeconomic stabilization could be easily and rapidly achieved through rapid liberalization and monetary austerity; it was supposed (at

least implicitly) that this would then pave the way for setting the economy on a path of high and self-sustained growth. This paradigm embodied strong reliance on the automatic operation of the market mechanisms in restructuring the economy, an assumption incorporated – at least implicitly – in the design of the transition programmes. The main ingredient of success, it was believed, was the strong political will to press ahead with a reform agenda so formulated.

The increasing number of transformation failures has shown that in many cases this paradigm did not perform in accordance with expectations. In particular, it was found to pay insufficient attention to a number of factors which were crucial for the transformation process. Among these are several that are clearly identified in the analysis of the Romanian crisis (section 3.2(iii)), namely, the crucial importance of the starting conditions for the success of economic restructuring and transition in general; the key role of institutions, not only for the establishment and proper functioning of markets (an issue that has been repeatedly stressed in previous issues of this *Survey*) but also for avoiding a vicious circle of "path dependence" in economic performance during the transition; and the fact that the endogeneity of the policy process may become a dominant factor during a period of severe structural adjustment.

As shown in section 3.2(iii), the starting conditions can in principle be presented in terms of the transition economy's "distance" from the "normal" state of mature market economies (or, equivalently, from any desired "end-point"). This quantifiable measure (which is country-specific and which in general depends on the inherited distortions in the domestic allocation of resources and in relative prices) helps to define the magnitude of the required adjustment effort to be made in the course of the transformation process. As adjustment is costly and painful, and because there is a limit to the pain that will be endured by the population, (beyond which social cohesion will be threatened) the needed adjustment time basically depends on two parameters: 1) the "distance" from the starting point to the desired structure and 2) the available (locally or attracted from abroad) resources required to make the necessary adjustment.

The transition economies that have made the most progress in the transformation process so far are those that had to cover a smaller "distance" and/or were capable of attracting more external resources (in the first place FDI). In contrast, the most severe transformation crises have occurred in countries where both these conditions were most unfavourable. The fact is that 10 years after the start of economic transformation, some transition economies are still incapable of sustaining their own economic performance and can only keep functioning with the continued support of international assistance.

However, the issue of regaining economic sustainability is intimately related to economic restructuring in the broader sense, that is, to the

---

[176] Since the Essen Council of December 1994, EU assistance programmes, PHARE in particular, are to be increasingly directed at preparing the potential candidates for accession. The Court of Auditors has interpreted this to mean "that a substantial part of the PHARE Programme should be oriented towards a larger-scale and more adequate preparation of the administrations of the candidate states concerned for the understanding, the adoption and the implementation of the main Community policies and the related regulations". See the *Annual Report* concerning the financial year 1994 together with the institutions' replies, OJC303 (Luxembourg), 14 November 1995, p. 216. On the strategic influence of the EU on the development of policies and institutions in both candidate and non-candidate transition economies, see UN/ECE, "Enlarging the European Union to the transition economies", *Economic Bulletin for Europe*, Vol. 48 (1996), pp. 7-18.

[177] An analytical account of the transformation crisis in Bulgaria is given in UN/ECE, *Economic Survey of Europe in 1996-1997*, pp. 75-84; the Czech exchange rate crisis is discussed in UN/ECE, *Economic Survey of Europe, 1998 No. 1*, pp. 75-82; and the crisis in Russia is analysed in UN/ECE, *Economic Survey of Europe, 1998 No. 3*, pp. 31-41.

establishment of a sufficiently large number of viable businesses that would pull the whole economy onto a viable performance path. In this respect, some transition economies appear to be unrestructurable on their own – that can only be done if there is an inflow of external resources on a significant scale (and considerably larger than current levels of official assistance). Obviously, the international financial markets would hardly be willing to supply such funds on such a scale, especially, given their current sentiment towards emerging markets. This underlines the need for a more differentiated approach by the international community towards the transformation process in individual transition economies.

Wide public support is crucial for the success of complex and painful reforms. This aspect of the reform process has been repeatedly emphasized in the recent policy reform literature.[178] An important part of this literature has studied the importance of political constraints for the success of policy reforms: it has been argued that political constraints may be a key factor in the reform process and may impede the successful implementation of a reform package even in the presence of the political will to push it forward, and even if the latter increases long-term social welfare.[179] Other important findings concern the endogeneity of the policy process: the policy process can be strongly affected by the actual outcome of the ongoing reform process.[180]

It can be argued that, given the scale of the required adjustment effort which needs to be engineered through policy reforms in the course of economic transformation (and which is largely determined by the starting conditions) and the available resources at the disposal of the authorities, the endogeneity of the policy process by and large determines the plausible speed of restructuring. As shown in the case of Romania (section 3.2(iii)), when the required adjustment is very large, the endogeneity of the policy process (i.e. the extent to which policy can be followed independently of previous outcomes) may

become a dominant factor that determines the plausibility of the policy course and de facto sets upper limits to the possible speed of restructuring. If adjustment is pushed at a greater speed than the plausible one (in terms of social cohesion), policy is likely to generate perverse results and resistance to reforms.

In this context, public resistance to transformation reforms and the emergence of political structures that are strongly opposed to the policy of reforms in some countries is not solely based on ideological grounds as is often suggested. These reflect the emergence of large numbers of people who are not only losers in the transformation process but who also see no chance of becoming winners.[181] These processes are at the same time the regrettable outcome of wrong policy prescriptions made in the first phase of economic transformation; had this first phase been more successful – and more successful in a greater number of countries – the political environment could have been much more reform-friendly in the transition economies in general and in each individual country.

On the other hand, domestic policy can affect the level of resources deployed in support of an adjustment effort (especially those attracted from abroad), and hence may also have a positive impact on the plausible speed of restructuring. Establishing a favourable investment climate, policy transparency and predictability, the establishment of the rule of law, legislative as well as political stability, are all factors that can affect the inflow of external resources, in particular FDI. Thus, Hungary provides a good example of policy attracting FDI at the early stages of transition when there was relatively much greater interest by direct investors in expanding business in the former centrally planned economies. At the same time Hungary never applied shock-therapy type of liberalization-cum-monetary austerity and never pushed for speedy disinflation; rather, a more gradualist approach was followed towards macroeconomic stabilization coupled with a pragmatic and non-doctrinaire approach to foreign participation in the economy.

On balance, despite the considerable progress in transformation reforms, the policy challenges and dilemmas in the current phase of transition still appear to be formidable. The questions are still much more numerous than the readily available answers and most transition economies, even the most advanced ones, still have a long way to go before they reach the mature state. The international community, the IFIs as well as the European Union – the leading regional economic power – have a great responsibility in assisting and guiding this difficult process.

---

[178] This literature analyses the process of policy reform in the context of motivated behaviour of policy agents (representing interest groups, in particular, "winners" and "losers" from policy reforms) who operate under political constraints (support or resistance to the reform process).

[179] For example, some studies have analysed the importance of uncertainty as a political constraint for policy reforms. If there is considerable *ex-ante* uncertainty about the outcome of reforms, political support for the reform may be weak and these expectations may negatively affect electoral results. R. Fernandez and D. Rodrik, "Resistance to reform: status quo bias in the presence of individual-specific uncertainty," *American Economic Review*, Vol. 81, No. 5, 1991, pp. 1146-1155; A. Drazen, "The political economy of delayed reform," *Journal of Policy Reform*, Vol. 1, No. 1, 1996, pp. 25-46. Other studies have focused on the political constraints to microeconomic restructuring due to the resistance of workers that are threatened by displacement. M. Dewatripont and G. Roland, "Economic reform and dynamic political constraints," *Review of Economic Studies*, No. 59, October 1992, pp. 703-730.

[180] The endogeneity of reform policies and public attitude to reforms (and the fact that they may and do change endogenously over time) have been studied in the same vein of literature. A. Krueger, "Virtuous and vicious circles in economic development," *American Economic Review (AEA Papers and Proceedings)*, Vol. 83, No. 2, 1993, pp. 351-355.

[181] Russia and Ukraine are among the countries that are most frequently quoted as examples of where public resistance to reforms has taken the form of organized political structures which even dominate the current political spectrum. However, similar processes have taken place in other transition economies as well.

(ii) Monetary policy

(a) Overview of monetary policy in 1998-1999

In pursuing their main objective – maintaining the general price level within a specified range – national monetary authorities use indirect levers which affect prices through the monetary transmission mechanisms.[182] Hence, in most cases, the monetary policy goals are defined in terms of intermediate targets which, in turn, depend on the chosen monetary and exchange rate regime. In the case of a fixed or pegged exchange rate regime the target is the nominal exchange rate and the main policy tool of the central bank is its own lending rate (which serves as a reference point for the level of domestic interest rates) while money supply is more or less treated as endogenous.[183] In the extreme case of a currency board regime, there is no room for an independent monetary policy as the monetary authority cannot act as a lender of last resort and loses the interest rate as a policy tool.[184] In the case of a pure floating regime, the monetary authorities usually target the level of money supply (as defined by a selected monetary aggregate) while the exchange rate is left to be determined on the market. The main policy tool is again the interest rate but in some cases direct controls over the monetary aggregates are also applied. In the intermediate cases of a pegged exchange rate with a fluctuation band or a managed float, the central bank may set multiple targets (with explicit or implicit priorities among them).

The central banks in the transition economies still face numerous challenges in implementing monetary policy. The conduct of monetary policy is largely hampered by the inefficient monetary transmission mechanisms which, in turn, is a consequence of underdeveloped money and capital markets. The institutional infrastructure of these economies (even in the more advanced let alone the less advanced reform countries) is still relatively fragmentary and weak. Markets are marred by inherited or transition-specific distortions and are far from being efficient. In general the transition economies lack robustness: they remain quite fragile and prone to disturbances, and policy makers cannot afford to neglect these imperfections in setting their policy agenda.

These inherent weaknesses have come to the forefront of the policy debate since the beginning of the Asian crisis which was marked by high volatility on global financial markets. The Russian crisis – apart from being a major domestic shock – had a further destabilizing impact on the ECE transition economies. These external developments served as a detonator to the internal pressures which had been building up in a number of transition economies in recent years. The exchange rate regimes were especially vulnerable to these pressures and several countries were faced with full-blown currency crises. Many ECE transition economies are now in the process of painful adjustments which, *inter alia*, require some major macroeconomic policy changes.

Contagion from the turmoil in the international financial markets also posed serious challenges to the monetary authorities in the transition economies; on several occasions in this period some of them were forced to revert to emergency measures such as excessive tightening of monetary policy (in some east European and Baltic countries) or even restrictions on the convertibility of the currency (in some CIS countries) to prevent financial and macroeconomic destabilization. Moreover, the immediate impact in terms of direct contagion, strong as it was, was not the only negative consequence of the recent crisis. With time it became clear that the global financial instability and the resulting, unexpectedly strong slowdown of global economic activity would have lasting negative implications not only for output in the transition economies but also, more broadly, on their macroeconomic balances.

The negative developments in the global environment will almost certainly require changes in the focus and priorities of monetary policy. Among the major developments are the possible further weakening of external demand (especially in western Europe) and the rising costs of financing current account deficits. In the two years or so prior to mid-1998 the central banks in the fast-growing transition economies were concerned at the prospect of overheating and the consequences of significant capital inflows; but they are now facing the opposite problem: an economic slowdown and emerging balance of payments constraints. Thus the focus of monetary policy in the more advanced reform countries has been gradually shifting from seeking a balance between growth and stability towards invigorating domestic economic performance and growth. Indeed, some changes in policy priorities along these lines were already observable in the second half of 1998; others were made explicit with the setting of the 1999 monetary policy guidelines.

The introduction of the euro so far does not appear to have had any major impact on the monetary stance of the transition economies. However, in purely practical terms it did affect the conduct of monetary policy insofar as all the transition economies that used the deutsche mark as a reference currency (for a direct peg or as a component of a currency basket) switched to the euro as the reference currency as of 1 January 1999.

_____

[182] During the last decade, a number of developed market economies have turned to "inflation targeting", a regime under which the government or the central bank sets directly an explicit inflation target. G. Debelle, *Inflation Targeting in Practice*, IMF Working Paper WP/97/35 (Washington, D.C.), March 1997. Since 1998, some transition economies (notably the Czech Republic and more recently Slovakia and Poland) have introduced elements of this regime in their policy framework. However, the monetary authorities in these countries have continued, de facto and in parallel, to meet other targets as well and it will probably take some time before inflation targeting will emerge in its pure form.

[183] See, for example, E. Koch, "Exchange rates and monetary policy in central Europe – a survey of some issues", *MOCT-MOST*, Vol. 7, No. 1, 1997, pp. 1-48.

[184] For a description of the currency board regime see UN/ECE, *Economic Survey of Europe in 1996-1997*, p. 70.

Exchange rates

The ECE transition economies apply a wide variety of exchange rate arrangements, covering practically the whole range of existing currency regimes. The various regimes in 1998-1999 were as follows:[185] currency boards in Bosnia and Herzegovina, Bulgaria, Estonia and Lithuania; a fixed exchange rate in Latvia; an adjustable peg in Yugoslavia (where there was a forced devaluation and multiple rates now exist); a fixed rate with a fluctuation band in Slovakia (until 1 October 1998, managed float afterwards); a crawling peg against a currency basket with a fluctuation band in Hungary and Poland; a target band in Russia (until 18 August 1998, managed float afterwards) and in Ukraine (however, with forced changes in the band in this period); a managed float in Croatia, The former Yugoslav Republic of Macedonia, and Slovenia. The rest of the CIS countries formally have floating exchange rate regimes, with varying degrees of intervention by the central banks; however, in most of these countries currency convertibility is limited and multiple exchange rates exist de facto in some of them.

For much of 1998, public attention was focused on the escalating financial and economic crisis in Russia.[186] The crisis culminated in August, when the persistent loss of investor confidence led to a massive outflow of capital from Russia, to the collapse of the exchange rate regime (which had been maintained since 1995), and default on domestic public debt. After the rouble was floated, it lost much of its value[187] and has been under intense pressure ever since; without the reintroduction of some administrative controls over the currency market it would have depreciated even more in this period.

The global financial turmoil and the Russian crisis had a negative impact on the financial markets of all the transition economies. The currencies of a number of them came under growing pressure both as a result of changing investors' sentiments (see next section) and the inherent internal weaknesses of some of these economies. In addition, the collapse of the rouble in August 1998 reduced the competitiveness of Russia's trading partners and especially those neighbouring countries with which it has relatively intense trade relations (see section 3.6). This resulted in import substitution by Russia and lost revenue for the affected exporters.

In effect, the Asian and the Russian crises triggered a series of currency crises in the region which unfolded in an almost identical manner: a persistent run on the currency leading to a drain of the limited currency reserves forced the monetary authorities to give up futile attempts to maintain the exchange rate within its targeted range. Thus on 4 September 1998, Ukraine was forced to abandon the previous fluctuation corridor of 1.8-2.25 hryvnia per dollar and to adopt a new band of 2.5-3.5 hryvnia per dollar, a significant effective currency devaluation. As pressures on the currency continued, a further devaluation occurred on 9 February 1999 when the trading band was raised to 3.4-4.6 hryvnia per dollar.

In the second half of the year pressures also started to increase on the Moldovan leu.[188] After losing some one third of its reserves in defence of the currency,[189] the central bank was forced to discontinue intervention on the foreign exchange market on 2 November. In the week after this decision the leu depreciated by more than 30 per cent. Towards the end of the year, following a worsening of the fiscal balance in the aftermath of the Russian crisis, the Georgian lari also became the target of a speculative attack and on 4 December the central bank abandoned its support of the currency. Within a month the lari lost almost half of its value against the dollar only to recover slightly in the first months of 1999. Following a significant deterioration in the trade and current accounts, the Kyrgyz som also fell victim to a currency run losing over 50 per cent of its value in the second half of 1998.

Among the most affected CIS currencies was the Belarussian rouble. For some time now the Belarussian authorities have been engaged in soft-lending to ailing companies and to the agricultural sector (for which Russia has been the main export market) which had resulted in the weakening of the currency already in 1997. The drying-up of Russian import demand in the second half of 1998 resulted, *inter alia*, in increasing pressure on the currency. Between September 1998 and the time of writing this *Survey* the Belarussian rouble has been falling steadily, resulting in a considerable loss in its value and in the persistent widening of the margin between the official and the trading rates.[190]

---

[185] For an overview of exchange rate regimes and their implications for monetary policy in the transition economies see P. Desai, "Macroeconomic fragility and exchange rate vulnerability: a cautionary record of transition economies", *Journal of Comparative Economics*, Vol. 26, 1998, pp. 621-641; H. Wagner, *Central Banking in Transition countries*, IMF Working Paper WP/98/126 (Washington, D.C.), August 1998.

[186] These developments have been analysed in more detail in previous issues of the *Survey*. UN/ECE, *Economic Survey of Europe, 1998 No. 2*, pp. 22-26; and *1998 No. 3*, pp. 31-41.

[187] Some 70 per cent between September 1998 and February 1999.

[188] Apart from the negative impact of the Russian crisis, the economy of the Republic of Moldova has been marked for several years by serious domestic and external imbalances (a "twin" deficit problem). The lack of progress in correcting these prompted the International Monetary Fund in mid-1997 to discontinue disbursements under a 1996 agreement which rendered the balance of payment constraint even more acute. IMF financing resumed in January 1999 after a tough 1999 budget was approved; however, the current imbalances (and the further weakening of the economy by the Russian crisis) will require a major policy effort to restore equilibrium.

[189] According to a statement by the Central Bank Chairman Leonid Talmaci, intervention by the bank in the period September-October resulted in a fall in the country's hard currency reserves from $300 million to $200 million. RFE/RL, *Newsline*, Vol. 2, No. 212, Part II, 3 November 1998.

[190] It is difficult to be precise about the actual extent of the devaluation due to the complicated system of multiple exchange rates which exists in Belarus as a result of the numerous currency regulations. The official rate is in practice only applied to transactions between the central bank and the government. The trading rate at the interbank market, although formally subject to regulation, has in fact been deviating considerably from the official rate. The exchange bureaus operate at a cash rate which is also subject to regulation. In addition, apparently there exists a black market rate.

Currency troubles were not confined to the CIS region. Faced with a persistently large current account deficit and a worsening fiscal deficit, the National Bank of Slovakia had been experiencing problems for quite some time in maintaining the peg of the koruna; these pressures increased considerably after the collapse of the Russian rouble.[191] On 1 October the central bank abandoned the fixed exchange rate regime and floated the koruna. However, as this move was coupled with a further tightening of monetary policy, it has not so far resulted in a substantial depreciation of the Slovak currency. The considerable deterioration of the economic situation in Romania in 1998 (see section 3.2(iii)) was reflected in a substantial weakening of the currency: in the course of the year the leu lost some 25 per cent of its value against the dollar and continued to fall sharply in the first months of 1999. The Yugoslav dinar was also devalued twice in 1998 (in March and in May).

It is important to note that although contagion from Russia played a role in triggering financial disturbances in other transition economies, in virtually all cases of currency crises the fundamental source of the turmoil was rooted in the serious economic difficulties they were facing in implementing their transformation agenda. The pressures which led to the subsequent collapse of the various exchange rates were in themselves indications of much deeper economic problems and merely signalled the need for major macroeconomic adjustments. One of the regrettable implications of forced devaluation (or unwelcome depreciation) is that it will probably cause a significant upsurge of inflation in these countries thus reversing the favourable disinflation trend of the last several years.

It is also important to note that no early end can be foreseen to the current instability of exchange rate regimes in the affected transition economies and especially those in the CIS. One of the factors that increases the tension is the continuing weakness of the Russian rouble: at the moment of writing this *Survey*, there was still no clear-cut strategy in place for stabilizing the Russian currency.[192] As noted above, the depreciation of the rouble is tantamount to a competitive devaluation vis-à-vis the currencies of neighbouring countries and, as long as the rouble continues to fall, downward pressure will continue to be exerted on them as well.

The capacity of national currencies to resist the financial turmoil that followed in the wake of the Asian and Russian crises seems to have drawn another dividing line between the successfully reforming transition economies and those lagging behind in the process. Despite growing volatility in their financial markets and a significant outflow of capital abroad, most of the central European and Baltic countries have managed to weather the crisis without substantial damage to their currencies.

The crisis did not prevent some of the leading reform countries from successfully pursuing both their long-term and immediate monetary targets. Thus both Hungary and Poland, in the course of 1998, made cuts in the monthly rates of the crawl in their currencies and it is noteworthy that the actual reductions were larger than the *ex-ante* targets.[193] Poland went ahead with a new currency law (in force since January 1999) which constitutes a further step towards meeting the standards of the Organization for Economic Cooperation and Development.[194] Despite the floating exchange rate regime, both Slovenia and to some extent Croatia were less affected by exchange rate volatility, due to the overall coherence of their macroeconomic policies and the use of some instruments for direct capital controls (especially in Slovenia.)

Because of their proximity to and more significant trade relations with Russia, the economies of the Baltic states were strongly affected by the Russian crisis; however, so far, they have been able to sustain their exchange rate regimes. Lithuania continued to prepare for a future exit from the currency board regime, notably through reintroducing some monetary instruments in 1998.[195]

_____

[191] In September alone the central bank reportedly spent some $1 billion of its reserves to support the exchange rate. *Reuters News Service*, 2 October 1998.

[192] Recently several observers have repeated the idea of establishing a currency board in Russia as the most radical and effective approach to achieving macroeconomic stabilization in Russia (it was suggested first by the international financier George Soros, but has since been supported by a number of economists. See, for example, P. Boone, A. Breach and S. Johnson, "Institutions and prospects for a currency board in Russia: perspectives on a deepening crisis", *Post-Soviet Geography and Economics*, Vol. 39, No. 7, 1998, pp. 371-378). Although the discussion of this proposal has helped to achieve a better understanding of its economic problems, a currency board is hardly a viable option for Russia. As argued in previous issues of this *Survey*, the nature and the depth of the Russian crisis, which is largely microeconomic and institutional in origin, appear to demand different approaches to the resolution of the current problems, especially when these are seen in a longer-term perspective. In fact, a number of economists have expressed deep reservations about the chances of success of a currency board in Russia. See, for example, R. Schweickert, "Chancen und Risiken eines Currency Board Systems", *Die Weltwirtschaft*, No. 4, 1998, pp. 421-441.

[193] On 26 February 1998 Poland reduced the monthly rate of the crawl from 1 to 0.8 per cent (and at the same time the fluctuation band for the zloty was widened from ±7 per cent to ±10 per cent from parity). Further cuts in the monthly rate of devaluation took place on 10 July (to 0.65 per cent) and on 4 September (to 0.5 per cent). On 4 November the fluctuation band of the zloty was widened to ±12.5 per cent from parity. Hungary cut the monthly rate of the crawl by 0.1 percentage point to 0.7 per cent with effect from 1 October; a further reduction to 0.6 per cent was made on 1 January 1999. The fluctuation band of the forint has remained unchanged since March 1995, at ±2.25 per cent from the central rate.

[194] The new law contains provisions guaranteeing and facilitating the current account convertibility of the zloty while maintaining controls over certain types of short-term capital flow.

[195] The Bank of Lithuania first started open market operations in late 1997. In 1998 the set of monetary instruments was expanded to include repurchase agreements, deposit auctions and lombard credits. R. Šarkinas, "Euro: the integration process and the Bank of Lithuania", Bank of Lithuania, *News Release*, 13 February 1999. Nevertheless, due to the recent financial turmoil, the actual dismantling of the currency board will probably take longer than was previously envisaged. Thus, in January 1999, the Lithuanian central bank decided to postpone by at least a year the re-pegging of the litas from the dollar to a dollar-euro basket, a change which was due to be made in mid-1999. Statement by Central Bank Governor R. Šarkinas, as reported by *Reuters News Service*, 29 January 1999.

Interest rates and money supply

To the extent that there is room for an independent monetary policy,[196] interest rates are the main policy instruments used by central banks in the transition economies to pursue their monetary policy targets. The monetary authorities pursue their objectives through changes in the rates that they charge on their own domestic currency assets.[197] In the case of a fixed or pegged exchange rate regime, the nominal interest rate is a second anchor which supports the targeted range of the nominal exchange rate. In the case of a floating exchange rate regime, the level of interest rates on domestic currency assets is the main policy tool with which the central bank seeks to control its prime intermediate target, the money supply.

In pursuing their monetary policy, central banks have to take into account the fundamental macroeconomic importance of the interest rate as well as its dual role in the economy. Apart from serving as a nominal anchor for macroeconomic stability, interest rates directly affect economic activity as they determine the cost and accessibility of credit. As regards the supply side, the character of monetary policy ("restrictive" or "loose") is determined by the level of real interest rates, that is, by comparing the nominal rates with the rate of inflation.

To be efficient, monetary policy instruments, in the first place, have to target assets that have the greatest weight in the monetary aggregates. Despite the growing divergence in the patterns of economic performance, the term structure of domestic assets in most transition economies continues to be dominated by assets of short maturity.[198] This has implications for the conduct of monetary policy which has to give higher priority to targeting assets of shorter maturity.

In 1998, and especially in the second half of the year when concerns about the possibility of an economic slowdown started to outweigh worries about inflation, the central banks in the transition economies were unusually active in intervening on the money markets through changes in their reference interest rates. In general, the central banks tended to pursue a more active interest rate policy when their prime monetary target was the exchange rate.[199] Thus between April 1998 and February 1999 the National Bank of Poland cut its main reference rates six times;[200] between June 1998 and January 1999, the National Bank of Hungary made 14 changes in the interest rate;[201] between July 1998 and February 1999, the Czech National Bank[202] changed the key two-week repo-rate nine times.[203]

Under a currency board arrangement, interest rates are market determined and the monetary authorities cannot influence interest rates directly. However, they can use other policy tools (notably, reserve requirements and prudential regulations) to affect the stance of monetary policy. In 1998, partly in response to the financial volatility resulting from the Asian and Russian crises but also to fears of overheating (and, in Estonia, to the unprecedented credit expansion which had occurred in the second half of 1997), the central banks of Estonia and Lithuania were particularly active in making their banking regulations more stringent which effectively resulted in a tightening of monetary policy and upward pressure on interest rates.

Subject to varying pressures and types of intervention, interest rates in the transition economies did not follow a uniform pattern in 1998 (table 3.2.1). The most spectacular change in nominal rates was in Bulgaria after the introduction of the currency board in July 1997: on average, interest rates fell from the three-digit level which had prevailed in 1996 (and the beginning of 1997) to a single-digit (or slightly above) in 1998. Nominal interest rates in many central European and Baltic countries declined markedly in 1998, continuing the downward trend of the previous few years. At the same time, the tightening of monetary policy in some countries (Croatia, the Czech Republic, Slovakia, Estonia) resulted in higher nominal lending rates than in 1997. However, as discussed in more detail in the next section, the combination of a certain degree of policy inertia and some specific external factors led to a large rise in real interest rates in a number of transition economies in 1998.

_____

[196] Under a currency board arrangement, the monetary authorities forfeit this privilege as a result of a one-to-one backing of the monetary base with foreign exchange reserves. The implications of the exchange rate regime on the conduct of monetary policy are discussed in UN/ECE, *Economic Survey of Europe in 1996-1997*, pp. 74-75.

[197] These vary considerably depending on tradition as well as on the specifics of individual central bank policies and targets. Among the most widely used reference rates are the repo-rate (the rate applied to repurchase agreements made by the central bank); the lombard rate (the rate charged on specific collateralized loans extended by the central bank); the discount/rediscount rate (applied on collateralized refinancing provided by the central bank); the rate on deposits with the central bank as well as various intervention rates.

[198] This largely reflects the inherent uncertainties of the transition environment which continue to be high even in the more advanced reform countries. That investors continue to be hesitant about the longer-term prospects of these countries is illustrated by the fact that even the markets of government securities are dominated by short-term paper. Only at the beginning of 1999 has debt paper of longer maturity started to gain ground in a few financial markets: Hungary issued a 10-year government bond and the Czech Republic a five-year bond.

_____

[199] This was not always the case though; for example, the key discount rate of the Bank of Latvia has not been changed since April 1997.

[200] During this period the lombard rate was reduced from 27 to 17 per cent, the rediscount rate from 24.5 to 15.5 per cent, and the repo-rate from 24 to 13 per cent.

[201] With the exception of a one-time reversal after the collapse of the rouble in August, the general direction was towards a lowering of rates. Thus, over the same period, the overnight repo-rate was cut from 23.9 to 18.5 per cent, while the one-month repo-rate was reduced from 18.4 per cent to 13.5 per cent.

[202] Although as of 1998 the declared policy of the Czech National Bank has been that of "inflation targeting", the de facto policy continued to be based (at least implicitly) on exchange rate targeting (through the managed float) with the deutsche mark being used as the reference currency (from the beginning of 1999 it was replaced by the euro).

[203] During this period it was cut from 15 per cent to 8 per cent.

TABLE 3.2.1

Short-term interest rates in selected transition economies, 1995-1998

(Per cent)

	Short-term credits				Short-term deposits (domestic currency)				Average yield on short-term government securities			
	1995	*1996*	*1997*	*1998[a]*	*1995*	*1996*	*1997*	*1998[a]*	*1995*	*1996*	*1997*	*1998[a]*
Bulgaria	79.8	300.3	209.8	14.2	43.7	146.4	80.8	3.0	61.7	278.7	200.8	6.2
Croatia	20.2	22.5	15.5	15.8	5.5	5.6	4.3	4.6	20.7	18.1	8.8	10.2
Czech Republic	12.7	12.4	13.2	13.7	7.0	6.8	7.7	8.1	..	..	..	..
Hungary	32.6	27.3	21.8	19.3	26.1	22.2	18.5	16.2	32.0	24.0	20.1	17.7
Poland	33.5	26.1	24.9	24.6	22.7	18.5	18.1	17.0	25.6	20.3	21.6	19.1
Romania	48.9	55.3	72.5	55.4	36.5	38.1	55.8	37.3	41.4	51.1	85.7	64.0
Slovakia	17.7	14.3	17.3	20.6	9.0	6.7	8.0	10.1	..	..	..	..
Slovenia	23.4	22.6	20.0	16.1	15.3	15.0	13.2	10.6	10.3	5.7	5.0	4.4
The former Yugoslav Republic of Macedonia	..	..	21.4	21.1	..	..	11.5	11.7	..	..	..	..
Estonia	19.0	14.9	11.8	15.0	8.8	6.1	6.2	8.1	..	..	..	..
Latvia	34.6	25.8	15.2	14.3	14.8	11.7	5.9	5.3	28.2	16.3	4.7	5.3
Lithuania	27.1	21.6	14.4	12.2	20.1	13.6	8.1	6.5	29.3	21.0	8.6	10.7
Belarus	148.0	64.3	32.9	27.0	80.4	32.3	15.5	14.3	..	..	..	..
Russian Federation...............	319.5	146.8	46.2	43.6	102.0	55.1	16.4	15.1	168.0	85.8	26.0	45.2
Ukraine	122.7	79.9	49.1	54.4	70.3	33.6	18.2	21.9	..	..	..	..

Source: Central bank publications and direct communications to UN/ECE 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: weighted average rate on new credits; Czech Republic: average rate on total short-term loans; Estonia: weighted average rate on short-term loans; Hungary: weighted average rate on loans of less than one year; Latvia: average rates on short-term credits; Lithuania: average rates on loans of one to three months; Poland: median of the rate on low-risk short-term loans. Beginning January 1995, weighted average rate; 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: midpoint rates for short-term loans to all sectors; Ukraine: weighted average rate on short-term loans.

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; 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 households' deposits in domestic currency; Romania: average short-term deposit rate; Russian Federation: prevailing rate for time deposits with maturity 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.

Yields of government securities – Bulgaria: yield on government securities is computed as the 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 auctions; Poland: yield on bills purchased, weighted average, 13 weeks; Romania: rate on 91-day treasury bills; Slovenia: BS tolar bills, 14 days overall nominal rate; Latvia: weighted average auction rate on 91-day treasury bills; Lithuania: average auction rate on treasury bills with maturity of 91-days; Russian Federation: weighted average rate on government short-term obligations (GKO) with maturities of up to 90 days. Beginning in April 1997, the rate is calculated on the basis of GKOs with remaining maturity of up to 90 days.

[a] January-November for Bulgaria, Hungary, Slovakia and Russian Federation.

Despite significant progress in a wide range of reforms, the financial systems in many transition economies remain relatively underdeveloped, a state which is largely a reflection of the legacies of the former economic systems. Even in the more advanced economies financial markets are still rather shallow in terms of product diversification and the extent of their penetration into the economy.[204] This is clearly demonstrated by the monetization ratios (table 3.2.2) which with the possible exception of the Czech Republic and Slovakia (where they reflect specific historic factors) remain rather low by international standards.[205]

Moreover, the transition experience so far has indicated that changes in this sphere take place only very slowly: in fact, on average there has been very little change in the level of monetization since the start of reforms[206] and it will probably take decades for the depth of financial markets in these countries to reach levels comparable to those in the developed market economies.

The remonetization of the transition economies involves a number of delicate policy issues related to the balance between stability and growth. The evolution of commercial credit in the transition economies in recent years (credit to the non-government sector as a proportion

[204] Actually the range of products offered by the banks in some of the transition economies has increased enormously in recent years and continues to grow rapidly; however, this improvement still touches only a tiny segment of the market so far.

[205] UN/ECE, *Economic Survey of Europe in 1996-1997*, p. 75.

[206] It is noteworthy that in the cases where radical changes did occur, as in Bulgaria in 1996-1997, they were in the reverse direction: the financial crisis provoked scaling down of the level of monetization due to the erosion of the value of domestic assets by very high inflation.

<div align="center">

TABLE 3.2.2

Monetization in selected transition economies: share of monetary aggregates ^a in GDP, 1995-1998

(Per cent)

</div>

	M1 [b]				Total broad money [c]				Total credit [d]			
	1995	1996	1997	1998[e]	1995	1996	1997	1998[e]	1995	1996	1997	1998[e]
Albania	21.3	34.7	..	..	39.1	62.6	..	..	5.5	6.4	..	..
Bulgaria	9.3	7.4	6.5	9.7	56.9	44.4	23.9	26.8	35.5	34.5	17.4	15.7
Croatia	7.9	9.0	10.0	9.8	21.2	28.4	36.0	39.5	30.2	33.2	33.1	40.4
Czech Republic	30.6	29.1	25.7	22.3	68.5	69.9	69.3	67.6	64.8	63.5	65.2	63.6
Hungary	16.4	15.2	14.7	14.7	37.2	36.4	35.6	33.0	27.8	23.3	24.2	23.8
Poland	9.9	10.9	13.9	13.3	32.0	33.5	41.2	43.0	16.0	17.2	20.4	22.7
Romania	6.9	7.3	5.0	5.1	18.0	20.8	18.5	21.0	17.6	19.2	14.9	14.6
Slovakia	23.8	25.8	23.5	21.3	66.1	64.6	64.3	63.1	57.5	58.9	55.9	52.8
Slovenia	7.9	7.8	7.9	8.9	37.7	40.6	42.5	47.3	23.0	26.9	26.3	28.4
The former Yugoslav												
Republic of Macedonia	..	..	6.4	..	..	..	12.7	..	..	..	26.7	..
Yugoslavia	6.0	5.3	6.4	6.2	29.4	36.6	31.3	36.5	..	..	..	..
Estonia	17.4	17.9	19.1	17.9	22.0	23.3	26.4	25.4	13.2	16.6	24.7	33.2
Latvia	12.7	12.4	14.3	16.4	27.4	19.7	23.0	26.1	15.4	7.3	9.1	14.8
Lithuania	11.7	10.6	10.7	11.9	20.8	16.5	16.3	17.6	16.5	12.3	10.4	12.1
Belarus	..	6.7	6.4	7.6	..	12.4	12.1	14.0	..	4.3	3.9	4.9
Russian Federation..............	7.0	7.8	10.9	10.4	13.9	14.8	16.5	17.8	11.2	10.1	10.7	11.3
Ukraine	..	6.6	8.5	8.8	..	9.5	11.9	13.0	..	7.1	7.6	8.0

Source: National statistics and direct communications from national statistical offices to UN/ECE 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.

^e January-November for Bulgaria, the Czech Republic, Hungary, Poland and The former Yugoslav Republic of Macedonia; GDP data for 1998 are estimates.

of GDP, see table 3.2.2) shows that in a number of the faster growing countries (for example Croatia, Poland, Estonia, Latvia, among others) the share of credit also increased in 1996-1998. An increasing share of credit in GDP indicates an intensification and widening scope of banking activity. Moreover, when credit to the corporate sector increases faster than the narrow components of money supply (M0 and M1), this suggests an increase in the value of the money multipliers and thus a deepening of financial intermediation in the country. Such a development also suggests that the improved access of firms to finance may have contributed to the strong economic performance of these countries.[207] It is noteworthy that in most of the countries where there was an economic downturn in this period there was also a shrinking share of commercial credit: this was the case in Bulgaria, the Czech Republic, Romania and Russia. It is difficult to draw general conclusions about the direction of causation in these cases; most likely the shrinking share of credit reflects the outcome of a vicious circle of contracting money demand and more cautious lending policy due to the unfavourable economic environment.

As argued in previous issues of this *Survey*,[208] money demand in the transition economies tends to be highly unstable and it is imperative that the day-to-day conduct of monetary policy takes due account of that.[209] Financial volatility and, in particular, rising concerns about the stability of the currency or of the exchange rate regime may provoke rapid changes in money demand, and ultimately, a run on the currency. Foreign exchange reserves can be used to protect the currency in the case of a speculative attack and the extent to which domestic assets can be matched by reserves is one of the indicators of financial vulnerability.[210] Hence, in overseeing and monitoring the rate of monetary expansion, central banks need to take into account the extent to which domestic currency assets (including the broader definitions of domestic monetary aggregates) are backed by reserves. As indicated by the monetary ratios in table 3.2.3, most east European and Baltic countries can be regarded as

_____

[207] It should be stressed, however, that credit expansion is a healthy development only when banks perform proper credit screening and finance viable economic projects. As indicated by the painful experience of some transition economies (Bulgaria is an example), providing credit to unviable firms leads to a snowballing of bad loans which, if unchecked, can lead to a financial crisis.

[208] For example, UN/ECE, *Economic Survey of Europe in 1996-1997*, pp. 73-75.

[209] Moreover, abrupt ad hoc financial market interventions by the monetary authorities may themselves trigger unwelcome shifts in money demand which, in turn, may have a destabilizing impact on the financial markets.

[210] When markets panic, the restructuring of investors' portfolios in response to the changes in money demand usually involves attempts to convert all domestic currency assets into a reserve currency.

TABLE 3.2.3

Monetary ratios for selected transition economies, 1995-1998
(Per cent)

	Dollarization: share of foreign currency in broad money				Official foreign exchange reserves as percentage of M1				Official foreign exchange reserves as percentage of broad money, domestic currency			
	1995	*1996*	*1997*	*1998[a]*	*1995*	*1996*	*1997*	*1998[a]*	*1995*	*1996*	*1997*	*1998[a]*
Bulgaria	27.2	34.8	49.8	41.0	107.2	77.0	222.1	200.3	24.5	21.3	119.9	131.3
Croatia	52.9	59.8	62.1	65.1	124.3	125.7	123.6	124.5	98.3	98.7	91.0	88.3
Czech Republic	7.5	8.0	10.3	11.3	64.2	78.2	81.5	91.7	31.0	35.5	33.6	34.3
Hungary	25.1	26.6	23.4	19.4	110.8	150.2	126.1	109.5	65.6	85.5	68.0	60.4
Poland	22.0	17.0	14.1	12.9	83.1	111.9	96.6	116.0	32.8	43.7	37.9	41.3
Romania	22.5	23.0	32.0	29.7	71.9	67.5	160.6	160.3	34.6	30.8	63.4	55.7
Slovakia	12.7	10.6	10.7	12.0	57.3	70.9	68.5	74.9	26.5	31.7	28.8	28.8
Slovenia	33.3	34.9	31.5	27.2	113.0	129.3	214.9	206.3	35.6	38.2	54.3	53.1
The former Yugoslav Republic of Macedonia	..	..	..	..	..	34.0	53.4	85.3	..	..	..	..
Yugoslavia	69.7	79.4	72.1	75.4	..	..	..	..	..	..	..	..
Estonia	12.1	11.1	12.7	17.5	86.8	77.0	71.7	80.4	78.2	66.4	59.4	60.1
Latvia	..	32.2	32.6	30.7	..	89.2	85.1	77.2		83.1	78.7	70.0
Lithuania	30.5	25.7	25.3	23.4	91.0	85.2	87.8	100.3	73.2	73.2	76.6	88.3
Belarus	..	..	..	..	..	..	44.1	33.4	..	..	..	..
Russian Federation..............	..	19.5	17.9	21.7	..	37.4	37.7	31.9	..	24.5	25.7	24.1
Ukraine	..	18.9	14.3	17.6	..	34.0	53.4	41.4	..	28.9	44.6	33.5

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

a January-November for Bulgaria, Czech Republic, Hungary, Poland and The former Yugoslav Republic of Macedonia.

relatively safe on this account. In some of the CIS countries, however (for example Belarus, Russia and Ukraine), the level of reserves as a share of the money supply has on average been much lower in recent years, a situation which made their currencies more vulnerable to speculative attacks and added to the currency turmoil in 1998.

While the overall level of dollarization of an economy may reflect some country-specific features (in particular, historical traditions and persistent habits), its evolution largely reflects changes in the overall level of confidence in the national currency. Indicative of this is that in many of the more advanced transition economies (for example, Hungary, Poland, Slovenia and Lithuania), the level of dollarization has been shrinking rapidly in recent years (table 3.2.3). Conversely, a deterioration in the economic situation, and especially a financial crisis, usually results in currency substitution and growing level of dollarization. Such a change occurred even in the Czech Republic after the 1997 currency crisis (table 3.2.3).

To sum up, the remonetizing of the transition economies needs to be conducted with utmost caution. Thus, in targeting the money supply (or in assessing the state of the money supply when the latter is not being directly targeted by policy), the central banks need to distinguish the different nature of the various forces driving money demand. A clear distinction needs to be made between money demand generated by robust economic performance and growing sophistication of the economy (in fact, by the catching-up process in which some of the transition economies have already engaged)

and the "appetite" for permanent access to easy finance emanating from an inconsistent fiscal policy (or a malfunctioning economy in general). Monetizing "healthy" money demand is beneficial and essential for the normal functioning of the economy (indeed, not monetizing such demand would risk the creation of unnecessary obstacles to improved economic performance). Conversely, accommodating monetary claims arising from chronic fiscal (or quasi-fiscal) deficits can set the stage for macroeconomic destabilization and persistently high inflation.

One of the greatest policy dilemmas facing a transition economy at present is how to remonetize the Russian economy while minimizing the negative side effects. The artificial macroeconomic stabilization programme pursued in 1995-1998 was founded on what turned out to be an unsustainable exchange rate regime based on an unnecessarily restrictive monetary policy. This resulted, *inter alia*, in a mushrooming of monetary surrogates. The size of these flows and the extent of their propagation put them on a comparable level with the official monetary circulation.[211] The return to a normal functioning of the economy necessitates the remonetization of all commercial and fiscal relations. However, this is not a minor task and no easy solutions appear to be at hand. The greatest source of apprehension is the likely macroeconomic impact of

_____

[211] For details see UN/ECE, *Economic Survey of Europe, 1998 No. 3*, pp. 31-41.

remonetization: injecting new liquidity is likely to have a strong inflationary impact and to cause a further weakening of the exchange rate. The main dilemma arises from the doubts as to whether, at this stage, there exists a workable solution to the problem of non-monetary payments (and, for that matter, of non-payments as well) and whether it can be resolved in a one-off operation. While the existing "stock" of non-monetary instruments can in principle be removed in the framework of a one-time monetary emission, the difficult issue is how to address the "flow" of non-monetary payments.[212] If this problem remains unresolved, simply monetizing a continuous flow of payments in non-monetary form will not only produce a one-step increase in the price level but will result in a persistent and very high rate of inflation.

The policy issues related to the remonetization of the Russian economy are also relevant for a number of other transition economies facing similar problems. Thus finding an efficient, workable solution to the problem in Russia may have important policy implications for other countries as well.

(b) Selected policy issues: can monetary policy be efficient when trapped between conflicting targets?

Policy makers often face difficult choices between conflicting goals and the monetary authorities in the transition economies are especially prone to policy dilemmas in implementing their agenda. There are no universal prescriptions as to how to proceed in such situations: in some cases it may turn out that the de facto optimal solution goes against the conventions of economic theory; in other cases it may turn out that an optimal solution simply does not exist and that the choice is between "second-best" or even "third-best" solutions. Yet another source of confusion is the fact that policy decisions are as a rule judged by the public in accordance with their *ex-post* efficiency which may not necessarily coincide with the *ex-ante* efficiency due to the fundamental uncertainty characteristic of the environment in which decisions are taken.

The Asian and Russian crises and the ensuing global financial turbulence in 1998 created a difficult and equivocal environment for the monetary authorities in the transition economies in which they were faced with conflicting goals and the need to compromise between controversial alternatives. Apart from the fundamental uncertainties of the transition environment, there were several additional sources of external disturbance in this period that generated monetary pressures with a variety of consequences.

First, there was a general increase in financial market volatility which affected practically all the transition economies.[213] The change in investors' sentiment about emerging markets in the aftermath of the Asian crisis provoked an outflow of foreign capital (mostly short-term) from the transition economies which had a destabilizing effect on their financial markets and put downward pressure on their currencies. One of the conventional policy responses in such circumstances is to tighten monetary policy and, in particular, raise interest rates.

The rationale behind such a move is related to the change in the investors' perception of the risk of holding assets denominated in the currencies affected (directly or indirectly) by financial instability. The series of crises in 1997-1998 increased investors' perception of the risk associated with financial investments in all emerging markets (including the ECE transition economies). Consequently investors started to require higher interest premia to compensate for the increased risk of investing in the affected currencies. If, as a result of the change in expectations, the returns on the financial assets denominated in the local currency do not match the expected risk premium, investors may decide to pull out of the currency and of the country and, as noted above, this is what happened in many transition economies in 1998. In an attempt to counter this outflow, the monetary authorities often revert to tightening monetary policy in order to engineer a rise in the yields of local assets sufficient to match the higher risk premium. The result is a general upward pressure on interest rates, and a tendency for them to rise above the level at which the monetary authorities would have set them in the absence of the external pressure.

During the same period, however, there were other external factors at play that acted in the opposite direction. In the wake of the Asian crisis, the weakening of global demand for primary commodities and semi-processed goods generated strong downward pressures on prices, especially those for tradeables, in many parts of the world. On average, world market prices of internationally traded goods probably declined in nominal terms in 1998. The transition economies are basically price-takers and, given their openness and very little domestic price protection, lower import prices resulted on average in a much faster rate of disinflation in 1998 than in 1997.

In the course of 1998 it became clear that actual inflation in many of the transition economies was going to be lower than the *ex-ante* targets (either the explicit inflation targets or the inflation expectations on which monetary policy in general was focused). After years of fighting inflation this was an unexpected outcome, and for a number of transition economies this was the first time since the start of economic transformation that actual inflation was below expectations. At the same time, output growth throughout the region was losing pace, prompting the possibility of a need for a change in policy. Due to its nature and focus, it is usually monetary policy that bears the brunt of policy adjustments in the short run. Did policy makers – in particular, the monetary authorities – respond to the increasing gap between expectations and outcomes?

---

[212] This aspect of the remonetization of the economy is one of the issues that has not been properly addressed in recent proposals to establish a currency board in Russia. If non-monetary payments re-emerge after a currency board is put into operation, they may easily compromise this monetary regime.

[213] UN/ECE, *Economic Survey of Europe, 1998 No. 3*, pp. 41-43.

As discussed in the previous section, the monetary authorities throughout the region but especially in central Europe were rather active during the second half of the year in moderating monetary austerity. In fact, in terms of the number of changes in key interest rates, 1998 was probably the most "activist" year since the start of transition. These policy changes not only reflected some revision of inflation targets or expectations by the central banks but also the worldwide fall in interest rates which allowed interest differentials to be maintained at lower local rates.

However, in terms of actual real interest rates, these policy moves were far from sufficient in moderating the restrictive character of monetary policy. On the contrary, real interest rates actually increased in many transition economies in 1998. This is especially striking in terms of the forward-looking *ex-post* real lending rates (chart 3.2.1):[214] while not necessarily resulting from deliberate policy actions, the actual outcomes point to a considerable de facto tightening of the stance of monetary policy in a number of countries in 1998. Thus, rather than providing the required (and probably desired) support to activity, the persistently (in some cases increasingly) restrictive character of monetary policy may have actually depressed it, reinforcing the deceleration of economic growth.

It is difficult to be definite as to the exact set of country-specific factors that could have led to such an unwelcome outcome. Besides, as seen on chart 3.2.1, there was considerable variation in the extent of monetary tightening in those countries where the information on real lending rates is available. Moreover, at the moment of writing this *Survey*, it was not quite clear what direction this trend would take in each individual country. However, the fact that monetary tightening was not an isolated phenomenon but occurred in a large group of countries, suggests that it may have been influenced by some common factors related to the nature of the monetary policy process and the policy instruments available in the transition economies.

Leaving aside the question of whether the monetary authorities were actually ready to respond quickly to rapidly changing external conditions, the real issue is whether they had efficient policy alternatives and policy instruments at their disposal. The basic problem is that as a result of the two divergent and externally induced trends, monetary policy became trapped between two conflicting objectives: on the one hand, central banks were faced with capital outflows and downward pressure on their currencies; on the other, with an unexpected deflationary impulse from the prices for imports.

The degrees of freedom of the monetary authorities to cope with such a situation are determined by the monetary and exchange rate regime as well as by the actual monetary targets (nominal anchors) and the tools available to pursue these targets. As noted above, when the exchange rate is chosen as the intermediate target of monetary policy (as is the case in fixed or pegged exchange rate regimes), the main policy instrument at the disposal of the central bank is the nominal interest rate. Assuming that the exchange rate provides a reference point to the price level in the country (or country zone) of the peg, keeping the exchange rate within the targeted range acts as an anchor for the level of domestic prices.

One basic requirement for the proper functioning of the monetary transmission mechanism in countries with fixed or pegged exchange rates, following the logic outlined above, is that there are no major and systemic misalignments in the change in foreign trade prices relative to the change in prices in the reference country. However, such a misalignment is exactly what happened in 1998: there was a substantial drop in the relative prices of many internationally traded goods which produced a "third party" bias (that is, a bias that did not originate in the reference country). This created a serious distortion for monetary policy in transition economies that adhered to exchange rate targeting, since the exchange rate failed to provide the relevant reference point for monetary targeting; in reality, the trade-induced price effect was different in magnitude and probably in direction.[215] An interest rate policy aimed at defending an exchange rate target under these circumstances would tend to create (and is likely to have done so) an undesirable rigidity in monetary policy.

An indirect argument in support of this conjecture is the fact that countries where monetary policy did not target the exchange rate directly were much less affected by such a policy bias as regards the level of real interest rates. This especially seems to be the case in Slovenia but also, to some extent, in Croatia (chart 3.2.1).[216] There was, indeed, an upsurge of real interest rates in these countries towards the end of 1997, largely due to the Asian crisis, but afterwards the pressure on real lending rates subsided rapidly. Since the intermediate target of the central banks in these countries is the money supply and the monetary aggregates were not affected by the above-mentioned price misalignment, there was no "instrumental" upward bias generated by monetary policy.

---

[214] The *ex-post* forward-looking real interest rate is the nominal rate deflated by the prevailing inflation rate in the period when the loan is actually being taken up. For practical purposes this means that the prevailing interest rate at time t should be deflated by the average inflation rate prevailing in the period (t+T), where T is the maturity of the loan. Note that this is the period following the drawing of the loan, so that interest rates reported at time t have to be deflated by average inflation reported in a subsequent period of time (hence, forward-looking). Such a quantitative assessment can only be performed *ex post*. Another important detail is the price index to be used for this assessment. Conventional logic suggests that if the loan is used to finance a production cycle, then the proper price deflator should be that of the goods produced. Thus the closest aggregate proxy for assessing the real interest rate on corporate loans is the Producer Price Index (PPI). On chart 3.2.1 the short-term nominal lending rates are deflated by the average PPI in the subsequent three-month period.

---

[215] A major shift in the cross exchange rates of the currencies comprising a currency basket may create similar distortions for monetary policy in an economy whose currency is pegged to such a basket.

[216] It is more difficult to make a clear judgement about the recent trends in real interest rates in Romania because of the major regime change that took place at the beginning of 1997: monetary policy was tightened considerably and the long-standing practice of soft bank lending (often at negative real rates) was discontinued.

CHART 3.2.1

Nominal and real lending rates [a] in selected transition economies, 1996-1998
(Three-month moving averages)
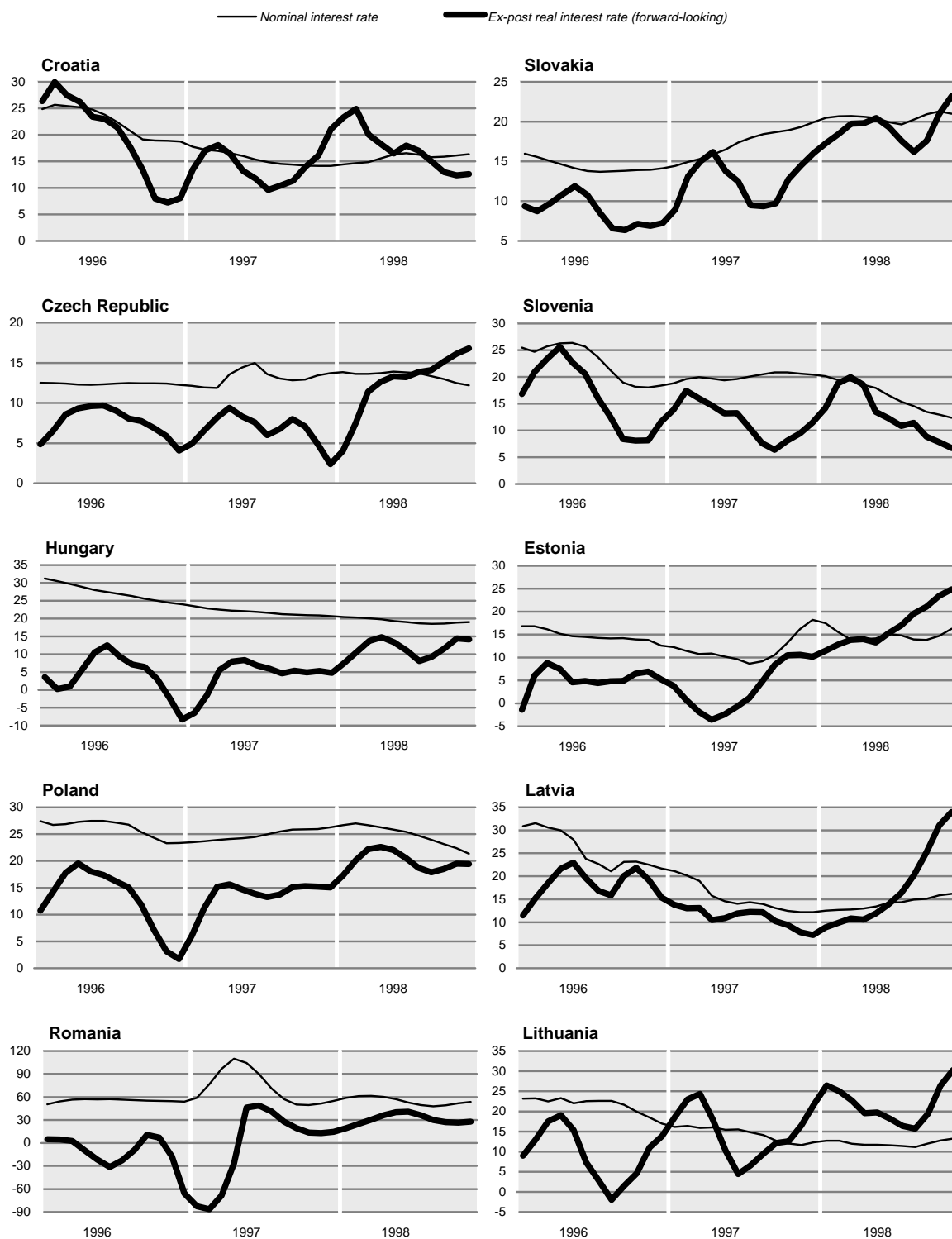
—— *Nominal interest rate*   **——** *Ex-post real interest rate (forward-looking)*

Source: UN/ECE secretariat calculations, based on national statistics and direct communications from national statistical offices.

[a] *Ex-post*, forward-looking rates computed by deflating the nominal rates quoted for a given month by the average producer price inflation in the three-month period following this month.

However, there is another possible cause of the unwelcome upsurge in real lending rates in some of the transition economies in 1998 and it is related to the actual set of policy tools used to pursue the monetary targets. The fact is that by and large the central banks used one and the same instrument (interest rates) both to prevent rapid capital outflows and to pursue a targeted level of the exchange rate. Hence, when faced with conflicting objectives, they were trapped with no efficient strategies to pursue these two goals simultaneously and thus they were compelled to give up one objective at the expense of the other. Related to this issue is a sequencing problem: initially, interest rates were kept too high for too long (to serve as "capital controls"); but then, when they were lowered, they were not allowed to fall enough (due to the policy misalignment).

In short, in 1998 monetary policy in the transition economies has been revealed to have a certain "downward rigidity" in the face of negative, externally induced price shocks due to a reluctance or failure to respond quickly. Whether deliberate or unintended, the de facto outcome was that monetary policy turned out to be unnecessarily restrictive in the post-shock period and this probably contributed to the slowing down of output growth in 1998 and in early 1999. Although so far there has been little debate over this episode, and the future evolution of policy is still not clear, some policy lessons can already be suggested.[217]

One of the lessons is that monetary policy did not apply the most efficient tools to target the two divergent trends (or to pursue the two conflicting objectives). In line with the discussion in chapter 1, it can be argued that interest rates are probably not the most efficient policy instrument to regulate the movement of short-term capital flows: arguably, if the latter were targeted by other policy instruments (for example by some form of capital controls), the monetary authorities could have lowered interest rates more rapidly and more aggressively.

Another policy lesson concerns the impact of the quality of banking assets on real lending rates. When banks' portfolios are burdened with substantial shares of

substandard and non-performing loans, they tend to charge higher interest rates to their "good" clients in order to be able to compensate for the lost income. This results in higher spreads between lending and deposit rates. Although in recent years interest rate spreads in some transition economies have declined considerably, they still remain stubbornly high in others (table 3.2.1). Undoubtedly, the existence of high nominal spreads played a negative role in supporting the rise in real lending rates in 1998, at least in some transition economies.[218]

The negative impact of high interest rate spreads becomes especially pronounced at low nominal rates. When rates of inflation and interest are high, a wide interest rate spread alone would have a relatively small impact on real rates as it would be diluted by the high nominal values. However, in a period of disinflation, when nominal interest rates are falling, a persistent markup on lending rates caused by the low average quality of bank assets would create a permanent upward bias in real lending rates. This is one more reason for emphasizing the fact that the soundness of the banking system is a prerequisite for effective policy and a healthy economy.

Finally, another lesson concerns the set of monetary policy tools: a further diversification of the monetary policy instruments is highly desirable in order to avoid a situation of policy paralysis or "second best" solutions in the face of conflicting objectives. Closer monitoring of the components and driving forces of inflation (in particular, the trade-induced impact on domestic prices) could also be helpful in enabling policy to assess the situation more accurately and respond with adequate policy instruments.

(iii) Structure, strain and economic adjustment: the crisis in Romania

(a) Introduction: the starting point

This section discusses restructuring and macroeconomic adjustment during the post-communist transition in Romania and links them to two major issues: the legacy of resource misallocation, or what can be termed inherited structure, and institutional fragility. The legacy of resource misallocation leads to very intense strain in the system when there is a brutal and dramatic change of relative prices to market-clearing levels. At the new prices resources should flow from low to high productivity areas, a process which can generate much pain and friction in a real economy. The strain or tension involved explains why there is much opposition to change, and why coalitions of interests emerge to hinder

---

[217] In terms of the policy lessons of this episode it might also be useful to consider the hypothetical "mirror image" of the 1998 developments, that is, what would have been the likely outcome of a symmetric policy overshooting in the opposite direction. Consider a transition economy using an exchange rate anchor in the hypothetical but not unrealistic situation of a positive shock to world commodity prices and the prices of internationally traded goods in general (i.e. the relative prices of internationally traded goods increase vis-à-vis the general price level in the reference country). In this case there will be a higher than normal trade-induced upward pressure on local prices which will not necessarily be targeted by monetary policy due to the inherent misalignment of the exchange rate target. Assume at the same time a situation of non-negligible net capital inflows. If the central bank relies on interest rate policy to discourage an unwanted capital inflow, it might be tempted to lower interest rates in order to reduce the premium. Thus, apart from the direct impact of higher imported inflation, such a monetary policy overshooting (due to the delayed response by the monetary authorities to the changing external conditions, implemented entirely through interest rates) may in fact lead to an inappropriate easing of monetary policy and, consequently, an even stronger upsurge in the rate of inflation.

[218] A detailed assessment of the impact of spreads on real interest rates would require a detailed comparative analysis of individual banks' portfolios and lending practices, information which was not available at the time of writing this *Survey*.

deep restructuring. Strain also explains why large fiscal and quasi-fiscal deficits, of varying degrees of visibility, are a feature of post-command economies which create an endemic proclivity to high inflation.

Some analysts relate inflation, primarily, to the breakdown of the political process and rent-seeking activities by old elites.[219] While this is not implausible, the approach adopted in this section emphasizes the magnitude of the required resource reallocation, which is sometimes so large that it undermines attempts to achieve durable stabilization. It is arguable that the success of the leading transition economies is due, primarily, to policy being able to deal with the magnitude of required resource reallocation while not being "captured" by vested interests.

Institutional fragility is another dimension of the transformation process which underlines the complicated nature of change, restructuring included. The lack of institutions, of organized markets, hinders a smooth reallocation of resources and has a negative effect on performance at both the micro and macroeconomic levels; it also helps to explain the intense friction in the system, especially rising transaction costs, that arises during the passage between two regimes. This line of reasoning finds substantial analytical support in recent work.[220]

Together with strain, institutional fragility helps to explain stop-go policies, as well as many of the setbacks and inconsistencies in the transition process. Fuzziness and a lack of transparency characterise the realm of public finance. For example, banks are frequently the vehicle for the granting of subsidies. Primitive banking systems, in the grip of redundant structures, are likely to perpetuate much of the old pattern of resource allocation (or misallocation) and engage in significant quasi-fiscal operations, with the latter showing up in high rates of inflation or of bank failures.

Romania's experience is a highly relevant example of how strain[221] and institutional fragility condition macroeconomic stabilization.

In the following review of economic developments during 1990-1998, stop-go policies, resurgent inflation and macro-disequilibria, as well as bank failures, all emerge as an inevitable outcome of a feeble pace of restructuring and fragile institutions. It is emphasized that without large inflows of foreign direct investment (FDI) and the creation of appropriate institutions, the economy is unlikely to be able to escape from the grip of the old structures. It is also clear that a more rapid rate of privatization would help to increase the inflow of foreign capital. The slow pace of restructuring has maintained intense strain in the system and has led to a bad "path dependency". Romania started the transition process at a disadvantage, with significantly worse initial conditions than those prevailing in the leading reform countries,[222] which suggests that her policy makers have also had less room for manoeuvre. Nonetheless, the end result is that they have not yet been able to find a clear way forward to a well-functioning market economy. Under the current unfavourable conditions in the world economy it will be increasingly difficult for the Romanian economy to escape from this path dependency.

In comparative analyses of the transition economies insufficient attention has been paid to the initial conditions prevailing when the transformation process got underway.[223] Communist Romania, particularly in the 1970s and 1980s, provides an interesting and instructive case of "immiserising-growth" which was caused by the logic of the system, in particular, the rush to speed up industrial growth and to increase ties with market economies on a very weak functional basis (by totally ignoring market mechanisms). In the literature, this phenomenon is explained by the existence of various price distortions which harm resource allocation, worsen the terms of trade, and lower welfare.[224] But it can also be argued that it was the way the economy functioned as a whole (including the genesis of wrong industrial choices) which constituted *the* distortion that led to immiserising growth. It has been shown that the inner dynamics of the system − its incapacity to cope with

[219] P. Boone and J. Hoerder, "Inflation: causes, consequences, and cures" in P. Boone, S. Gomulka and R. Layard (eds.), *Emerging from Communism. Lessons from Russia, China and Eastern Europe* (Cambridge, MA, MIT Press, 1998), pp. 42-72.

[220] O. Blanchard, *The Economics of Post-communist Transition* (Oxford, Clarendon Press, 1997).

[221] A formal development of the idea of strain was given in D. Daianu, *The Changing Mix of Disequilibria during Transition: A Romanian Background*, IMF Working Paper WP/94/73 (Washington, D.C.), 1994, and D. Daianu, "An economic explanation of strain", in J. Bachaus (ed.), *Issues in Transformation Theory* (Marburg, Metropolis, 1997). Essentially, strain (J) measures the distance or dissimilarity between two vectors of prices and quantities, namely:

$$J = \sum_i qi \mid \rho i - \rho i^* \mid / \sum_i \rho i^* qi^*$$

where pi and qi refer to prices and quantities at the start of the transition for sector i and the asterisk denotes their level after full adjustment

towards international prices and a new, "western-like" economic structure. The higher the value of J the greater the required change in relative prices and the greater is the strain of adjustment. Obviously other variables such as quantities, employment or relative wages, can be substituted for the price vectors in the index. For empirical estimates of strain, made by OECD, see table 3.2.7.

[222] Romania practised late Stalinism until the very end of the communist regime. Initial conditions can be related to the magnitude of resource misallocation, the institutional ingredients of a market environment, the existence of a private sector, to a certain industrial culture, etc.

[223] An IMF report of 1997 acknowledges that "Romania emerged from communism with an economy that was suffering from considerably more deep-seated structural problems than most former communist countries in the region". IMF Staff Country Report No. 97/46, *Romania, Recent Economic Developments* (Washington, D.C.), July 1997, p. 7.

[224] J. Bhagwati, "Immiserising growth – a geometrical note", *The Review of Economic Studies*, Vol. 25, June 1958, pp. 201-205; H. Johnson, "The possibility of income losses from increased efficiency of factor accumulation in the presence of tariffs", *The Economic Journal*, Vol. 77, 1967, pp. 151-154.

increasing complexity and its inability to assimilate and generate technological progress – led to a "softening" of output, characterized by its expansion with a strong bias towards low value added industrial goods, which led to a steady deterioration of the terms of trade.[225]

Since "immiserising growth" limited the potential to increase exports, the targeted trade surpluses in the 1980s – required to pay back the external debt – were achieved through very large cuts in hard currency imports. Apart from the reduced level of investment, growth possibilities were also impaired by a sharp reduction in imports of machinery and equipment from the western countries. The heavy overtaxation of domestic absorption that took place during this period subsequently resulted in lower growth rates of production, reduced welfare (consumption), and bigger domestic imbalances (both visible and hidden). In addition, shortages were rising in both production and consumption.

The immiserising nature of "growth" in communist Romania is well illustrated by its income per capita (which has remained one of the lowest in Europe) and the very high energy intensity of its GDP.[226] Another telling fact is that whereas the GDP grew – allegedly – by almost 28 per cent during the 1980s exports decreased over the same period.

The structure of industry also revealed a strong bias towards the creation of gigantic units, with no regard for the important sources of flexibility in an economy, namely, the small and medium-sized enterprises. Thus, in 1989, 1,075 enterprises with more than 1,000 employees each, represented more than 51 per cent of all units, provided jobs for 87 per cent of all industrial workers and supplied almost 85 per cent of all industrial output; enterprises with over 3,000 workers (which accounted for about 16 per cent of the total) supplied over 50 per cent of total industrial output and provided jobs for 53 per cent of all employees in industry. At the same time, the small- and medium-sized enterprises (with less than 500 employees) accounted for 4 per cent of all workers and 6 per cent of total industrial output.

The forced reduction of the external debt in the 1980s (actually a *sui generis* shock-therapy), accentuated the decline in the competitiveness of the economy, exacerbated imbalances among sectors, increased shortages, and generally lowered the welfare of the people.

(b) The high inflation period, 1990-1993

The early years of post-communism in Romania were marred by severe economic difficulties, including a very large fall in output (table 3.2.4), an institutional

hiatus,[227] and "systematic" policy incoherence. Institutional hiatus refers to the melting down of much of the old institutional structures without a rapid build up of market-based institutions. This, obviously, contributed to increasing uncertainty, fuzziness, and volatility in the national economic environment. At this stage "the entrenched structures are being broken and changed, which means that the quantity of friction in the system goes up considerably and important energies (resources) are consumed in order to accommodate change. A lot boils down to a change of the organizational behaviour of actors, to the buildup of new organizational capital. In this phase of transition there exists a territory over which market coordination failures combine with an "abandoned child" feeling of many enterprises, which are no longer able to rely on central allocation of resources and customers. For these enterprises information and transaction costs skyrocketed".[228]

In spite of its tortuous path some institutional change did take place during those years; through spontaneous processes, such as massive land privatization and the emergence of a private sector (which preceded Law 54 of 1990 on the setting up of private enterprises),[229] as well as measures "from above" initiated by government. Among the latter are the start of the two-tiered banking system (in 1990), the commercialization of state owned enterprises (Law 15 of 1990), and the privatization Law 58 of 1991 which aimed at giving 30 per cent of the equity of commercial companies to Romanian citizens.[230] What happened with the privatization law is symptomatic of the vacillations and inconsistencies of reform policies during that period; Law 58 of 1991 created much confusion regarding the actual structure of property rights and the need for enhanced management of assets. What was totally lacking was a concern for building institutionally organized markets for factors of production.

Overall and in a formal sense, it can be said that policy makers practised a sort of "institutional mimetism" by trying to adopt, although in a highly inconsistent way, institutions found in the western world. A problem with institutional mimetism, however, is that it cannot deal with the fine print of reforms (institutional change) and, frequently, it lacks substance since the real functioning of institutions is driven by vested interests.

---

[225] D. Daianu, "A case of immiserising growth", *Revista Economica*, No. 20 (in Romanian), 1985.

[226] The energy consumption per unit of GDP is twice as high in Romania as in Hungary, and more than 4 times larger than the OECD average. EBRD, *Transition Report 1995* (London), p. 77.

[227] R. Kozul-Wright and P. Rayment, "The institutional hiatus in economies in transition and its policy consequences", *Cambridge Journal of Economics*, Vol. 21, No. 5, September 1997, pp. 641-661.

[228] D. Daianu, *The Changing Mix of Disequilibria during Transition: A Romanian Background*, IMF Working Paper WP/94/73 (Washington, D.C.), 1994.

[229] In 1991 the number of private companies rose quickly to 72,277; they operated mainly in trade and services. By the end of 1995 the number had risen to almost half a million. It should be recalled that, in contrast with Hungary or Poland, the communist regime in Romania did not allow any form of private property.

[230] It should be said that commercial companies represented only 60 per cent of state assets; the rest belonged to the so-called "*régies autonomes*", which were created according to the French model.

Macroeconomic indicators of Romania, 1990-1998
(Per cent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
GDP *(annual change)*	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.9	-7.3
Unemployment rate *(end of period)*..........................	–	3.3	8.2	10.4	10.9	9.5	6.6	8.8	10.3
Inflation									
Average	5.1	170.2	210.4	256.1	136.7	32.3	38.8	154.8	59.1
December/December	37.7	222.8	199.5	295.6	61.9	27.7	56.8	151.7	40.7
M2 *(end of period)* growth rate	22.0	101.2	79.6	141.0	138.1	71.6	66.0	104.9	27.4[a]
Nominal devaluation									
Average	50.3	240.5	303.1	146.8	117.8	22.8	51.6	132.5	23.8
December/December	140.4	444.5	143.3	177.4	38.4	45.9	56.5	98.8	36.5
M2/GDP	55.7	27.4	20.1	13.8	13.3	18.1	20.5	18.1	..
Budget deficit [b]/GDP	1.0	3.3	-4.6	-0.4	-1.9	-2.6	-3.9	-3.7	-4.0[c]
Current account/GDP	-8.5	-3.5	-8.0	-4.5	-1.4	-5.0	-7.2	-6.7	-6.6
Real wage index	5.1	-18.3	-13.0	-16.7	0.4	12.6	9.5	-22.2	4.7[a]

Source: National Bank of Romania.

[a] November 1998.

[b] Consolidated budget.

[c] Estimates.

After December 1989 there was tremendous *pressure from below* to consume tradeables, to reduce exports and boost imports of both consumer and intermediate goods, after the years of severe deprivation in the 1980s. The switch in favour of tradeables was almost instantaneous and virtually unstoppable; it was also strengthened by a "shunning of domestic goods" syndrome. In 1990 the boost in consumption was financed primarily by dissaving (the depletion of foreign exchange reserves).

However, there is another side of the story that needs to be highlighted, namely, that policy makers complicated the state of the economy both by commission and omission. By commission, since they faltered in the face of pressures from below and were influenced also by the prospect of elections in May 1990. This resulted in the concession of large wage rises[231] and the introduction of the five-day workweek, despite the fact that output was plummeting, together with the maintenance of wide-ranging price controls, a greatly overvalued exchange rate, and mismanagement of the foreign exchange reserves. By omission, for there were no serious attempts to deal with macroeconomic imbalances before November 1990. Events during that year revealed a fundamental flaw in the transformation process, namely, the considerable decision-making power of enterprises when they do not have to face hard-budget constraints.

Confronted with a rapid deterioration of the economy and unable to contain growing disequilibria (unsustainable trade deficits, rising prices, vanishing investment) a stabilization plan, supported by the IMF, was introduced at the start of 1991.[232] The middle-of-the-road, gradualistic stabilization programme that took shape included the following: a tightening of fiscal and monetary policy (although real interest rates remained highly negative), a tax-based incomes policy, a new devaluation and introduction of a two-tier exchange rate system (through the initiation of an interbank foreign exchange auction system, in February 1991). The programme failed to stop inflation.

At the end of 1991 there were growing tensions in the system: for example, an overvalued official exchange rate; artificially low prices for energy and raw materials which encouraged their overconsumption; and insufficient inflows of foreign capital to compensate for the low levels of domestic saving and the weakness of fixed investment. Many exporters and importers found a way out of the *impasse* in making barter deals, which introduced an *implicit* exchange rate into the functioning of the economy; this rate mitigated the pernicious effects of overvaluation but entailed considerable information and transaction costs. However, capital flight and insufficient exports were becoming matters of major concern.

In the spring of 1992 policy makers were compelled to act. Interest rates were raised considerably, the refinance rate of the National Bank reaching 80 per cent; the exchange rate was devalued substantially and exporters were granted full retention rights in the hope of overcoming their mistrust of policy makers and encouraging the repatriation of capital. The full retention measure was thought necessary since enterprises still had a vivid memory of the "confiscation" of their hard-

[231] This development should be seen in the context of the elections in May 1990. Measured real wages rose by 11 per cent between December 1989 and October 1990, while output continued to fall. The removal of price controls began in November of that year.

[232] D. Demekas and M. Khan, *The Romanian Economic Reform Program*, IMF Occasional Paper, No. 89 (Washington, D.C.), 1991.

currency holdings at the end of 1991. But the policy turnround was incomplete and interest rates remained negative as a result of a large array of preferential credits and very low deposit rates − the latter reflecting a high propensity to shun the domestic currency in favour of the dollar. Political factors, resulting from the elections of September 1992, also weakened the determination of the government to pursue a consistent policy.

(c) A policy breakthrough, 1993-1994: "the interest rate shock"

Rising inflation and the persistence of a large trade imbalance eventually forced a reconsideration of policies. A breakthrough occurred in the last quarter of 1993 when several key decisions were made in order to contain and reverse the dynamics of inflationary expectations, to start the remonetization of the economy and to create a transparent, functioning foreign exchange market. The major omission in the whole strategy, however, was privatization, which would have had a major influence on the size of capital inflows and on the scope and intensity of restructuring.

The main decision, a dramatic rise in nominal interest rates, led to positive real interest rates. Thus, the central bank's average refinancing rate rose from an annual rate of 59.1 per cent in September 1993 to 136.3 per cent in January 1994 and remained at that level for another three months. Commercial banks' lending rates followed suit with a two-month lag. This measure had two major consequences: first it stemmed the flight from the leu and started a rapid rate of remonetization; and, second, it greatly helped the formation of a transparent foreign exchange market and, thereby, strengthened the potential for an export drive. The scale of remonetization explains why the policy shock of 1994 did not lead to a decline of output as was the case in 1997 (when the economy was subject to a credit crunch).

Another key decision was the substantial devaluation (in several stages) of the official (interbank market) exchange rate which lowered it to more or less the rate prevailing on the grey market; this also increased the transparency of the foreign exchange market which in turn reduced considerably the entry costs for those in need of foreign exchange.

The third measure involved a stricter control of base money and consequently a reduced rate of money creation. And finally, the fiscal stance was tightened to aim at a low budget deficit when corrected for the removal of explicit and implicit subsidies.[233]

The results of this policy breakthrough were much as expected. Inflation fell to an annual rate of 62 per cent (December-on-December) in 1994 and there was a large

reduction in the trade deficit to $411 million.[234] The economy absorbed the shock of high positive real interest rates and of the exchange rate unification − which meant the suppression of some implicit and explicit subsidies to inefficient producers – and there was no decline of output. The removal of subsidies explains why the budget deficit went up to 4.3 per cent in 1994, with a large part of its financing being obtained from external sources.

The export drive played a major role in the recovery, but it cannot explain why so many enterprises in the weak sectors also did well in 1993, especially as arrears did not "appear" to be rising sharply in 1994.[235] Several explanations can be suggested. One is the existence of important market imperfections, such as monopolies that can extract rents and which operate in the less efficient sectors. Another is that there are huge amounts of "X-inefficiency" in the system.[236] This means that potential micro-efficiency gains are ubiquitous and that, when under pressure, even firms in the backward sectors can realize some of them and cope with the situation. But accepting this explanation requires an evaluation of the resilience of *organizational routines* in the system. An implication of the X-inefficiency explanation is that the pressure for fundamental restructuring begins to bite only when most of the efficiency reserves are exhausted. A third explanation is that there was more reliance on self-financing, although in fact many companies were plagued by a lack of working capital. Last, but not least, unwarranted bank lending (rollover of loans) may have played a significant role in supporting the weaker enterprises.

(d) Fragile growth and relapse into inflation, 1995-1996

In 1995 there was a rapid growth of GDP in Romania, 7.1 per cent against just under 4 per cent in 1994 and under 2 per cent in 1993; at the same time the inflation rate at the end of 1995 was about 28 per cent. The remonetization of the economy continued, as indicated by the expansion of the money supply (72 per cent) far exceeding the rate of inflation (table 3.2.4 and chart 3.2.2); money velocity (for the aggregate M2, which includes hard currency deposits) fell below 5 − from over 7.5 in 1993 − reflecting a rise in money demand. While exports continued to grow rapidly (by over 20 per cent) imports increased by more than 30 per cent, causing the trade imbalance to increase again to more than $1,570 million and putting pressure on the foreign exchange (interbank) market.

---

[233] The budget deficit was actually higher in 1994 than in 1993, but most of the implicit and explicit subsidies had been removed, which was a key objective.

[234] It can be argued, however, that the *ceteris paribus* condition does not apply in this assessment since there were favourable external "shocks" as well.

[235] Caution is required with the numbers since arrears can be obscured by inefficient activities being kept afloat by bank lending (via rollovers). Ultimately, these "hidden" arrears will show up in a deterioration in the portfolios of the banks. This is what appears to have happened in 1996 and thereafter.

[236] H. Leibenstein, "Allocative efficiency vs. X-efficiency", *American Economic Review*, Vol. 56, No. 3, 1996, pp. 392-410.

CHART 3.2.2

Remonetization vs. demonetization in Romania, 1994-1998
(Per cent, December over December)
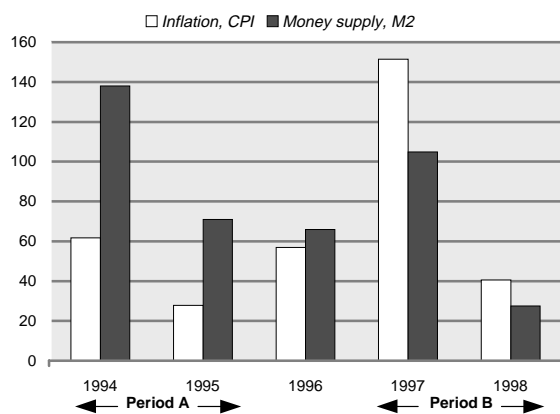
Source: National Bank of Romania.

Note: The change in M2 for 1998 refers to November over November.

What caused the trade imbalance to deteriorate again, bearing in mind that the real exchange rate did not appreciate in 1995 (although it did so in the second half of 1994) and that there were no major changes in the terms of trade in this period? One explanation is that an import and consumer spending boom started in the last months of 1994, which, arguably, might have been encouraged by perceptions that the exchange rate was unsustainable. But this explanation would have to be reconciled with the fact that in 1994 the trade and current account imbalances improved dramatically and the foreign exchange reserves of the banking system (including the central bank) increased substantially, which might have suggested that the exchange rate was in fact sustainable. It is also possible that the various economic agents were unused to stability of the nominal exchange rate and therefore anticipated an inevitable depreciation which, paradoxically, may not have been justified by the economic fundamentals. Another conjecture is that some of the improvement in the trade balance in 1994 was caused by temporary factors; their removal in the following year then put additional pressure on an exchange rate that was already overvalued. Without dismissing these factors, the more important explanation is probably that the higher growth rate of the economy, driven by highly import-dependent branches, led to overheating and the rapid growth of imports.

In 1996 there was a clear link between inflation and the way the budget deficit was financed. Whereas the target for the consolidated budget deficit was 2.2 per cent, it turned out to be 5.8 per cent, on an accrual basis. More significant was that its financing was inflationary as a result of the commercial banks buying an increasing volume of three-month treasury bills. The scale of inflationary financing was augmented by the injection of base money in order to cover the quasi-fiscal deficit which arose because of the losses of agriculture and of the *régies autonomes.* Together with the quasi-fiscal

deficit the fiscal imbalance reached 8.4 per cent (on an accrual basis) in 1996 (table 3.2.5).

The process of remonetization had supported the efforts to subdue inflation in 1994 and 1995. Regarding remonetization several aspects should be emphasized:

- It facilitated the subsidization of various sectors of the economy (agriculture, energy) from the central bank's resources, allowing the central bank to pursue simultaneously the reduction of inflation. The sectoral financing mirrored the existence of major structural disequilibria in the economy;

- It "helped" put off dealing resolutely with the two failed banks – Dacia Felix and Credit Bank; more then 1,700 billion lei (approximately $400 million) were injected in both through special credits during 1995-1996. If money demand had not grown for most of 1995 and 1996 the size of the special credits would have certainly fuelled inflation. The reason for this injection was that there was no insurance scheme for small depositors and so it was felt necessary to forestall a run on the banks and, therefore, a possible systemic crisis;

- It involved the expansion of base money through the increase of net domestic assets, and not through the accumulation of net foreign assets. Ideally, remonetization should have taken place as an outcome of a rise in net foreign assets − that is, as a result of capital inflows or of net exports − and not, primarily, via base money injections which supported the expansion of domestic credit;

- It can be argued that this remonetization slowed down the development of monetary policy instruments, namely open market operations. This is because the central bank did not face the pressure to cope with a surge of liquidity as would have been the case with substantial capital inflows. The main reasons why such inflows did not occur are the feeble pace of privatization during 1994-1996, the poor functioning of the domestic capital markets, and the credibility problem surrounding domestic policies.

By the end of 1996 several worrying tendencies had emerged: a very sharp rise in the monthly inflation rate which was in double-digits in the last quarter of the year; the sharp rise in the trade and current account deficits, although the growth rate of GDP was lower than in 1995 (3.9 per cent as against 7.1 per cent); and still greater distortions in relative prices due, especially, to the delay in adjusting energy prices and to the administrative control of the exchange rate. Overall, the macroeconomic stabilization programme was losing steam. The inflation rate at the end of the year was 57 per cent. Furthermore, in spite of heavy borrowing (over $1.5 billion) on the international capital markets,[237] the foreign exchange

---

[237] During 1995 Romania was rated BB- by the principal western rating agencies (and BB+ by JCRA), which helped the raising of money on the international capital markets. These accommodating capital inflows fended off a major balance of payments crisis in 1996.

Fiscal and quasi-fiscal deficits of Romania, 1993-1997
(Percentage share in GDP)

	1993	1994	1995	1996	1997
Budget balance					
Total					
Cash	-0.4	-1.9	-2.6	-3.9	-4.5
Accruals	-0.4	-1.9	-3.0	-5.8	-3.5
Primary					
Cash	80.6	-0.5	-1.2	-2.2	-0.5
Accruals	0.6	-0.5	-1.6	-4.1	0.5
Quasi-fiscal deficit [a]	-3.1	-3.6	-0.3	-2.6	–
Budget balance including quasi-fiscal deficit					
Total					
Cash	-3.5	2-5.5	-2.9	-6.5	-4.5
Accruals	-3.5	-5.5	-3.3	-8.4	-3.5
Primary					
Cash	-2.5	-4.1	-1.5	-4.8	-0.5
Accruals	-2.5	-4.1	-1.9	-6.7	0.5
Memorandum item:					
Interest payment	0.9	1.4	1.4	1.7	2.4

Source: National Bank of Romania.

[a] National Bank of Romania refinancing.

reserves of the national bank stood at about $600 million at the end of 1996. The external debt of the country was rising rapidly with peak payments looming in the following years. In addition, the policy mix being pursued by the government (multiple exchange rates, price controls, subsidies, etc.) was making it unlikely that it would be possible to reach a new arrangement with the IMF. Such developments were clearly leading to a dead-end and a policy change was urgently required.

The events of 1995 and 1996 underscored both the importance of privatization for inducing autonomous capital inflows and for enhancing restructuring, as well as the danger of "populist macroeconomics".[238]

(e) The "policy shock" of 1997 and its consequences, 1997-1998

At the end of 1996 the economic situation was as follows: the monthly inflation rate was over 10 per cent; the consolidated budget deficit and the quasi-fiscal operations of the central bank were in excess of 8 per cent of GDP; the current account deficit was about 7.2 per cent of GDP; and foreign exchange reserves were down to some $600 million, less than a month's imports in spite of the large loans that had been raised in the international capital market. At the same time, financial indiscipline (total arrears) had reached a magnitude that was causing serious concern (about 34 per cent of GDP), while inadequate steps were being taken toward privatization and restructuring. Last but not least, the remonetization of the economy had allowed massive

subsidies to be given to agriculture and other sectors in 1995 and 1996 without raising inflation; as the remonetization process came to a halt in the latter half of 1996, maintaining subsidies without igniting inflation was to prove an impossible endeavour.

What happened in 1997? The new government's first step was to liberalize the foreign exchange market and the prices of certain goods which were still administratively regulated. Paradoxically, in a year when renewed efforts were made to achieve macroeconomic stabilization, the expected annual inflation rate, 90 per cent, was much higher than in 1996 (57 per cent). The explanation of this paradox lies in the magnitude of the effect of liberalizing prices and the anticipated devaluation of the leu.[239] Nevertheless, the assault upon several of the major imbalances led to some positive results: the foreign exchange market began to function adequately; the consolidated budget deficit (including quasi-fiscal deficits) was reduced to 3.5 per cent of GDP;[240] the current account deficit shrank a little, from 7.2 per cent to 6.7 per cent of GDP; and the central bank's foreign exchange reserves soared to about $2.6 billion.[241] The size of the fiscal adjustment should also be seen against the backdrop of the sharp fall in output, which greatly reduced the tax base. But despite all this, there was another side to the coin: the actual inflation rate was 152 per cent and GDP fell by much more than expected (6.9 per cent as against 2 per cent). Both demand and supply shocks were behind the decline of the economy.

One consequence of the programme, which is not often mentioned, was its severe impact on the emerging private sector. The large contraction of real credit lowered considerably the prospects for many small- and medium-sized companies and was a major factor in the fall of output. Thus, total real credit (in domestic and foreign currency) declined by 52.5 per cent and its non-government component by as much as 61.3 per cent. This should be set against the growth of real credit in previous years when the non-government component increased by 19.7 per cent, 35.6 per cent, and 4.1 per cent in 1994, 1995, and 1996, respectively.[242] In many sectors sales fell by 20-25 per cent. This development was the reason behind the growing chorus of demands in the private sector for fiscal relaxation, demands which became very intense during 1998. Ironically, a programme which was meant to advance reforms,

---

[238] The elections of 1996 clearly had an impact on macroeconomic policy and, subsequently, on the performance of the economy.

---

[239] From some 4,000 lei/$1 at the end of December 1996 the rate rose sharply to about 9,000 lei/$1 in late February 1997, after which a nominal appreciation took place and the rate stabilized at around 7,000 lei/$1.

[240] This is an overstatement to the extent that arrears stood at a high level and even increased. The bail-out of Banca Agricola and Bancorex in 1997 indicated how serious the problem of arrears was and how they can obscure quasi-fiscal deficits.

[241] Significant amounts of portfolio capital entered the country, which tested the ability of the central bank to sterilize them when base money represented no more then 4.6-4.7 per cent of GDP.

[242] National Bank of Romania data.

affected negatively the emerging entrepreneurial class and encouraged the expansion of the underground economy because of the degree of austerity involved.

There are several factors that explain the high rate of inflation. First, the corrective component of inflation (price de-control plus a rise in some administered prices) came strongly into play in March when inflation reached almost 30 per cent. Secondly, the overshooting of the leu. Thirdly, the programme underestimated the role of monopolies and the slow response of supply as sources of inflation. Another factor lay in the economic policy slippages in the latter half of the year when there was a premature relaxation of monetary policy: there was an extensive and abrupt indexation of wages, redundancy payments were granted to laid-off workers, and large amounts of money were pumped into banks that were in difficulty. It was obvious that the macroeconomic policy mix was not well balanced and that the supply-side response had been greatly overestimated.

Belated moves were made to restructure some of the major "producers" of arrears. The delay was due to the inherent problems of undertaking such an operation in a year when the economy was in steep decline: on the one hand, the overall measures aimed at restructuring implied the need for layoffs, but on the other hand, the troubles confronting the small and medium-sized enterprises in the private sector, a direct consequence of the austerity measures, were discouraging the creation of new job opportunities. Privatization of large enterprises dragged on at a snail's pace and as for bank privatization, the various projects were left in abeyance. Such a situation could not provide incentives for direct foreign investment nor promote restructuring.

In the last months of 1997 the big losses of state banks, accumulated over a long period and mirroring the state of the real economy, attracted increasing attention. In the last quarter of the year, the central bank and the Ministry of Finance converted 8,000 billion lei ($1 billion) of poor credits granted by the Agricultural Bank and Bancorex into government bonds as a way of recapitalizing the two banks. While the Dacia Felix and the Credit Bank failures were caused by large-scale fraud and embezzlement, the failure of the state banks was the result of a chronic misallocation of resources and of poor performance in a number of large economic sectors, which in turn was due to slow restructuring and feeble capital inflows.[243]

GDP continued to decline in 1998, according to preliminary data, by 7.3 per cent. At the end of the year unemployment stood at about 10 per cent (as against 6.6 per cent in December 1996). Inflation in December (year-on-year) fell to 40.6 per cent, and the consolidated budget deficit was kept to just below 4 per cent. The latter should be seen against the background of a further reduction of the tax base (because of the fall in output)

and the implications for government spending of the rescue package for the two state owned banks. Actually, the budget deficit was kept under control by a very severe cut in public expenditure undertaken in August.

Real interest rates stayed high in 1998[244] as a result of the tight monetary conditions and a lack of sufficient credibility in macroeconomic policy. Their level indicated how small the room for manoeuvre available to policy makers was. Interestingly, real credit started to grow again in 1998 although output did not. Between December 1997 and November 1998 real domestic credit rose by some 24 per cent with the non-government component increasing even more. A note of caution is needed here, however, since over the same period, the net foreign assets of the banking system fell by almost a half and the real money supply shrank (see table 3.2.4).

Based on consumer prices, the exchange rate appreciated in real terms by about 30 per cent since mid-1997 (after the sharp devaluation at the start of that year), which helps to explain the rising trade and current account deficits in 1998. The foreign exchange reserves of the national bank declined to less than 1.9 billion at the end of the year, a result of its interventions to stem the fall of the leu. It should also be mentioned, that excessively lax income policies also help to explain the size of domestic absorption in a year when there was a further contraction of output. Real wages actually grew by about 4.7 per cent in the year to December (table 3.2.4).

Because of the fallout from the financial crisis in Russia external bond issues were postponed, which in turn casts doubt on the possibility of rolling over a portion of the external debt in 1999. Because of the size of payments due in 1999 (about $2.9 billion) there is a threat of a financial crisis and default unless an agreement with the international financial organizations is reached early in 1999. This threat explains the considerable efforts to conclude privatization deals at the end of 1998 (Romtelecom, Romanian Development Bank, etc.) and the attempt to close down large loss-making companies.

(f) A comparison of the two stabilization programmes, 1994-1995 and 1997-1998

There are several features which differentiate the two attempts at macroeconomic stabilization in 1994-1995 (hereafter policy A) and in 1997-1998 (policy B). These differences help to explain why output grew, albeit on a very fragile basis, during the first attempt whereas it declined in 1997 and 1998. It should be stressed that in both cases the pace of restructuring was feeble.

Both policies were accompanied by interest rate shocks. However, policy A did not involve a credit crunch; on the contrary, M2 grew rapidly and so did

---

[243] Behind these developments was the slow pace of privatization which failed to attract capital inflows and thereby help restructuring.

[244] In the second half of the year *ex-post* dollar returns on three-month treasury bills hovered at about 50 per cent.

lending. As was mentioned already, this was due to the rapid remonetization of the economy, which was enhanced by a psychological factor: for the first time people found it worthwhile to put their savings into banks (because of positive real interest rates). Consequently, bank deposits grew rapidly. The psychological-cum-savings reorientation factors were no longer strong in the second period, and the sharp rise in interest rates (in 1997) could not be accompanied by remonetization. Policy B, as a matter of fact, involved a major credit crunch.

It should also be emphasized that the process of remonetization came to a halt in the second half of 1996, which created a major constraint for policy in 1997. The increase in the velocity of money forced policy makers to consider a much tighter monetary policy. The issue at stake was how much tighter it should be.

Policy B involved exchange rate unification via a large overshooting of the leu, which magnified inflation and the decline of money balances in real terms. Policy A included multiple exchange rates and controls on key prices such as energy.

Policy B involved a major fiscal adjustment, including a large reduction in explicit and implicit subsidies, which affected certain sectors more heavily than others.

Policy B used as a nominal anchor base money (which actually recovered its 1996 December level in the second quarter of 1997), whereas policy A was quite eclectic, relying on both the control of the money supply and a certain degree of stability in the exchange rate[245] during the phase of intense remonetization.

Macroeconomic imbalances persisted, or even developed, over the 1994-1996 period. Arrears rose to over 34 per cent of GDP in 1996 (from an average of 22-23 per cent in previous years), which was increasingly worrisome since, as the economy had been growing, restructuring should have been encouraged. A factor here is that policy makers ignored the need for a restructuring policy, an industrial policy conceived as a damage-control device.[246] The growth of arrears indicated the unsound basis of economic growth. The rising trade deficits in 1995 and 1996 were financed by substantial accommodating or compensatory capital inflows, which created a dangerous situation for the following years. With the benefit of hindsight, one can imagine various scenarios against the backdrop of the world financial crisis.

Policy B tried to speed up privatization and used the stock market to this end. This explains the large inflows of portfolio capital in the first half of 1997 and the accumulation of foreign exchange reserves by the central bank. In 1997 Romania, for the first time, received substantial autonomous capital inflows, which tested the sterilization capacity of the central bank. These flows later subsided as policy ran into an impasse.

An apparent puzzle comes out of comparing the two programmes. In the period 1994-1996 the trade and current account deficits rose in the wake of the expanding economy. With the very severe compression of domestic absorption in 1997 and 1998 an improvement in the current account deficit might have been expected. There was a slight reduction of the deficit in 1997 (as against 1996), but it started to grow again in 1998. The fact is that, after a fall in GDP of more than 13 per cent in just two years, the current account deficit remained in the vicinity of 7 per cent of GDP. The immediate explanation is that this was due to the real appreciation of the exchange rate (see chart 3.7.1) and the lax incomes policy in 1998.

Whether the fall in output could have been smaller, or even avoided, in 1997 can only be a matter for speculation. It is clear nonetheless that, owing to very tight credit conditions, a continuation of growth was hardly possible and this is why the programme anticipated a decline of 2 per cent in GDP. One policy issue for analysis is the appropriateness of the nominal reduction of base money in the first quarter of 1997, instead, for instance, of keeping M0 fixed for a while. The reasons for the reduction – a rising velocity of money and the desire to mitigate the size of the correction in the price level – are plausible but not indisputable. In addition, the appropriateness of moving at the same time on two tracks, the cut in M0 and floating the exchange rate, can be questioned. It is possible to conceive of a sequence of moves so that the floating of the exchange rate would have followed the correction of the inflationary surge that had been set off by the too rapid expansion of base money in late 1996. There might also have been a closer and more critical look at the size of tariff reductions proposed for agriculture. The conclusion is that policy makers underestimated the scale and extent of supply rigidities in the economy.

As for the 1994-1995 programme, it should again be emphasized that the slow pace of privatization and restructuring damaged its effectiveness. A faster rate of privatization, and consequently more capital inflows, especially of FDI, could have changed significantly the structure of the economy. Even if the then government had not allowed the official exchange rate to float, a dual system – a commercial rate with rationing, and a free rate for financial transactions – could have created an exit window for potential foreign investors in the local equity market. The government might have also used the favourable circumstances of an expanding economy to deal with the large loss-making units. The failure to do so represents a missed opportunity.

_____

[245] The plural "exchange rates" is emphasized since a de facto quasi-unification of the rates occurred during 1994. The relative stability of the rates helped the stabilization effort at that time.

[246] Such an industrial policy, seen as managing the gradual phasing-out of chronically inefficient companies, was advocated already in the early 1990s. D. Daianu, "Transformation and the legacy of backwardness", *Économies et Sociétés*, No. 44, May 1992, pp. 181-206.

(g) What next?

In early 1999 Romania faces three major interlinked threats and policy challenges: the risk of an external payments default;[247] the danger of a banking crisis owing to the scale of bad loans in the banking system and the size of the foreign exchange reserves of the central bank, which were less than base money and insufficient to stem a run on the banks;[248] and a possible financial crisis as a result of persistently high real interest rates and the consequences of a further bail-out of Bancorex (about $400 million in December 1998). Other important constraints on policy are social and policy fatigue,[249] and an increasingly unfavourable external environment.

In February 1999 the parliament approved a budget that envisages a deficit of 2 per cent of GDP and which relies on a rise in taxation and further cuts in expenditure.[250] The big unknown in the whole picture, however, is the real quasi-fiscal deficit in the economy which is hidden by arrears and the accumulation of bad loans to enterprises. What happened with Bancorex and Banca Agricola is an illustration of the result of years of weak restructuring, which shows up in the balance sheets of the banks[251] and, ultimately, in the consolidated budget deficit when the "day of reckoning" cannot be postponed any longer.

In the short run, in order to avoid default on external payments, it is essential for the government to reach an agreement with the IMF and the World Bank. The difficulties of concluding such agreements stem from the requirements of further drastic cuts in the consolidated budget deficit and of finding resources to finance substantial lays-offs in a year when GDP is expected to fall again. As already mentioned, a very critical challenge for policy is to avert a banking crisis. Over the longer term, the government needs to design a strategy which will help the export-orientation of the economy, lead to better management of the external debt, and create conditions for sustainable economic growth.

(h) Concluding remarks

If it is accepted that a command system allocates resources inefficiently because of the impossibility of economic calculation, the implication is that the freeing of prices and the functional opening of the economy put the latter under tremendous strain since resource reallocation cannot take place quickly enough and without friction. One effect of this strain are massive interenterprise arrears, which appear as a *sui generis*, and unintended financial innovation and create a structural trap for stabilization policy.[252] Strain is also intensified by the disorganization in the system which results from the institutional hiatus during the process of regime change.

The magnitude of the required resource reallocation can seriously qualify the attempt to pursue a low inflation rate in the short run − particularly if the lack of capital markets, the presence of large and growing budget deficits, low savings rates, and meagre foreign capital inflows and external aid are taken into account. In a system subject to substantial strain there are strong forces that create a high propensity to generate inflation as a way of diffusing tension by spreading out, or putting off, the costs of adjustment. The *inflation tax* and *negative real interest rates* are implicit subsidies for those that are unable to make ends meet financially in a competitive environment. Inefficient enterprises develop a vested interest in raising prices at a faster pace than the increase in costs (wages), and, in addition, tend to form strong lobbies to obtain cheap credit. Their endeavours are made easier since markets tend to be heavily monopolized, the control of money supply is shaky for both technical and political reasons, and a fixed exchange rate − as an anchor and source of market discipline − is virtually a practical impossibility.

Analysts have frequently highlighted the relatively tighter financial discipline in countries such as the Czech Republic, Hungary and Poland (table 3.2.6), as compared with Romania, the Russian Federation or Ukraine. Nonetheless, the pernicious effects of arrears are a problem for policy makers in all the transition economies. It is noteworthy that even where macrostabilization has been seen as comparatively successful − as in the Czech Republic where the underlying inflation rate was already below 10 per cent in the early 1990s − arrears remained resilient and were a warning of substantial *strain* in the system.[253] But the question remains: why have the first three countries fared better in this respect? It is suggested here that the answer can be pursued by looking at the *structure* of these economies,[254] their ability to export to

---

[247] Despite a moderate level of external debt (which does not exceed 30 per cent of GDP), it has nevertheless been increasing rapidly. Questions, however, can be raised about the management of the external debt, with a peak payment approaching $3 billion in 1999.

[248] At the start of 1998 the $500 limit to the purchase of hard currency by individuals was lifted. This measure may increase the risk of a run on the banking system.

[249] The result of an austerity policy underway for two years in which GDP has fallen by more than 13 per cent.

[250] Particularly worrisome are the low shares in the state budget of expenditure on education and healthcare, and the plunging share of capital expenditure (especially on infrastructure).

[251] Non-performing loans were 57 per cent of total outstanding loans at the end of 1997.

[252] D. Daianu, *Inter-Enterprise Arrears in a Post-Command Economy. Thoughts from a Romanian Perspective*, IMF Working Paper WP/94/54 (Washington, D.C.), September 1994. For the history of arrears in Romania see also E. Clifton and M. Khan, "Inter-enterprise arrears in transforming economies. The case of Romania", IMF, *Staff Papers*, Vol. 40, No. 3 (Washington, D.C.), 1993, pp. 680-696.

[253] In the Czech Republic it was noted that, "Many companies are locked in a circle of bad debt caused by unpaid bills from customers ... Officials fear that many other companies could be affected if major companies are allowed to go bankrupt". P. Blum, "Czechs set to act on bankruptcy", *Financial Times*, 17 February 1993, p. 2.

[254] A World Bank study shows the median number of employees in a sample of firms in Romania to be 1,327, whereas in other countries it was very low: Slovenia, 213; Poland, 820; Hungary, 241; Bulgaria, 291.

TABLE 3.2.6

Government revenues in selected east European economies, 1990-1996

(Per cent of GDP)

	1990	1991	1992	1993	1994	1995	1996
Romania	39.7	41.9	37.4	33.9	32.1	31.9	29.6
Albania	46.8	31.5	23.5	25.6	24.5	24.0	..
Bulgaria	52.9	40.4	38.4	37.2	39.9	36.2	33.6
Czech Republic	..	..	48.2	50.5	49.4	48.4	..
Hungary	52.1	50.9	50.0	50.7	49.6	46.6	45.8
Poland	45.4	42.4	43.9	47.6	47.2	47.2	45.7
Slovakia	..	..	46.1	44.2	46.3	46.8	..

Source: Country authorities and IMF estimates.

western markets and to attract foreign investment, their size, and their economic policies. Furthermore, *structure* is influenced by whether or not there was a history of partial reforms (that, in some cases, brought about several of the ingredients of a market environment), the degree of concentration of industry, and the prior existence of a private sector. Policy credibility[255] can be singled out as a major explanatory factor, but credibility itself depends on how much structural adjustment can be brought about by that policy over a stated period; and the *capacity to adjust* is influenced by the initial *structure* and the scale of *resource misallocation* that it contains.

If it is accepted that the roots of financial indiscipline are to be sought in *structure* − however multifaceted − and the *strain* to which the economy is subjected, the obvious conclusion is that both *structure* and *strain* have to be targeted by policy. Dealing with *structure* includes a focus on both property rights and corporate *governance*. Also attention must be paid to the development of appropriate and effective market institutions and to finding ways to erode the existing economic power structure and to change enterprise behaviour. *Strain,* which reflects the scale of the required resource reallocation, should be approached by starting with the simple truth that structural adjustment is always difficult even in an advanced market-based economy and even when reform is credible.[256]

The structure of the economy has to be tackled firmly and industrial restructuring must be enhanced by privatization and supported by capital inflows: both must take place if real interest rates are to fall significantly.

Otherwise, high real interest rates will maintain intense strain in the system and make it prone to macroeconomic instability. High real interest rates will also maintain the fragility of banks, particularly of domestic ones.[257]

The situation of potentially viable enterprises, but which are burdened with heavy debts, should be dealt with more carefully and creatively. It should be kept in mind that many companies are heavily in debt because they were undercapitalized (without working capital) by design, and not by choice, as was the case of firms in South-East Asia. The fact is that tight monetary conditions and high real interest rates can kill even potentially viable companies. One way of reducing this risk would be to distinguish between past and current payments. On past debts the interest rate applied should be slightly above an average inflation rate whereas current interest rates should concern only current payments.[258] Something along this line could mitigate the plight of many potentially sound companies.

There is much need for foreign capital to act as a powerful influence for modernization and restructuring. The more this capital is committed long term, the easier it will be for post-communist economies such as Romania to weather the inherent risks of a market environment. Policy makers, however, need to be aware that the competition for capital is intensified by the effects of the redistribution of economic power in the world. The nature of capital inflows needs to change. Currently, most of them are of an accommodating nature, a result of the existing pattern of production and consumption in the Romanian economy, rather than a force for structural change.

Romania's experience emphasizes once again the principle and problems of continuity, that *natura non facit saltum,* that making institutions function properly takes time, and that there is a grip of *structure* − the product of history − that is hard to loosen. It would be naive to assume that the institutions of the post-communist economies can quickly and easily perform according to the various role models of western Europe or North America; they need time to develop in order to perform effectively. Realism is needed not only in designing policies, but also in making balanced judgements as to "what constitutes good performance" and "what is to be done next".

A crucial lesson is that institutions in the making are fragile, and that their very *fragility* makes the economic system more vulnerable to both internal and external shocks. This institutional fragility magnifies the *strain* in

_____

[255] Defining *policy credibility* in post-command economies needs qualification since, with the exception of Hungary and Poland, there is no history of stabilization attempts. Without such a history agents react according to entrenched behavioural patterns, and not on the basis of what they have learned about past policy intentions and their possible reversal. Certainly, when widespread bail-outs represent a reversal of a major policy goal, stabilization history starts on the wrong foot and policy credibility is impaired from the very beginning.

[256] M. Bruno, "Stabilization and reform in eastern Europe: a preliminary evaluation", IMF, *Staff Papers*, Vol. 39, No. 4, (Washington, D.C.), December 1992, p. 753.

[257] This is because foreign banks will cater less to the needs of Romanian companies and will be less dependent on the vagaries of the local environment.

[258] Martin Feldstein has proposed something similar for Asian companies hurt by the high real interest rates resulting from austerity measures. M. Feldstein, "All is not lost for the won", *Wall Street Journal*, 4 June 1998.

Levels of strain in labour market adjustment
(Percentages)

	Romania		Hungary		Poland		Czech Republic		Slovakia		Slovenia		France	United Kingdom
	1990	1995	1992	1995	1992	1995	1991	1995	1991	1995	1993	1995	1992	1994
Relative wages *(average monthly earnings=100)*														
Agriculture and forestry	104.2	81.6	68.9	76.8	82.3	90.6	97.2	84.2	99.7	81.7	105.3	95.5	72.5	77.9
Industry	98.6	107.6	99.0	104.0	98.7	108.9	104.5	99.2	101.4	104.3	84.9	85.0	111.1	116.5
Construction	110.9	106.4	90.2	84.4	106.1	92.5	106.2	108.0	102.4	104.8	83.0	82.5	98.6	109.2
Trade, hotel and restaurant	86.1	78.2	97.0	90.0	90.3	88.9	85.8	88.2	89.3	94.0	102.2	99.8	90.9	69.9
Transport, communications	108.5	121.0	105.8	106.5	102.1	101.2	102.1	100.7	102.1	108.4	115.0	110.9	105.4	144.6
Financial, banking and insurance, real estate and other services	109.3	126.8	144.7	137.4	147.7	137.3	99.9	130.7	103.9	131.4	143.8	124.6	128.0	136.8
Education, health and social assistance	96.5	85.3	93.5	86.5	86.9	81.7	93.2	91.2	97.6	87.2	111.8	109.6	75.8	53.0
Public administration and defence, other branches	88.9	88.6	118.0	111.3	115.7	108.9	88.5	103.8	103.4	102.5	127.8	132.7	91.0	93.6
Index of "strain" on prices	23.0	9.8	24.1	19.7	18.3	17.0	21.1	19.1	23.8	17.2	33.9	33.1	11.7	..
Excluding agriculture	21.2	12.9	26.0	21.3	22.9	18.1	21.2	20.0	24.0	18.6	34.5	34.8	12.0	..
Employment shares *(per cent)*														
Agriculture and forestry	29.0	34.4	11.4	8.1	25.5	22.6	12.1	6.6	15.8	9.2	10.7	10.4	5.2	2.0
Industry	36.9	28.6	30.2	27.1	25.2	25.9	41.0	33.2	35.9	30.3	38.7	38.0	20.6	20.2
Construction	6.5	5.0	5.4	6.0	6.6	6.1	5.7	9.2	8.2	8.6	5.4	5.1	7.2	6.4
Trade, hotel and restaurant	6.9	10.4	14.8	15.9	10.7	13.6	7.8	15.7	8.1	13.1	14.6	15.4	17.4	20.8
Transport, communications	7.0	5.9	8.6	8.8	5.5	5.8	9.0	7.7	5.5	7.8	6.5	5.9	5.8	5.8
Financial, banking and insurance, real estate and other services	3.9	4.2	5.2	5.9	1.3	2.0	5.4	6.7	5.4	5.8	4.6	6.1	10.8	12.5
Education, health and social assistance	6.7	8.1	13.6	15.6	13.1	13.3	13.8	12.1	16.5	14.5	10.2	11.4	6.9	14.5
Public administration and defence, other branches	3.1	3.4	10.6	12.5	12.1	10.7	5.1	8.8	4.6	10.7	9.2	7.6	26.2	17.9
Index of "strain" on quantities	91.4	76.6	47.6	37.2	60.4	56.7	68.1	47.1	68.7	45.9	62.2	56.7	13.8	..
Excluding agriculture	76.4	57.5	41.5	33.7	46.0	42.4	63.1	44.4	63.4	43.2	52.9	48.3	21.8	..
Indicator of total "strain"	94.2	77.2	53.3	42.1	63.1	59.2	71.3	50.8	72.6	49.0	70.9	65.6	18.1	..
Excluding agriculture	79.3	59.0	49.0	39.9	51.4	46.1	66.6	48.7	67.8	47.0	63.2	59.5	24.9	..

Source: OECD, Centre for Cooperation with Non-members (CCNM); *OECD Economic Surveys 1997-1998, Romania* (Paris), 1998, p. 171; D. Daianu, *The Changing Mix of Disequilibria during Transition: A Romanian Background*, IMF Working Paper WP/94/73 (Washington, D.C.), 1994 and D. Daianu, "An economic explanation of strain", in J. Bachaus (ed.), *Issues in Transformation Theory* (Marburg, Metropolis, 1997).

the system caused by the resource misallocation inherited from the command economy. The time constraint is increasingly short for the Romanian economy and society, but time (and breathing space) is precisely what policy makers need after years of indecisiveness in dealing with a complicated and burdensome legacy, a legacy which is indicated by the intensity of the foreign exchange constraint and the persistence of soft budget constraints throughout the economy.

3.3 Output and demand

(i) Output

Output performance in the ECE transition economies as a whole deteriorated in 1998: aggregate GDP fell by over 0.5 per cent from its previous year's level, a considerable slide from the 2 per cent growth achieved in 1997. Output performance worsened most in the Commonwealth of Independent States where after a modest 1.1 per cent rise in 1997, aggregate GDP declined by 2¾ per cent in 1998, mostly as a result of the Russian crisis. Economic growth in the Baltic states decelerated

rapidly in the second half of the year but the average increase in GDP remained relatively high (around 4¼ per cent), although below the 7.6 per cent in 1997. GDP growth in eastern Europe as a whole (some 2 per cent) was lower than in 1997 (2.8 per cent); but within this aggregate, output in central Europe increased by 3.6 per cent, while it actually declined by almost 2 per cent in south-eastern Europe. In all parts of the region, the deterioration of performance occurred in the second half of 1998; in the first half, GDP was growing more or less at the same rates as in 1997.

Performance in the transition economies in 1998 remained highly differentiated across countries and subregions. While the shrinking of external demand had strong negative repercussions on economic activity across the board, the central European countries managed to a large extent to shield their economies from contagion and financial turmoil. However, for a large number of transition economies, the external demand shock was amplified by the deepening of internal problems and this undoubtedly reinforced the negative trends in these countries.

(a) Central Europe

With the notable exception of the Czech Republic, the central European transition economies as well as the three Baltic states experienced a period of rapid growth in the 18 months ending in mid-1998. It was underpinned by relatively successful macroeconomic stabilization, progress in structural reforms and booming exports, especially to western Europe. However, with the escalation of negative external developments, this trend was reversed towards the middle of 1998 and as a result the course of output in the two halves of the year was quite different. Thus although the average annual figures for economic performance in 1998 look quite favourable, economic growth was obviously losing its previous vigour in the course of the year and there will have to be an adjustment to more moderate rates of growth in 1999.

After several years of robust growth, some slowing down had been expected in Poland in 1998 as in the final months of 1997 there had been fears of overheating due to the rapid growth of private spending and a rising current account deficit. Thus the *ex-ante* policy stance in 1998 implied a moderate degree of monetary and fiscal restraint which targeted domestic demand on the assumption, however, that external conditions would remain favourable. The moderation in the pace of activity in the second half of 1997 and during the first half of 1998 followed this pattern of orderly adjustment towards the desired balance between growth and stability.

However, the external conditions in 1998 turned out to be much more unfavourable than expected. Actually Poland was hit by the weakening global demand for commodities and intermediate goods already in the second quarter of the year; Russian import demand (especially the "shuttle" trade) had also started to shrink at the same time. With the escalation of the Russian crisis in August, Polish exports suffered a further blow; as suggested by the estimates of potential losses from the Russian crisis (table 3.6.5), Poland appears to have incurred the largest absolute export loss among the central European exporters. At the same time, as discussed in section 3.2, policy was slow to respond to these unfavourable developments; apart from the lag in the appreciation of the problem, policy makers do not appear to have had at their disposal the necessary instruments to cope with it efficiently. Thus despite the gradual easing of monetary policy in the second half of the year, monetary austerity de facto lasted for too long and turned out to be harsher than intended.

The worst affected sector of the Polish economy was industry (table 3.3.1 and chart 3.3.1); the growth of industrial output rapidly decelerated in the course of 1998 and in the last quarter of the year it turned negative (-1.5 per cent, year-on-year). In fact, this was the first time that Polish industrial output had fallen since 1992; during this period manufacturing was the main engine of economic recovery in Poland.

As a result, the growth of GDP also decelerated rapidly and much more than expected during the second half of 1998: in the fourth quarter, GDP growth slowed to some 3 per cent. At the moment of writing this *Survey*, the future direction of Polish output in 1999 was not at all clear;[259] moreover, the available data were not sufficient to assess the extent to which individual sectors were affected by the weakening of industrial output.[260] Apparently there was no negative impact on the construction sector where gross output continued to grow at double-digit rates in 1998 (table 3.3.6). However, most of the uncertainties at the beginning of 1999 pointed to a considerable increase of the downside risks and thus a rising probability of a further deceleration in growth.[261] On the other hand, the continuing large inflow of foreign direct investment to Poland[262] suggests that foreign investors still judge the medium-term prospects for Poland as quite favourable.

Compared with the other central and east European economies, Hungary passed through the 1998 turbulence rather successfully and so far has incurred the least damage from the worsening external environment. In 1998 the Hungarian economy grew at a steady and even pace (quarterly GDP growth was in the range of 4.5-5.5 per cent) throughout the whole year (table 3.3.1) underpinned by sound fundamentals and a balanced macroeconomic policy mix. While booming exports continued to be a major factor, an upsurge in domestic demand also contributed to the robust performance of the Hungarian economy in 1998 (table 3.3.7).

The principal driving force behind the Hungarian upturn in 1997 and 1998 has been the revival of the manufacturing sector. In both years gross manufacturing output grew at double-digit rates (table 3.3.4): it has been growing without interruption since 1993 (despite the uneven performance in other sectors of the economy) and increased by more than 62 per cent over the period 1993-1998.[263] Hungarian manufacturing benefited from a massive inflow of foreign direct investment which, in

---

[259] According to preliminary data industrial output was continuing to fall in January 1999.

[260] Despite the notable progress in statistical practices, only a few transition economies (Poland being one of them) report quarterly national accounts. Due to the lags in reporting, only data for the first three quarters of 1998 were available at the time of writing (table 3.3.2). Thus the available data do not reflect, for the most part, the impact of the changes that occurred (as in the case of Poland) in the last quarter of the year.

[261] Consequently, it appears increasingly unlikely that the 5.1 per cent GDP growth target incorporated in the 1999 budget (which was finally passed in February) will be reached.

[262] In 1998 Poland became the leading destination among the transition economies for foreign direct investment which (in terms of commitments) amounted to some \$9 billion. As stated by Economy Minister J. Steinhoff, "Direct investment amounted to \$1 million an hour last year", as reported by *Reuters News Service*, 28 January 1998. A similar or higher inflow of FDI is expected in 1999. In terms of capital flows recorded in the balance of payments, the inflow of FDI in 1998 was somewhat lower (table 3.7.4).

[263] Among the ECE transition economies, only Polish gross manufacturing output increased more (by some 85 per cent) over this period. UN/ECE secretariat calculations, based on national statistics.

TABLE 3.3.1

GDP and industrial output in the ECE transition economies, 1997-1998

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

	GDP					Industrial output				
		1998					1998			
	1997	Jan.-Mar.	Jan.-Jun.	Jan.-Sept.	Jan.-Dec.	1997	Jan.-Mar.	Jan.-Jun.	Jan.-Sept.	Jan.-Dec.
Eastern Europe	2.8	..	..	..	2	5.6	6.1	4.4	3.4	1.4
Albania	-7	..	..	..	8*	-5.6	-12.4	-1.3	9.3	10*
Bosnia and Herzegovina	..	..	..	..	..	35.7	14.2	21.1	25.4	23.8
Bulgaria	-6.9	18.9	11.9	4.3	3*	-10.2	6.2	-0.7	-6.7	-9.4
Croatia	6.5	3.3	3.2	3.3	3*	6.8	6.4	5.8	6.8	3.7
Czech Republic	1.0	-0.9	-1.7	-2.1	-2.7	4.5	8.4	6.7	5.0	1.6
Hungary	4.6	4.5	4.8	5.1	5	11.1	13.6	13.6	13.6	12.6
Poland	6.9	6.4	5.8	5.5	4.8	11.5	11.0	8.4	7.0	4.7
Romania	-6.9	-9.4	-5.2	-5.7	-7.3	-7.2	-21.9	-19.2	-17.3	-17.0
Slovakia	6.5	6.2	6.2	5.8	4.4	1.7	4.7	5.3	6.4	4.6
Slovenia	4.6	6.4	4.6	4.4	4	1.0	9.8	4.2	4.5	3.7
The former Yugoslav Republic of Macedonia	1.5	..	..	..	2.9	1.6	8.3	9.6	7.9	4.5
Yugoslavia	7.4	..	..	..	2.6	9.5	15.9	12.3	7.0	3.6
Baltic states	7.6	..	..	..	4¼	9.4	11.6	9.5	7.2	3.6
Estonia	11.4	9.3	7.4	5.4	4.2	13.4	11.4	7.9	4.0	0.8
Latvia	6.5	7.6	6.4	4.9	4*	13.8	14.7	11.2	7.0	2.0
Lithuania	6.1	4.7	7.3	5.7	4.5	3.3	8.9	9.2	9.6	7.0
CIS	1.1	..	..	..	-2¾	2.6	3.0	1.8	-1.2	-2.3
Armenia	3.1	6.4	6.7	6.9	7.2	0.9	4.3	3.2	0.6	-2.5
Azerbaijan	5.8	8.2	9.1	8.5	10.0	0.3	0.2	0.7	1.1	2.2
Belarus	11.4	13.0	12.5	10.0	8.3	18.8	14.6	13.5	10.8	11.0
Georgia	11.3	11.2	8.9	7.3	2.9	8.2	-3.2	0.8	-1.2	-2.7
Kazakhstan	1.7	1.9	1.7	–	-2.5	4.0	3.8	1.1	-1.2	-2.1
Kyrgyzstan	9.9	11.5	5.0	1.4	1.8	50.4	52.1	23.5	9.7	4.6
Republic of Moldova	1.6	-4.2	-4.7	-4.7	-8.6	–	3.4	2.3	-5.7	-11.0
Russian Federation	0.8	–	-0.9	-3.3	-4.6	2.0	1.3	0.1	-3.9	-5.2
Tajikistan	1.7	1.3	2.6	6.5	5.3	-2.0	9.5	12.5	8.7	8.1
Turkmenistan	-11.4	-8.0	3.0	4.4	5.0	-32.3	-11.0	-5.0	2.0	0.2
Ukraine	-3.2	-0.2	0.2	-0.5	-1.7	-0.3	1.7	0.7	-0.3	-1.5
Uzbekistan	5.2	3.3	4.0	4.4	4.4	4.1	4.3	5.5	6.1	5.8
Total above	2.0	..	..	..	-½	3.8	4.3	2.9	0.6	-0.9
Memorandum items:										
CETE-5	5.5	..	..	..	3.6	9.4	10.5	8.3	7.2	5.0
SETE-7	-3.1	..	..	..	-1.9	-3.9	-6.7	-7.2	-8.1	-9.2
Former GDR	1.7	3.6	1.7	1.7	2.0	5.8	..	..	..	7.5

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE secretariat (IMF and World Bank data for Albania).

Note: Industrial output figures for 1998 in table 3.3.1 are based on monthly data. Because of differences in coverage, the cumulative monthly figures for 1998 as a whole differ slightly from the reported annual figures for some countries; where this is the case, the annual figures have been used. On regional aggregates see the note to table 3.1.1.

turn, was encouraged by deliberate policy efforts.[264] The upsurge of manufacturing output in the last two years also partly reflected the expansion of aggregate production capacity as a number of new engineering plants started operation in this period.

What makes Hungary somewhat different from other transition economies is the fact that many of the new (or restructured) manufacturing facilities are operating within the international framework of the multinational companies that own them. A large share of their output

(and mostly that directed towards exports) is channelled through the distribution networks of these multinationals either for further processing or as final sales. These flows – responsible for a considerable and increasing proportion of the fast growing Hungarian exports – have two important characteristics. In terms of composition, these are products of relatively high degree of processing (even in the case of intermediate products) and thus are less subject to the price and demand volatility that characterize the markets for primary commodities and products with a low degree of processing. In terms of marketing, being part of the multinational distribution channels and with deliveries mostly based on long-term contracts, these exports are less subject to demand fluctuations than products marketed through the local firms' own distribution channels.

[264] Hungary opted for aggressive privatization sales to foreign investors already in the early phases of transition; at the same time attractive conditions were offered to prospective greenfield investors.

Gross industrial output in selected transition economies, 1995-1998
(Year on year percentage changes)

Quarterly output · 12-month output

Bulgaria

Poland

Croatia

Romania

Czech Republic

Slovakia

Hungary

Slovenia
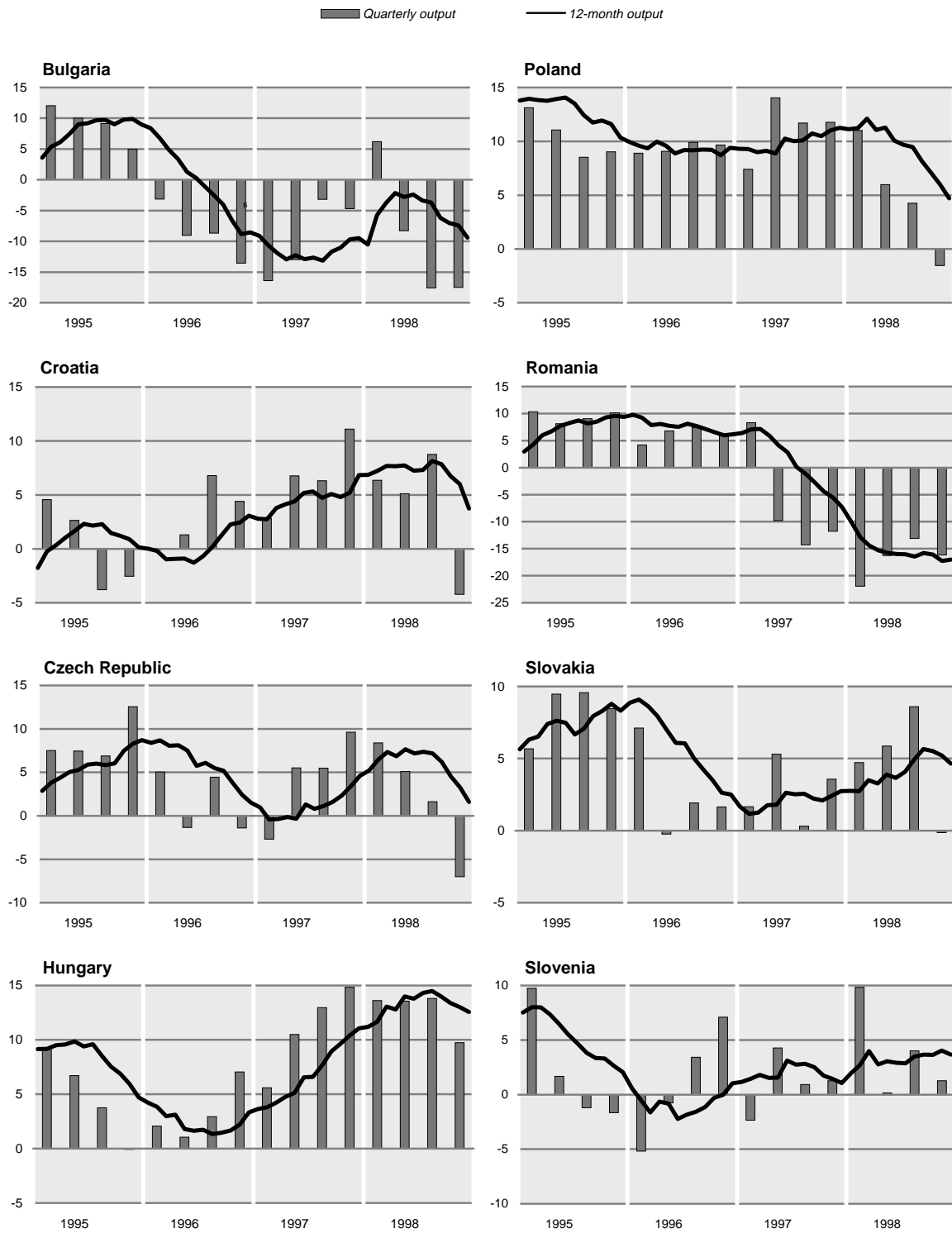
(For source and notes see end of chart.)

CHART 3.3.1 (concluded)

Gross industrial output in selected transition economies, 1995-1998
(Year on year percentage changes)

▬ *Quarterly output* ——— *12-month output*

The former Yugoslav Republic of Macedonia

Lithuania

Yugoslavia

Kazakhstan

Estonia

Russian Federation

Latvia

Ukraine
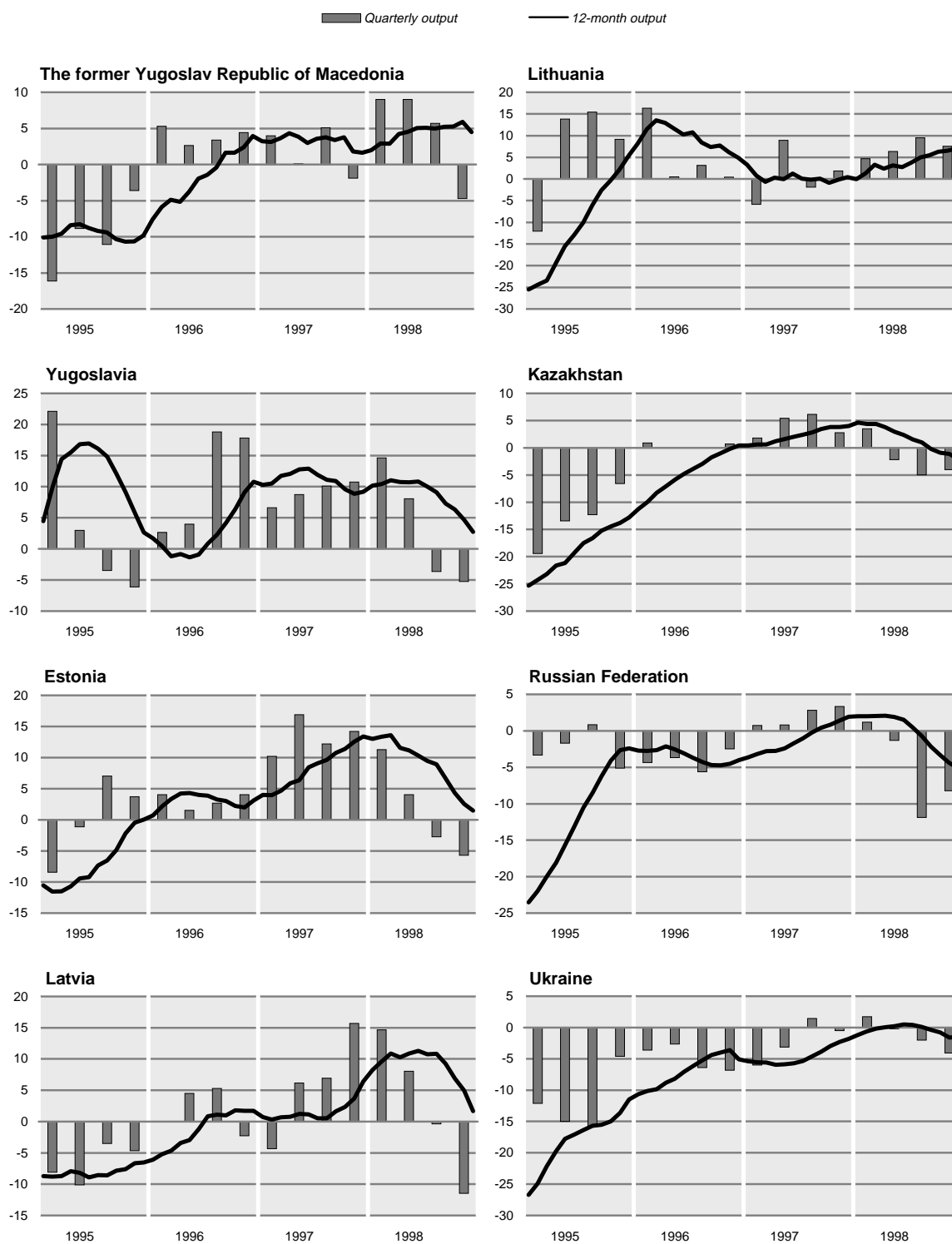
Source: National statistics and direct communications from national statistical offices to UN/ECE secretariat.

Note: The coverage of industrial output in the monthly statistics may differ from the coverage in the annual data.

TABLE 3.3.2

Share of major sectors in GDP [a] in eastern Europe and the Baltic states, 1993-1998
(Per cent of GDP, at current prices)

	1993	1994	1995	1996	1997	1998 [b]
Albania						
Agriculture	54.6	54.6	54.6	52.8	..	..
Industry	13.9	12.5	11.7	12.5	..	..
Construction	9.1	9.6	10.3	11.4	..	..
Wholesale and retail trade	..	..	..	..	..	..
Transport and communication	..	..	..	..	..	..
Financial services, real estate	..	..	..	..	..	..
Other services [c]	22.5	23.2	23.4	23.3	..	..
Bosnia and Herzegovina						
Agriculture	..	..	25.0	20.7	18.3	..
Industry	..	..	24.4	21.5	21.7	..
Construction	..	..	3.0	4.3	6.1	..
Wholesale and retail trade	..	..	..	..	..	..
Transport and communication	..	..	..	..	..	..
Financial services, real estate	..	..	..	..	..	..
Other services [c]	..	..	47.6	53.5	53.9	..
Bulgaria						
Agriculture	10.6	12.3	13.9	15.4	26.2	20.0
Industry	29.2	27.0	28.5	25.9	26.7	26.8
Construction	5.8	5.1	5.2	4.3	2.8	3.5
Wholesale and retail trade	..	..	..	11.8	9.6	..
Transport and communication	..	..	..	7.3	7.4	..
Financial services, real estate	..	..	..	26.7	18.3	..
Other services	54.4[c]	55.6[c]	52.5[c]	8.6	9.1	49.7[c]
Croatia						
Agriculture	13.3	11.2	10.4	10.0	9.3	..
Industry	29.7	27.4	23.1	25.6	25.9	..
Construction	4.8	5.1	5.9	6.6	7.1	..
Wholesale and retail trade	..	..	..	15.2	15.6	..
Transport and communication	..	..	..	8.8	8.7	..
Financial services, real estate	..	..	..	14.7	14.0	..
Other services	52.3	56.3	60.5	19.1	19.5	..
Czech Republic						
Agriculture	5.2	4.4	4.6	..	..	..
Industry	32.5	32.1	33.2	..	..	..
Construction	7.1	7.6	8.1	..	..	..
Wholesale and retail trade	14.5	16.2	14.9	..	..	..
Transport and communication	7.7	7.2	7.7	..	..	..
Financial services, real estate	20.2	18.8	17.5	..	..	..
Other services	12.8	13.8	14.0	..	..	..
Hungary						
Agriculture	6.6	6.7	6.7	6.6	5.8	..
Industry	26.2	25.3	26.3	26.3	28.2	..
Construction	5.3	5.1	4.6	4.3	4.6	..
Wholesale and retail trade	13.3	12.6	13.3	13.3	13.3	..
Transport and communication	8.8	8.5	9.0	9.2	9.6	..
Financial services, real estate	17.8	19.7	19.6	21.1	19.6	..
Other services	22.0	22.1	20.5	19.3	18.8	..
Poland						
Agriculture	7.2	6.9	7.0	6.5	5.6	5.6
Industry	35.7	31.1	31.9	30.3	29.5	29.6
Construction	7.1	7.4	7.3	7.5	8.0	7.7
Wholesale and retail trade	16.8	21.2	20.9	22.0	22.1	..
Transport and communication	6.6	7.4	6.6	6.5	6.5	..
Financial services, real estate	6.9	9.3	9.2	9.8	11.2	..
Other services	19.7	16.7	17.1	17.5	17.1	57.1[c]

	1993	1994	1995	1996	1997	1998 [b]
Romania						
Agriculture	21.6	20.6	20.7	20.1	19.7	17.6
Industry	34.9	37.6	34.5	34.8	38.6	35.0
Construction	5.4	6.8	6.9	6.8	5.7	5.7
Wholesale and retail trade	10.6	8.5	11.0	12.2	10.8	–
Transport and communication	10.4	9.1	8.1	9.4	11.0	..
Financial services, real estate	8.6	8.2	8.8	7.0	7.4	..
Other services	8.6	9.2	9.9	9.7	6.9	14.7[c]
Slovakia						
Agriculture	4.9	6.9	6.0	5.5	5.1	5.2
Industry	32.0	25.1	34.6	32.0	29.6	26.9
Construction	4.9	4.7	4.9	5.0	5.5	5.7
Wholesale and retail trade	21.7	..	19.3	23.7	22.9	25.3
Transport and communication	8.4	8.9	9.0	8.9	8.5	8.3
Financial services, real estate	14.2	..	13.0	12.0	15.1	16.1
Other services	13.9	54.4	13.2	12.9	13.2	12.5
Slovenia						
Agriculture	5.1	4.5	4.5	4.4	4.2	..
Industry	33.4	34.7	32.6	32.0	31.8	..
Construction	4.7	4.7	5.0	5.6	5.6	..
Wholesale and retail trade	14.0	14.8	15.0	14.6	14.5	..
Transport and communication	7.8	7.5	7.7	7.6	8.0	..
Financial services, real estate	14.6	14.6	15.7	16.0	15.6	..
Other services	20.5	19.2	19.5	19.8	20.3	..
The former Yugoslav Republic of Macedonia						
Agriculture	10.3	10.6	12.8	13.1	13.7	..
Industry	24.9	18.9	22.2	22.4	22.4	..
Construction	5.5	4.9	5.4	5.7	5.2	..
Wholesale and retail trade	11.6	14.4	16.8	17.3	18.3	..
Transport and communication	7.0	5.8	6.9	6.8	6.8	..
Financial services, real estate	20.5	26.0	12.2	10.5	10.1	..
Other services	20.1	19.4	23.7	24.1	23.6	..
Estonia						
Agriculture	11.0	10.3	7.9	7.5	7.1	6.4
Industry	24.5	24.1	23.1	22.2	22.1	20.9
Construction	6.6	6.4	5.9	5.8	5.5	6.3
Wholesale and retail trade	18.3	16.6	17.6	18.4	19.1	19.7
Transport and communication	12.4	11.6	10.5	10.8	11.8	14.3
Financial services, real estate	10.2	11.6	13.1	14.3	15.0	13.3
Other services	17.0	19.6	21.8	21.0	19.4	19.1
Latvia						
Agriculture	11.8	9.5	10.8	9.0	7.4	7.1
Industry	30.8	25.4	28.1	26.4	25.6	24.0
Construction	4.3	5.9	5.1	4.7	5.0	4.6
Wholesale and retail trade	9.6	11.4	12.4	16.5	17.7	18.7
Transport and communication	23.1	20.5	16.0	17.0	17.2	17.2
Financial services, real estate	7.8	12.1	9.9	9.0	8.1	7.1
Other services	12.7	15.3	17.7	17.5	19.0	21.3
Lithuania						
Agriculture	14.2	10.7	11.7	12.2	11.7	12.3
Industry	34.2	27.0	26.1	25.8	25.2	22.5
Construction	5.1	7.2	7.1	7.1	7.7	9.0
Wholesale and retail trade	15.3	18.9	19.3	18.4	18.2	17.5
Transport and communication	9.8	10.1	9.4	9.5	9.6	9.1
Financial services, real estate	11.5	11.7	10.5	10.5	9.6	10.7
Other services	9.9	14.4	15.8	16.5	18.0	18.8

Source: National statistics and direct communications from national statistical offices to UN/ECE secretariat.

Note: Data are presented in terms of the NACE/ISIC classifications. For Bosnia and Herzegovina, Croatia (for 1993-1995) and The former Yugoslav Republic of Macedonia, the three countries not reporting in NACE/ISIC, industry includes mining, manufacturing and water management; wholesale and retail trade includes trade, hotels and restaurants, tourism and crafts; financial services, real estate includes financial and other business services; other services include community services, education and culture, health care and social welfare and public administration.

[a] Percentage shares of total value added.

[b] Full year for Romania; January-September for other countries.

[c] All services.

TABLE 3.3.3

Share of major sectors in GDP [a] in the CIS economies, 1993-1998

(Per cent of GDP, at current prices)

	1993	1994	1995	1996	1997	1998		1993	1994	1995	1996	1997	1998
Armenia							**Republic of Moldova**						
Agriculture	50.8	43.5	40.8	..	..	..	Agriculture	30.3	28.1	32.2	29.8	28.8	27.5
Industry	22.5	29.1	24.3	..	..	..	Industry	37.8	32.2	27.5	25.0	22.5	25.3
Construction	4.0	6.7	6.5	..	..	..	Construction	3.2	4.6	3.9	4.1	5.3	4.9
Wholesale and retail trade	2.6	5.1	10.2	..	..	..	Wholesale and retail trade	9.1	9.3	9.7	9.8	9.9	10.0
Transport and communication	5.9	4.2	4.3	..	..	..	Transport and communication	4.3	6.4	5.7	6.1	7.0	8.3
Financial services, real estate	1.4	3.6	4.0	..	..	..	Financial services, real estate	5.9	7.0	6.1	9.6	9.5	10.8
Other services	12.8	7.9	9.8	..	..	..	Other services	9.5	12.3	15.0	15.6	17.0	13.2
Azerbaijan							**Russian Federation**						
Agriculture	26.7	31.4	26.7	27.2	21.9	21.8	Agriculture	8.2	6.5	8.0	7.7	7.4	6.9
Industry	24.5	19.8	29.0	28.4	27.1	23.9	Industry	34.4	32.8	30.7	29.8	28.5	28.1
Construction	7.2	7.1	3.9	10.2	15.0	17.6	Construction	7.9	9.1	8.8	8.2	7.8	7.1
Wholesale and retail trade	3.9	3.9	5.2	5.9	6.0	6.1	Wholesale and retail trade	19.0	18.4	18.6	15.9	16.6	19.2
Transport and communication	7.9	11.9	18.4	11.3	13.0	13.7	Transport and communication	8.6	9.9	11.3	13.5	12.3	12.1
Financial services, real estate	7.1	5.5	2.8	1.1	1.1	0.1	Financial services, real estate	6.9	5.8	3.6	2.8	3.8	4.0
Other services	22.7	20.3	13.9	15.9	15.9	16.8	Other services	15.0	17.6	18.9	22.1	23.6	22.6
Belarus							**Tajikistan**						
Agriculture	16.8	13.9	17.0	15.7	14.5	..	Agriculture	22.2	21.5	38.0	38.0	38.6	..
Industry	28.4	28.7	30.2	34.0	35.2	..	Industry	34.7	24.8	33.3	28.1	28.1	..
Construction	7.7	5.7	5.9	5.4	6.4	..	Construction	9.5	11.7	1.8	2.8	3.0	..
Wholesale and retail trade	11.0	15.2	11.5	10.3	10.1	..	Wholesale and retail trade	6.1	15.4	5.6	16.9	15.4	..
Transport and communication	12.0	12.2	13.3	12.6	11.9	..	Transport and communication	1.4	2.7	1.8	2.3	2.0	..
Financial services, real estate	9.1	8.2	5.2	3.4	3.3	..	Financial services, real estate	5.2	12.5	8.2	4.6	5.3	..
Other services	15.0	16.0	16.9	18.6	18.5	..	Other services	20.8	11.4	11.2	7.3	7.5	..
Georgia							**Turkmenistan**						
Agriculture	69.7	65.1	44.4	32.1	29.6	26.1	Agriculture	19.2	32.9	16.9	13.1	21.0	..
Industry	8.5	8.3	10.1	10.7	10.1	9.6	Industry	49.0	38.7	55.3	56.6	34.6	..
Construction	0.9	1.7	2.3	4.8	5.0	6.1	Construction	12.0	6.9	6.1	10.8	11.8	..
Wholesale and retail trade	7.6	8.4	27.6	23.0	23.1	22.9	Wholesale and retail trade	4.1	5.6	4.3	3.3	3.9	..
Transport and communication	3.8	5.1	9.0	6.5	10.4	13.9	Transport and communication	5.2	4.8	5.0	5.9	10.8	..
Financial services, real estate	2.6	2.5	0.2	..	..	..	Financial services, real estate	1.7	2.3	1.4	1.9	2.9	..
Other services	7.1	8.8	6.4	22.8	21.8	21.4	Other services	8.8	8.9	11.0	8.5	15.0	..
Kazakhstan							**Ukraine**						
Agriculture	16.4	15.2	12.8	12.7	11.9	..	Agriculture	20.0	15.3	15.0	13.7	12.6	..
Industry	28.6	29.7	24.4	22.1	22.3	..	Industry	27.6	36.7	33.8	30.6	33.5	..
Construction	8.3	9.8	6.7	4.6	4.4	..	Construction	6.4	7.8	7.5	6.6	5.9	..
Wholesale and retail trade	10.3	12.4	17.9	18.0	16.3	..	Wholesale and retail trade	11.5	7.6	7.6	7.8	6.4	..
Transport and communication	9.9	11.4	11.1	11.8	12.2	..	Transport and communication	10.9	8.5	13.1	14.6	9.5	..
Financial services, real estate	6.3	0.9	1.4	1.2	1.2	..	Financial services, real estate	9.5	7.8	3.2	2.9	..	..
Other services	20.2	20.6	25.7	29.6	31.7	..	Other services	14.1	16.3	19.8	23.9	32.2	..
Kyrgyzstan							**Uzbekistan**						
Agriculture	40.0	39.9	43.1	49.4	44.2	43.1	Agriculture	29.9	36.2	31.4	25.6	..	..
Industry	25.7	21.3	12.7	11.8	17.8	18.7	Industry	24.0	17.9	19.1	20.3	..	..
Construction	5.5	3.5	6.5	6.4	4.8	2.6	Construction	9.6	7.6	7.9	9.4	..	..
Wholesale and retail trade	7.9	10.5	12.0	11.2	11.3	12.3	Wholesale and retail trade	8.6	10.2	9.1	10.9	..	..
Transport and communication	4.0	4.7	4.8	4.9	4.5	4.7	Transport and communication	5.9	6.1	8.1	7.7	..	..
Financial services, real estate	5.8	5.3	4.3	1.1	1.9	2.0	Financial services, real estate	3.6	4.6	4.3	3.7	..	..
Other services	11.0	14.8	16.6	15.1	15.5	16.5	Other services	18.5	17.5	20.1	22.4	..	..

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

Note: To compile sectoral statistics, CIS countries use national classifications which are modified versions of the former Soviet Union's branch classification. Although the figures in the table are presented according to NACE/ISIC categories, they are not fully comparable with those in table 3.3.2. Agriculture covers agriculture, fishing, hunting and forestry; industry covers mining and quarrying, manufacturing, production of electricity, gas and water and their supply for production purposes; wholesale and retail trade covers trade and catering, supplies and procurement, renting of machinery and equipment and trade-related intermediation services; financial services and real estate cover banking, insurance and pension funding, real estate, information, computing and other business services; other services cover geology and exploration, publishing houses, recycling, security, housing, community services (including electricity, gas and water supply to households), hotels, personal service activities, health care, recreational, cultural and sporting activities, education, science and public administration. In some years non-reported sectors are included in "other services".

[a] Percentage share of total value added.

However, the risk of a large overall exposure to a single market exists for Hungary as well and the negative impact of weakening west European demand began to be felt towards the end of 1998. Thus while the rate of growth of industrial output still remained high in the fourth quarter, it was considerably lower than in the first three quarters (chart 3.3.1). Also, it has to be borne in mind that the high rates of growth in 1997-1998 partly reflect the introduction of new production capacities; it is only natural to expect that with the phasing out of this one-time effect the growth of manufacturing output will moderate.

In contrast to Hungary, the crisis in the Czech economy – which initially was only associated with the collapse of the exchange rate regime in May 1997 – deepened in 1998. It had been expected that after a meagre 1 per cent GDP growth in 1997, economic performance would accelerate in 1998. Indeed, there were some positive signs at the beginning of the year: the 1997 depreciation of the exchange rate, together with the austerity measures including, in particular, a certain degree of wage restraint, boosted Czech exports and as a result, manufacturing output started to recover strongly in the last quarter of 1997 and the first quarter of 1998 (chart 3.3.1).

However, during the second quarter of 1998 this trend was reversed and throughout the rest of the year there was a steady weakening of economic activity. The pace of industrial output gradually decelerated and by the fourth quarter had started to fall (chart 3.3.1). Construction output also continued to fall in 1998, for a second consecutive year (table 3.3.6). The downturn became especially pronounced in the fourth quarter of the year with quarterly GDP declining by 4.1 per cent (year-on-year) and industrial output falling by 7 per cent.

A number of factors – both on the supply and on the demand side – were behind these developments. As all the transition economies, the Czech Republic was severely hit by the external demand shock. However, the Czech economy in 1998 was a case where the combination of domestic and external factors amplified considerably the negative trends and resulted in an output performance that was much worse than expected.

On the domestic side, both factors that had contributed to the relative improvement in manufacturing performance lost momentum in 1998. Wage restraint turned out to be short-lived: real unit labour costs increased again in 1998 (table 3.4.4) and this had a negative effect on the competitiveness of Czech exports. The substantial tightening of monetary policy in 1998 caused, *inter alia*, a relative strengthening of the Czech koruna and this also had a negative effect on competitiveness. In addition, monetary policy resulted in an unprecedented rise in real interest rates (chart 3.2.1) which further depressed economic activity and domestic demand. In fact, all the components of domestic demand contracted in 1998 (tables 3.3.10 and 3.3.12), a reflection of growing uncertainties about the future of the economy.

These negative developments – which are the background to the current recession – are likely to continue to affect Czech economic performance for some time to come.[265] Their persistence is largely due to the slow progress in structural reforms (in turn, a result of the obscure ownership structure after the rapid mass privatization), inefficiencies and gaps in the institutional infrastructure, and the malfunctioning of important markets which constitute the microeconomic foundations of the Czech crisis.[266] It remains to be seen whether the proper policy responses can be found to resolve these problems and reverse the negative trends.

The Slovak economy is in the process of going through a painful macroeconomic adjustment. In fact, the annual figures on Slovak growth in 1998 (GDP increased by 4.4 per cent and gross industrial output by 4.6 per cent – table 3.1.1), which followed several years of robust recovery, may be misleading insofar as they conceal the magnitude of the required adjustment effort. For several years the Slovak government had followed a rather hazardous policy of artificially boosting output through large, publicly-financed infrastructural investment projects; a large share of the finance was raised by borrowing abroad.[267] While this policy did boost domestic output and ensured high rates of economic growth, it also gave rise to escalating macroeconomic disequilibria, notably, large current account and budget deficits and a snowballing of foreign debt.[268] At the same time very little progress was made in structural reforms, particularly in restructuring inefficient industrial firms.[269]

In 1998 policy came under the influence of the electoral cycle and no changes were made in policy until after the September parliamentary elections; consequently, there was little change in the pattern of performance. Gross industrial output grew strongly (chart 3.3.1) but this was mostly due to the expanding operations of the new Volkswagen plant whereas other manufacturing branches were facing difficulties (table 3.3.4). However, the post-election period was marked by an abrupt reversal in performance. Already on 1 October the National Bank of Slovakia was forced to abandon the fixed exchange rate regime. Faced with large and growing macroeconomic imbalances, the new government announced its intention to reduce considerably its involvement in investment projects. Together with the negative external impact, this decision triggered a considerable weakening of output in the fourth quarter: industrial output declined by 0.1 per cent (year-on-year), after growing by 8.6 per cent in the third quarter (chart 3.3.1).

---

[265] The 1999 budget was drafted on the assumption of 1.5 per cent GDP growth, but in February the Czech Statistical Office reduced its 1999 growth forecast to -0.8 per cent. *Reuters News Service*, 3 February 1999.

[266] The Czech crisis is analysed in more detail in UN/ECE, *Economic Survey of Europe, 1998 No. 1*, pp. 75-82.

[267] An estimated $3 billion, as reported by *Reuters News Service*, 16 September 1998.

[268] Previous issues of this *Survey* have questioned the sustainability of this policy and warned of the imminent need for a major adjustment. UN/ECE, *Economic Survey of Europe in 1996-1997*, p. 87; *Economic Survey of Europe*, *1998 No. 1*, p. 88 and *1998 No. 3*, p. 53.

[269] Moreover, in 1997 the government adopted a highly controversial programme of "revitalizing" ailing enterprises, which implied the provision of additional "soft credits" to these firms from public funds.

TABLE 3.3.4

Growth of industrial output by branch in eastern Europe and the Baltic states, 1997-1998
(Annual percentage change)

NACE codes	C-E	C	D	15, 16	17-19	20-22	23-25	26	27, 28	29-35	36, 37	E
	Total industry	*Mining and quarrying*	*Manu-facturing*	*Food, beverages and tobacco*	*Textiles, apparel and leather*	*Wood, paper and printing*	*Chemical industry*	*Non-metallic mineral products*	*Basic metals and metal products*	*Machinery and equipment*	*Other manu-facturing industries*	*Electricity, gas, steam and water*
Bosnia and Herzegovina												
1997	35.7	46.1	39.8	19.4	27.4	63.1	82.6	102.4	108.8	42.4	44.4	25.5
1998	23.8	22.8	29.7	13.8	17.7	16.9	32.6	27.3	121.4	14.3	-1.0	13.6
Bulgaria												
1997	-10.2	-10.2	-10.3	-18.1	-4.7	-21.3	-16.1	-2.9	12.4	-3.6	-26.4	5.9
1998	-9.4	0.6	-12.1	..	..	..	..	..	..	..	..	3.5
Croatia												
1997	6.8	-0.3	3.9	-6.7	1.8	35.1	-1.8	-11.2	20.9	14.0	31.5	24.2
1998	3.7	-2.4	3.2	3.6	-0.8	8.6	-2.8	14.0	12.5	2.9	-7.2	8.7
Czech Republic												
1997	4.5	-2.9	6.4	4.3	-6.2	10.5	2.8	8.2	4.1	17.7	4.6	-2.7
1998	1.6	-5.7	2.5	-0.4	-6.8	6.3	-1.8	1.1	-4.4	13.1	10.7	-1.5
Hungary												
1997	11.1	-8.5	14.8	-7.2	2.4	15.4	4.6	4.4	8.1	54.9	-0.7	1.2
1998	12.6	-18.2	16.2	0.8	10.6	5.4	3.2	12.6	2.8	41.4	24.1	-0.4
Poland												
1997	11.5	0.5	13.4	9.4	8.7	15.1	11.2	11.9	13.6	18.2	24.8	3.4
1998	4.7	-13.2	6.5	6.7	-2.4	12.4	-0.9	12.4	7.3	9.6	12.2	1.9
Romania												
1997	-5.9	-12.2	-4.7	-16.1	-9.3	-12.2	-16.1	-13.0	0.9	3.4	-8.1	-0.1
1998	-17.0	-13.9	-18.1	-1.0	-29.2	-34.5	-14.7	-16.8	-9.5	-17.3	-43.4	-12.4
Slovakia												
1997	2.0	7.3	2.6	-1.2	-15.2	14.2	0.2	2.0	6.3	9.2	-6.9	-3.9
1998	4.6	-11.1	6.1	3.0	-5.5	-2.0	-9.3	20.8	-2.5	37.5	-2.2	-5.8
Slovenia												
1997	1.0	1.8	0.2	-3.0	2.0	-17.1	6.6	4.8	-3.7	-6.9	16.4	8.2[a]
1998	3.7	-0.4	3.9	3.2	-1.3	-7.3	2.3	6.7	3.4	11.0	9.5	3.3[a]
The former Yugoslav Republic of Macedonia												
1997	1.6	-0.5	-2.1	7.5	-14.1	-12.4	-7.8	6.2	1.9	-1.0	-12.5	1.4
1998 [b]	5.7	2.4	5.8	-0.4	10.3	8.2	20.7	-8.8	18.1	-6.3	38.2	5.1
Yugoslavia												
1997	10.0	8.0	14.2	-3.4	8.1	2.4	33.6	3.4	29.9	12.3	2.7	6.0
1998 [b]	5.0	-0.2	6.8	7.1	7.0	-1.4	8.5	11.4	5.4	8.4	3.6	–
Estonia												
1997	13.4	5.6	16.9	18.6	11.7	36.0	2.3[c]	33.6	..	7.7[d]	17.9[e]	-3.1
1998	1.5	-1.4	2.9	-6.1	1.8	23.1	-14.2[c]	17.9	..	-14.7[d]	3.7[e]	-5.1
Latvia												
1997	15.0	7.5	15.8	14.3	11.0	35.9	18.8[c]	–	56.3	1.1[d]	7.9[e]	–
1998	2.0	6.2	2.5	1.1	-2.0	16.7	-7.1[c]	30.7	-4.8	-8.8[d]	0.8[e]	-1.0
Lithuania												
1997	0.8	12.3	4.9	-3.1	10.4	5.2	15.5	0.6	10.6	0.1	9.3	-11.8
1998	7.0	52.1	4.7	-3.6	-2.0	3.5	17.5	2.5	4.9	12.9	8.9	6.0

Source: National statistics and direct communications from national statistical offices to UN/ECE secretariat.

Note: Data are presented in terms of NACE classification except for The former Yugoslav Republic of Macedonia and Yugoslavia. For these two countries national classification data have been aggregated into NACE groups. Figures for total industry may differ slightly for some countries from those shown in other tables because of differences in coverage. (Statistics on industrial output by branches normally cover enterprises above a certain threshold defined in terms of the number of employed persons.)

[a] Production and distribution of electricity only (NACE 40.1).

[b] January-November.

[c] Excluding manufacture of coke, refined petroleum products and nuclear fuel (NACE 23).

[d] Excluding manufacture of office machinery and computers (NACE 30).

[e] Excluding recycling (NACE 37).

Obviously this is only the start of the adjustment necessary to restore macroeconomic equilibrium. In January 1999, in the framework of the budget debates, the government adopted a further package of austerity measures, mostly aimed at curbing the budget and external deficits. Given the magnitude of the imbalances, it appears that considerable further effort will be needed to reduce the current gaps. Judging from the experience of other transition economies that underwent similar adjustments (Hungary in 1995-1996 and the Czech Republic since 1997), this promises to be a long and painful process and is likely to entail an unwelcome economic downturn.[270]

In 1998 the Croatian economy followed a pattern of output performance which looked somewhat similar to that in Slovakia (table 3.3.1 and chart 3.3.1); however the underlying macroeconomic fundamentals and the policy stance were rather different. Indeed, the current account deficit had also reached dangerous proportions in 1997 (12.1 per cent of GDP, the highest among the east European and Baltic countries, table 3.1.2); however, Croatia's overall fiscal position was considerably more sound. As it was considered that the external imbalance reflected an overheating of domestic demand, a moderate and coordinated tightening of monetary and fiscal policy was made in 1998. Overall, this policy change produced in 1998 the required adjustment: the current account deficit was reduced substantially (table 3.1.2), and judging from the growth of retail trade (chart 3.3.2),[271] this was achieved mainly by curbing domestic demand. In terms of output, the adjustment was not costless either: the tightening of policy obviously dampened economic growth and by much more than was expected already in the first half of the year (table 3.3.1). In addition, and like most of the other transition economies, the Croatian economy was hit by the deteriorating external conditions in the second half of the year: industrial output fell strongly (by 4.2 per cent) in the fourth quarter (chart 3.3.1). Thus the 1998 pattern of output growth in Croatia reflects to a large extent the outcome of a policy-induced, "orderly" adjustment with increasingly negative external factors only adding to the further weakening of performance in the second half of the year.

In recent years, Slovenia has been following a cautious and balanced policy which has allowed moderate rates of economic growth (in the range of 3-4.5 per cent per annum in the period 1995-1998) while maintaining a relatively high degree of macroeconomic stability. At the beginning of 1998 the Slovenian economy benefited from a considerable surge in exports to western Europe which gave a considerable boost to economic activity (GDP grew by 6.4 per cent and industrial output by 9.8 per cent in the first quarter of the year – table 3.3.1). However, with the deterioration in external conditions, some manufacturing branches started to experience difficulties and this pace could not be maintained: average industrial output growth weakened considerably in the course of the year (chart 3.3.1).[272] A decline of output in the tourist industry[273] as well as in other services also contributed to the overall moderation of output.

(b) The Baltic states

Compared with the central European countries, the three Baltic states have a greater trade exposure to the Russian market;[274] moreover, some Baltic banks had accumulated sizeable exposure to Russian financial markets. Therefore the Baltic economies were more prone both to demand shocks and financial contagion from Russia. On the other hand, the recent strong recovery in these countries was predominantly driven by the rapid growth of exports, mostly to western Europe (to which trade exposure is much greater). They are thus highly susceptible to external demand shocks (see the argument in section 3.1). In addition, the persistently large current account deficit in the three countries (table 3.1.2) was another source of financial and macroeconomic vulnerability.

Financial markets throughout the Baltic region were shaken by the fallout from the Russian crisis and the pressure on them remained high during the second half of the year.[275] Banks were weakened by the incurred losses (especially in Latvia and to some extent in Estonia) and were forced to restructure partially their portfolios, which resulted, *inter alia*, in liquidity constraints and in a general tightening of credit. With monetary policy also remaining fairly restrictive (as discussed in section 3.2(ii)), this produced a significant rise in real interest rates (chart 3.2.1). In fact, despite the relatively high average annual growth figures, 1998 turned out to be a year of high volatility and deteriorating output performance in this region.

---

[270] The 3 per cent GDP growth forecast incorporated in the 1999 Slovak budget thus appears as overly optimistic, especially given the continuing slump in external demand.

[271] Regrettably, the national accounts data for Croatia are still complied only in current prices which creates considerable difficulties in accessing macroeconomic performance in more detail. In particular, with the exception of retail sales, the Croatian statistical office does not produce any indicators reflecting the dynamics of domestic demand in real terms.

[272] Actually, the relatively high annual manufacturing output growth (table 3.3.4) as well as the high rates of growth of total export that were maintained until the end of the year (table 3.6.1) were achieved to a large degree thanks to the rapid expansion in the motor vehicles industry which is mostly export oriented: according to preliminary estimates, the production of transport equipment in 1998 increased by more than 29 per cent. Institute of Macroeconomic Analysis and Development, *Slovenian Economic Mirror* (Ljubljana), January 1999.

[273] Compared with 1997, overnight stays in 1998 fell by 1.5 per cent while revenue from foreign tourists in the first 11 months dropped by 5.8 per cent over the same period of 1997. Institute of Macroeconomic Analysis and Development, op. cit.

[274] As suggested by the estimates in table 3.6.5, Estonia may have lost some 6-8 per cent of its total exports as a result of the Russian crisis, while in Latvia and Lithuania foregone exports amounted to some 7-10 per cent of total exports. These relative losses are much higher than those in other east European countries.

[275] UN/ECE, *Economic Survey of Europe*, *1998 No. 3*, pp. 42-45.

CHART 3.3.2

Volume of retail sales in selected transition economies, 1996-1998
(Year on year percentage changes)
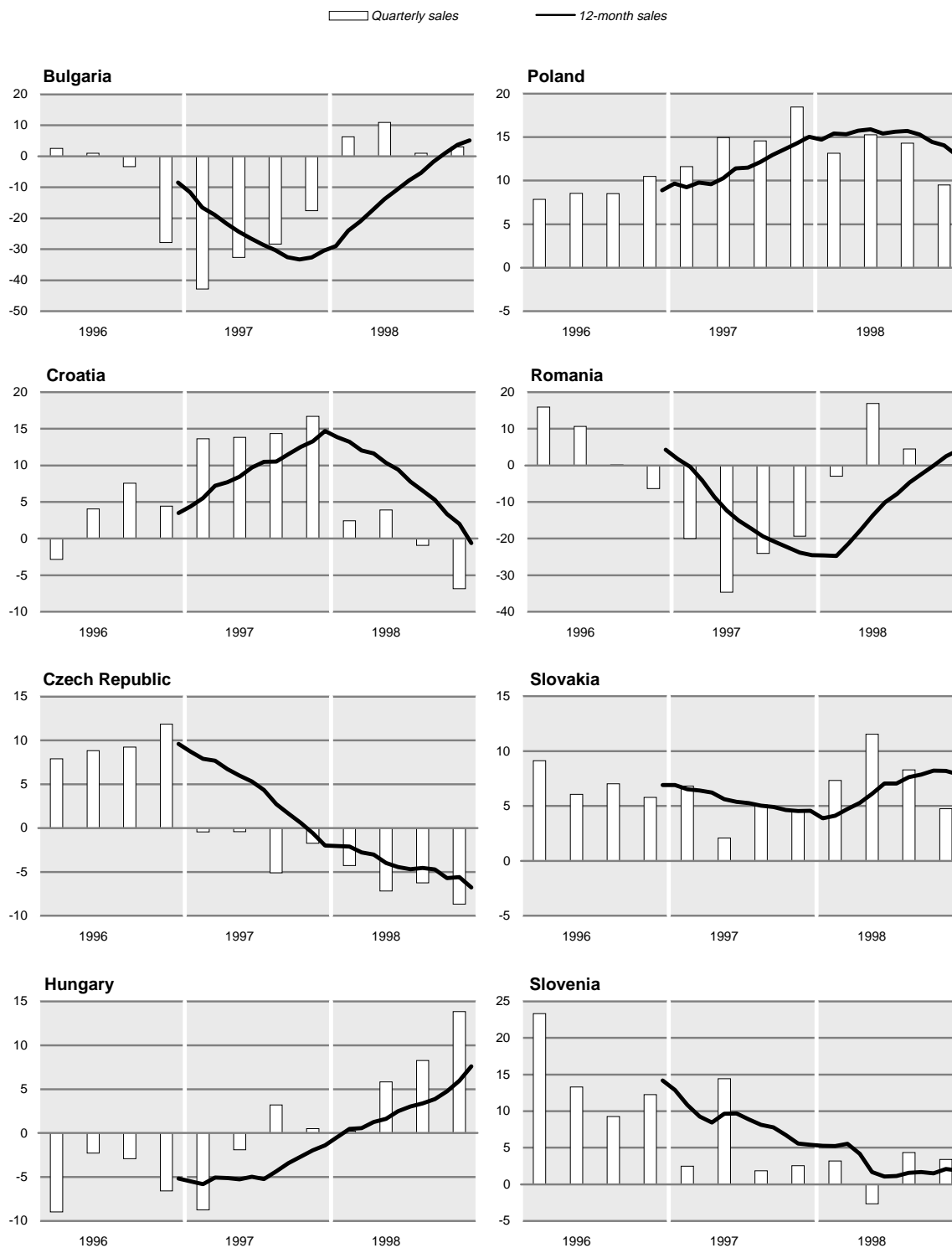
CHART 3.3.2 (concluded)

Volume of retail sales in selected transition economies, 1996-1998
(Year on year percentage changes)

Quarterly sales — 12-month sales

The former Yugoslav Republic of Macedonia

Lithuania

Yugoslavia

Kyrgyzstan

Estonia

Russian Federation

Latvia

Ukraine
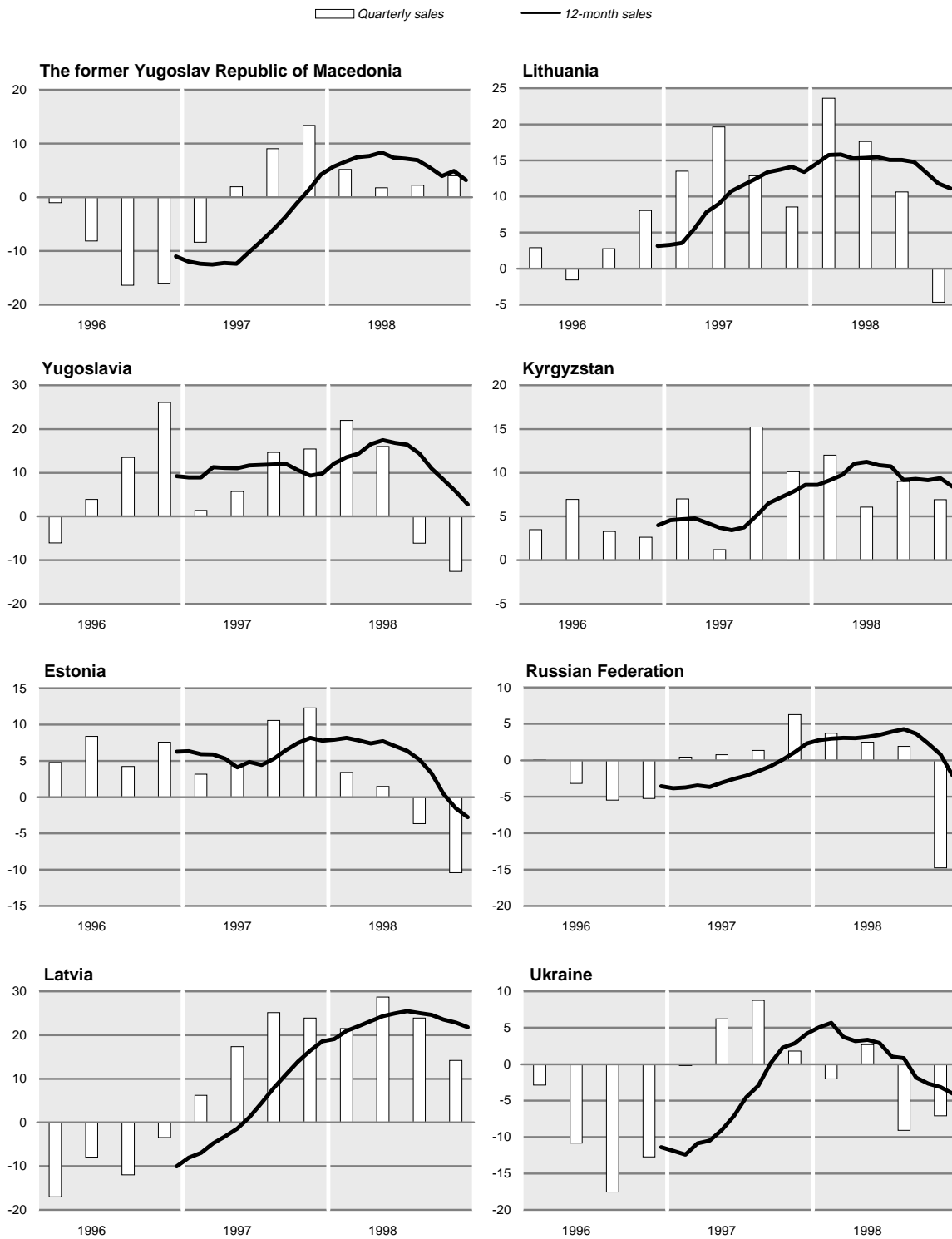
Source: National statistics and direct communications from national statistical offices to UN/ECE secretariat.
Note: The coverage of retail sales in the monthly statistics may differ from the coverage in the annual data.

In terms of their negative impact on the real economy, the repercussions from the Russian and the global crises were especially pronounced in Estonia and Latvia. The speed and the scale of the deterioration of industrial output performance in these two countries in the course of one year (chart 3.3.1)[276] indicate the fragility of transition economies in general, even those which have made considerable progress with reforms. In both countries, the biggest falls in annual output were in the chemical industry and in the manufacture of machinery and equipment (table 3.3.4); however, the industry that was probably worst hit by the Russian crisis was food processing, which incurred heavy losses in the second half of the year leading to the closure of many firms.[277] The Russian crisis also had a direct negative effect on other sectors of economic activity such as transport and other services. At the time of writing there were no clear signs of a reversal in these negative trends.[278]

Compared with Estonia and Latvia, the impact of the crisis on Lithuanian output so far has not been that strong. One of the factors that alleviated the negative impact was the relatively smaller exposure of Lithuanian banks to Russia. Another was the strong growth of output in mining and quarrying,[279] due to the start of a new oil-extraction facility; the latter probably also gave a boost to domestic oil refining. However, in view of the deteriorating conditions in other export markets, these factors could only provide a one-time cushion to external shocks. With falling exports and an emerging balance of payments constraint, economic activity is likely to weaken considerably in 1999.

(c)   South-east Europe

Most of the south-east European transition economies have been experiencing serious difficulties in the process of economic transformation. A wide array of factors – unfavourable starting conditions, a lack of clear vision as to the course of reforms, stop-go policies as well as the numerous conflicts in some of the successor states of the former SFR of Yugoslavia – have created a difficult environment for the implementation of the transformation agenda in the countries of this region.

Given their poor performance in the 1990s, the gap between them and the more advanced reformers in central Europe is becoming ever wider.

The Romanian economy has been in deep recession since the beginning of 1997. As discussed in more detail in section 3.2(iii), it is plagued by structural weaknesses (mostly inherited from the communist period) which were not addressed at the earlier phases of transition; instead, the authorities attempted to alleviate the pressure of the necessary adjustments through accommodating, soft policies. The 1997 programme of policy reforms did not bring about the expected results either; in particular, it did not produce the urgently needed reduction in the trade and current account deficits. On the contrary, inadequate policies exacerbated the crisis and instigated a severe economic downturn: in 1997 GDP fell by 6.9 per cent and this was followed by a further decline of 7.3 per cent in 1998 (table 3.1.1). The abrupt reversal in monetary policy led to a sharp rise in real interest rates (chart 3.2.1) and a credit squeeze, while devaluation and high inflation have eroded real wages and incomes. In addition, being predominantly an exporter of intermediate goods, the Romanian economy was badly hit by the weakening of international markets in 1998. The combined supply-and-demand shock provoked a steep plunge in industrial output by 23 per cent over the period 1997-1998 (table 3.1.1). With output and exports continuing to decline and debt service problems looming on the horizon, the troubles facing the Romanian economy are by no means over.

Neighbouring Bulgaria underwent a similar crisis in 1996-1997 which was resolved with the establishment of a currency board in July 1997. This ended a period of very high inflation (in December 1998 the year-on-year rate of CPI inflation in Bulgaria was one of the lowest among the east European and Baltic transition economies, see table 3.1.1) and helped to strengthen the banking system (whose weakness had been one of the causes of the crisis). However, despite the obvious progress in macroeconomic stabilization, the economy remains in a very difficult situation. In particular, manufacturing industry is in an extremely precarious state: industrial output has been declining persistently since the beginning of 1996, a fall which was only briefly interrupted in the first quarter of 1998 (chart 3.3.1).[280] With a composition of exports similar to that of Romania, Bulgarian exporters also incurred considerable market and revenue losses in 1998; consequently the decline of industrial output accelerated substantially in the second half of 1998 (chart 3.3.1)[281]

---

[276] In Estonia, the year-on-year rate of growth of industrial output dropped from 11.3 per cent in the first quarter to -5.7 per cent in the fourth; the corresponding numbers for Latvia (14.7 per cent in the first quarter and -11.4 per cent in the fourth quarter) suggest that the shock was even there.

[277] The importance of this sector is illustrated by the fact that in Latvia it accounts for some 40 per cent of total manufacturing output while in Estonia it was responsible for about half of its exports to Russia. In the second half of the year about half of Latvia's licensed fish processors were closed down increasing unemployment by some 5,000 persons. Economist Intelligence Unit, *Country Report. Estonia,* 1st Quarter 1999 and *Country Report. Latvia,* 1st Quarter 1999 (London).

[278] According to preliminary estimates, industrial sales in Estonia in January 1999 continued to decline rapidly, falling by some 15 per cent from their level in January 1998.

[279] Gross annual output in mining and quarrying increased in 1998 by 52 per cent (table 3.3.4).

[280] On the inconsistency of the statistical reporting of Bulgarian industrial output for 1996 see the note to table 3.1.1.

[281] It was around 18 per cent lower than a year earlier in both the third and fourth quarters of 1998; according to preliminary statistics the decline has continued into 1999: in January industrial sales were 23 per cent below their January 1998 level.

The preliminary (quarterly) national accounts for the first three quarters of 1998 do not reveal an unequivocal picture of the state of the economy in 1998 due to the very uneven and uncertain quarterly base against which they are measured.[282] According to these data quarterly GDP in the first quarter of 1998 increased year-on year by 18.9 per cent while in the third quarter it fell by 5.9 per cent from its level in the same period of 1997, resulting in an average growth of 4.3 per cent for the first three quarters of 1998 (table 3.3.1). Despite the apparent stability of the current macroeconomic regime, new pressures and imbalances are starting to build up. The trade and current account deficits deteriorated substantially in 1998 (table 3.1.2) and this trend is likely to continue; on the other hand, while the banks now appear to be more prudent in their lending policy, anecdotal evidence suggests a snowballing of other payment arrears (both among enterprises and to the budget). The key to stability in Bulgaria is to arrest the free fall of the real economy and to engineer a sustainable recovery of economic growth; unless this is achieved, the imbalances are likely to keep accumulating to the point when they could again endanger macroeconomic stability.

The assessment of current economic performance in some of the south-east European countries has traditionally been difficult either because of the lack of adequate statistics or due to substantial lags in compiling them.[283] Thus at the time of writing this *Survey* it was only possible to make a partial and rather incomplete assessment of the main developments in these countries in 1998.

After a prolonged period of stagnation or near-stagnation, the economy of The former Yugoslav Republic of Macedonia was apparently recovering in 1998. Industrial output grew solidly in the first half of the year (table 3.3.1 and chart 3.3.1) but, as in the rest of eastern Europe, it started to lose momentum in the third quarter and growth was negative in the fourth quarter. After an upsurge in late 1997, private consumption (as reflected by retail sales, chart 3.3.2) was only recovering modestly in 1998 and presumably did not provide much support to local producers. The declared intention of the government to boost foreign direct investment – and thus revitalize the economy – failed to materialize in 1998, in part due to the general reversal in investors' sentiment about emerging markets and in part due to the rising uncertainties about the Balkan region. The scanty additional data on current economic performance point to much the same picture of a weakening economy: for example construction activity continued to decline in 1998, for a second consecutive year (table 3.3.6).

After recovering at a relatively fast pace in 1996 and 1997, the Yugoslav economy entered another difficult year in 1998. The average annual figure for aggregate output growth (2.6 per cent in 1998) may be misleading as regards the actual state of the economy at the beginning of 1999. Thus chronic macroeconomic imbalances forced two devaluations of the dinar in 1998 (in March and in May) which triggered further instability and an upsurge in inflation. The tightening of external sanctions in June amplified the negative impact of the deterioration in external markets, and this led to the rapid shrinking of industrial output in the second half of the year (chart 3.3.1). In view of the persistently negative trade balance (table 3.1.2), the current exclusion from the international financial markets makes the balance of payments constraint extremely acute in the case of Yugoslavia. The escalation of the conflict in Kosovo in 1998 has undoubtedly weakened further the economy and as long as it is not resolved, it will remain a major impediment to the restoration of economic order in the country.

Since the signing of the Dayton Accord, a process of postwar reconstruction has been underway in Bosnia and Herzegovina. In the economic sphere it is focused on the rebuilding or establishment of new institutions (for example, a central bank functioning as a currency board started operation in August 1997), the restoration of production facilities and business outlets, and the reinstitution of markets, all of which were destroyed during the war. The reconstruction has been almost exclusively financed from official foreign aid. Despite a marked recovery since 1996,[284] the economy of Bosnia and Herzegovina is still extremely feeble. Obviously, considerable more external aid and a long reconstruction period is needed before the economy regains sufficient vitality to sustain economic recovery on its own.

After the considerable economic and political turbulence in 1997, the economy of Albania apparently has been recovering in 1998: some very preliminary estimates point to annual GDP growth of some 8 per cent. Nevertheless, the economic situation remains quite fragile especially in view of the considerable weakening of state institutions and continuing riots in 1998. Similarly to Bosnia and Herzegovina, the economy of Albania is extremely dependent on external assistance: most of it has been raised from foreign official (multilateral) aid; in addition there has been a steady and relatively large inflow of private remittances from the diaspora abroad. Considerable new investment will be needed if Albania is to create the basis for self-sustained economic growth. However, the continuing unrest and lack of political stability are deterrents to foreign investors; in fact since 1997, a number of foreign investors have reportedly suspended their Albanian operations due to the escalation of chaos and disorder.[285]

_____

[282] The 1997 quarterly national accounts are likely to be marred by the distortions caused by the hyperinflation combined with a deep recession in the first quarter of 1997.

[283] Quarterly aggregate output data are still unavailable for Albania, Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia, while the annual figures are usually published with long delays.

_____

[284] The growth figures need to be regarded with extreme caution because the reconstruction of the economy started practically from scratch.

[285] Economist Intelligence Unit, *Country Report. Albania* (London), 1st Quarter 1999.

(d)   The Commonwealth of Independent States

In 1998, current developments in the Commonwealth of Independent States were overwhelmed by the crisis in Russia whose repercussions left deep traces both on economic performance and on economic relations among these countries. Output performance in a number of CIS countries was deeply affected by the negative impact of the Russian crisis since Russia is still a major trading partner for most of them.

Output in Russia itself followed a rather hectic path, reflecting the escalation of financial turbulence and, subsequently, the fallout from the financial collapse in August.[286] The deceleration in the growth of industrial output, which had started already in the first months of the year (after the modest recovery in 1997), gradually gained momentum and from May onwards monthly output was declining year-on-year (table 3.3.1 and chart 3.3.1). The major shock occurred in the third quarter, when industrial output plunged by 11.9 per cent (year-on-year). The magnitude of the output decline at this early stage came as a surprise to many observers because of the relatively small financial exposure of the real economy and the fact that the negative repercussions of the financial crash had still not affected (measured) consumer demand.[287] Although the transmission mechanisms through which the financial crisis affected the real economy so early on are still not quite clear, obviously this initial large fall in output was largely due to a supply shock.

One important channel for the effects of this shock was undoubtedly the banking system. Russian banks – extremely leveraged and overexposed to exchange rate risk – started to have serious liquidity problems as soon as portfolio capital started to flow out of Russia. The August moratorium practically paralyzed the banking sector, blocking the payments and clearing system of the country for an extended period of time and thereby causing major disturbances in the Russian economy. At the same time, the devaluation of the rouble transformed the huge open foreign exchange positions of the banks[288] into direct losses which often exceeded their capital base, thus rendering them insolvent (as their net worth became negative). While the three-month moratorium temporarily shielded the banks from incurring these losses, when it ended the insolvency of a large number of banks became a reality.[289] The restructuring of the banking system is now one of the

numerous policy problems facing the Russian authorities. By some estimates several hundred insolvent banks have no future prospects and face bankruptcy and liquidation.[290] In December, an Agency for Restructuring Credit Organizations was established which was assigned the task of restructuring the failed Russian banks. The Agency is to be recapitalized with a special issue of government bonds,[291] and it is expected to consolidate and rehabilitate the banking sector.[292]

In the course of the second half of the year and especially in the fourth quarter, domestic demand also started to weaken significantly as real incomes fell sharply due to the upsurge in inflation after the collapse of the rouble.[293] At the same time, local producers apparently benefited on average from the devaluation: exporters gained in competitiveness while some domestic sales picked up thanks to devaluation-induced import substitution. A moderate loosening of monetary policy and a selective recapitalization helped some banks return to business and the payments system was partially restored. The combined effect of these factors produced a slight deceleration in the rate of decline of industrial output in the fourth quarter when output fell by 8.2 per cent, year-on-year (chart 3.3.1).

Overall, and according to preliminary estimates, Russian GDP fell by 4.6 per cent in 1998. In annual terms, gross industrial output decreased in 1998 by 5.2 per cent, with the biggest falls in ferrous metals, engineering, chemicals and light industry (table 3.3.5). Apart from the fall in industrial output, a poor harvest also contributed to the economic downturn: gross agricultural output in 1998 was down by 12.3 per cent (table 3.3.6).[294] At the time of writing this *Survey* the economic decline in Russia had not been arrested and was expected to continue at least through 1999. In the absence of a coherent programme to address the array of problems plaguing the Russian economy, there is much uncertainty about the economic prospects even in the short run.

---

[286] For more details about the Russian crisis see UN/ECE, *Economic Survey of Europe, 1998 No. 2*, pp. 22-26 and *1998 No. 3*, pp. 31-41.

[287] In the third quarter of the year the volume of retail sales was still growing, albeit at a decelerating rate (chart 3.3.2).

[288] These positions resulted from excessive and highly risky exposure mainly in two types of financial activities: foreign exchange credits obtained from foreign banks (with the funds subsequently invested in rouble assets) and forward contracts on the rouble hedging the exchange rate risk of foreign portfolio investors.

[289] According to some estimates, as a result of the incurred losses, the aggregate net worth of the Russian banking system fell by more than 60 per cent in 1998. Oxford Analytica, "Russia: bank restructuring", *Oxford Analytica Brief*, 29 January 1999.

[290] According to estimates of the Russian central bank, at the end of 1998 some 720 banks (or half of the operating banks) were insolvent. Oxford Analytica, op. cit. Later, central bank governor V. Gerashchenko reportedly stated that Russia might be left with only 200-300 banks by the end of 1999, down from about 1,500 at the peak of the financial crisis. *Reuters News Service*, 10 February 1999.

[291] The initial issue amounts to R10 billion (worth some $500 million at the date of the announcement) in five-year OFZ bonds that bear a fixed rate and start maturing from 2005. *Reuters News Service*, 6 January 1999.

[292] As there are no clear policy guidelines on implementation, discretion will apparently play an important role in the process of bank restructuring and, especially, in deciding the fate of individual banks. Thus, according to anecdotal evidence, several technically insolvent banks have been hand-picked for a bailout by the authorities in the absence of openly declared selection criteria. In addition, the central bank has apparently extended refinancing to some troubled banks at its own discretion.

[293] In the fourth quarter the volume of retail sales fell, year-on-year, by 14.8 per cent (chart 3.3.2).

[294] Only 47.8 million tons of grain were collected in 1998, 46 per cent less than in 1997 when the grain harvest amounted to 88.6 million tons. Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii*, No. 12 (Moscow), 1998, p. 90. Reportedly, this was the worst grain harvest in 40 years.

TABLE 3.3.5

Growth of industrial output by branch in the CIS economies, 1996-1998

(Annual percentage change)

	Total industry	Fuels	Energy	Ferrous metals	Non-ferrous metals	Engineering	Chemicals	Building materials	Logging, wood and paper	Light industry	Food processing
Armenia											
1996	1.4	..	8.6	196.0	-9.5	-9.8	5.3	5.6	-11.1	-3.3	11.0
1997	0.9	..	-2.3	18.1	-25.4	-33.1	-1.6	6.2	..	50.4	24.3
1998	-2.5	..	-1.0	-25.6*a*	50.0	-20.0	-8.0	11.0	7.4*a*	10.0	12.0
Azerbaijan											
1996	-6.7	-1.6	-3.6	-72.8	-77.4	-18.0	25.0	7.1	-1.1	-40.6	-34.8
1997	0.3	0.2	-6.6	430.3	262.4	-0.7	-28.2	-4.4	7.3	-16.5	-6.6
1998	2.2	..	..	..	..	..	..	..	..	..	..
Belarus											
1996	3.5	-5.2	-1.6	23.4	31.9	1.6	7.2	-4.0	14.2	11.9	5.5
1997	18.8	-1.0	5.6	35.1	51.3	25.7	19.4	26.1	34.7	27.1	21.0
1998	11.0	0.6	-7.5	15.4	14.8*a*	13.2	6.0	14.3	21.2	22.2	19.0
Georgia											
1996	7.7	113.4	2.3	-16.8	23.8	15.0	47.3	52.2	21.6	-2.6	24.9
1997	8.1	64.7	3.2	14.0	-33.7	11.2	20.4	26.1	6.1	-12.6	10.7
1998 *b*	0.8	8.0	5.7	-10.1	57.4	10.9	-1.1	64.2	108.8	28.6	4.6
Kazakhstan											
1996	0.3	2.2	-10.3	-17.5	3.6	-9.2	-27.0	-33.6	10.1	19.8	35.1
1997	4.0	0.5	-14.2	25.2	13.8	-29.9	-29.9	-19.3	-27.4	-18.8	0.3
1998	-2.1	..	..	..	..	..	..	..	..	..	..
Kyrgyzstan											
1996	8.8	-11.2	11.0	-64.6	6.5	-6.0	0.1	25.9	-27.8	0.7	-3.0
1997	50.4	7.9	-6.9	..	280.3	5.9	-20.5	11.7	1.2	-7.0	-9.7
1998	4.6	-53.0	-15.0	..	30.0	–	-45.0*a*	10.0	-19.0	-26.0	20.0
Republic of Moldova *c*											
1996	-6.5	..	5.6	..	..	-19.8	6.5	26.8	-21.2	-0.2	-8.4
1997	–	..	1.1	..	..	-22.4	-52.6	9.5	-5.6	-3.3	2.8
1998	-11.0	..	4.0	..	..	-10.0	–	-16.0	-20.0	-14.0	-12.0
Russian Federation											
1996	-4.0	-1.5	-1.6	-3.6	-3.6	-4.6	-7.1	-17.3	-17.5	-22.5	-4.2
1997	1.9	0.3	-2.1	1.2	5.0	3.5	2.0	-4.0	1.2	-2.4	-0.8
1998	-5.2	-2.5	-2.5	-8.1	-5.0	-7.5	-7.5	-5.8	-0.4	-11.5	-1.9
Tajikistan											
1996	-23.9	-13.3	-2.2	-96.8	-19.3	-29.5	-19.7	-33.3	-30.4	-46.7	-33.0
1997	-2.0	-0.9	-5.9	..	3.3	-21.3	-2.8	-19.5	-24.4	-4.0	-18.8
1998	8.1	-25.0	2.0	..	4.0	16.0	-46.0	-19.0	25.0	3.0	19.0
Turkmenistan											
1996	17.9	10.8	6.3	..	..	155.7	-1.6	-3.4	39.1	63.8	-18.6
1997	..	..	..	..	..	..	..	..	..	..	..
1998	..	..	..	..	..	..	..	..	..	..	..
Ukraine											
1996	-5.1	-6.7	-6.9	11.9	8.0	-26.1	-3.4	-34.2	-18.6	-24.6	-7.2
1997	-0.3	6.2	-2.6	8.1	9.4	-0.2	2.1	-10.4	-0.9	1.1	-10.3
1998	-1.5	-2.0	-1.0	-8.0	11.0	-5.0	2.0	5.0	10.0	–	4.0
Uzbekistan											
1996	2.6	0.4	1.0	30.5	18.3	40.1	15.1	5.6	21.9	6.4	15.0
1997	4.1	4.2	-1.0	-17.1	7.6	44.2	1.3	-3.4	11.1	11.3	34.2
1998	5.8	8.0	-2.0	2.0	–	5.0	24.0	1.0	5.0	3.0	10.0

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

Note: Data are presented in terms of national branch classifications comparable among the countries shown in the table. These classifications are not fully compatible with NACE or ISIC. Figures for total industry differ for some countries from those shown in other tables because of differences in coverage.

a January-September.

b January-June.

c Excluding Transdniestria.

TABLE 3.3.6

Gross output of agriculture and construction in the transition economies, 1993-1998

(Annual percentage change)

	Agriculture						Construction					
	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Bulgaria	-18.3	6.8	16.4	-11.8	20.2	..	-10.4	-6.7	-4.4	17.5	-27.6	-10.3*ᵃ*
Croatia *ᵇ*	5.0	-3.0	1.0	2.0	3.0	..	-10.7	-4.6	-3.8	9.0	17.0	2.3*ᶜ*
Czech Republic	-2.3	-6.0	5.0	-1.4	-5.9	-1.3	-7.5	7.5	8.5	5.3	-3.9	-7.0
Hungary	-9.7	3.2	2.6	6.3	-3.8	-1.0	2.6	12.1	-15.7	-0.1	9.7	13.1
Poland	6.8	-9.3	10.7	0.7	-0.2	6.6	4.5	0.3	5.6	3.0	15.5	11.6*ᵈ*
Romania	10.2	0.2	4.5	1.3	3.4	-7.6	11.4	29.1	13.2	3.6	-24.4	-18.0
Slovakia	-8.1	4.8	2.3	2.0	-1.0	..	-32.4	-6.7	2.9	4.4	9.2	-3.7
Slovenia *ᵇ ᵉ*	-0.7	20.0	0.1	0.7	-0.6	..	-18.2	-0.1	0.9	-2.5	-5.2	1.7
The former Yugoslav												
Republic of Macedonia *ᵇ*	-20.0	8.0	4.0	-2.0	..	..	-5.8	-10.6	-3.0	2.0	-16.0	-9.0*ᶜ*
Yugoslavia *ᵇ*	-3.0	6.0	4.0	1.0	7.0	-6.0	-24.4	-15.0	-3.0	-9.0	-3.0	-6.0
Estonia *ᶠ*	-12.2	-12.9	0.2	-6.3	-1.5	-1.0	20.3	-4.2	4.0	21.0	15.0	..
Latvia *ᵍ*	-22.0	-20.0	-7.0	-6.0	0.2	..	-37.0	5.6	5.9	5.3	8.2	11.1
Lithuania *ᵍ*	-5.5	-20.2	6.1	10.3	6.5	-3.0	-38.8	0.8	-1.0	-7.2	12.3	21.8
Armenia	24.0	3.0	5.0	2.0	-6.0	13.0	..	..	..	..	..	..
Azerbaijan	-15.0	-13.0	-7.0	3.0	-7.0	4.0	..	..	..	..	..	..
Belarus *ᵍ*	3.7	-14.4	-4.7	2.4	-4.9	-0.4	-17.0	-31.0	-21.0	-2.0	15.0	11.0
Georgia	-12.0	11.0	13.0	6.0	6.5	-8.0	..	..	..	..	..	..
Kazakhstan *ᵍ*	-5.2	-19.8	-24.4	-5.0	-0.9	-18.9	-31.0	-11.0	-45.0	76.0	..	..
Kyrgyzstan *ᵍ*	-10.0	-18.0	-2.0	15.0	12.2	4.1	-23.0	-52.0	-3.0	-31.0	14.0	-47.7
Republic of Moldova *ᵍ*	10.0	-25.0	3.0	-13.0	12.0	-10.6	..	-48.0	-37.0	-13.0	..	-7.0*ʰ*
Russian Federation *ᵍ*	-4.4	-12.0	-8.0	-5.1	1.3	-12.3	-8.0	-24.0	-9.0	-14.0	-6.0	-7.5
Tajikistan	-1.2	-6.5	-25.9	2.0	3.6	6.5	..	..	..	..	..	..
Turkmenistan	16.0	-4.5	1.3	-33.3	20.6	24.4	..	..	..	..	..	..
Ukraine *ᵍ*	1.5	-16.5	-3.6	-9.5	-2.0	-8.0	-9.9	-37.2	-38.4	-31.0	-10.4	..
Uzbekistan	1.0	-8.0	3.0	-6.0	4.0	4.0	..	..	..	..	..	..

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE secretariat. The volume of construction output in the Russian Federation is from the joint database of the Working Centre for Economic Reform and the Russian European Centre for Economic Policy (internet website).

ᵃ January-March.

ᵇ Construction refers to effective working time.

ᶜ January-October.

ᵈ Excluding work abroad and by enterprises not classified in construction.

ᵉ Agriculture is final agricultural output, excluding intra-branch consumption.

ᶠ Construction refers to sales of construction work.

ᵍ Construction refers to the volume of work done by construction enterprises and companies.

ʰ January-September.

The Ukrainian economy also suffered a setback in 1998 which was largely triggered by the Russian crisis, but it also reflected some deep-seated domestic economic problems, very similar in nature to those in Russia. At the beginning of the year it had been expected that the prolonged economic downturn in Ukraine had come to an end and that 1998 would be marked by the start of recovery (table 3.3.1). Indeed, in the first half of the year, there was a small increase in GDP growth for the first time since Ukraine gained independence. However, the subsequent loss of Russian markets, as well as the domestic financial squeeze in the second half of 1998, led to a substantial deterioration in Ukrainian output performance. Domestic demand also suffered a blow at the same time: after a modest recovery in 1997 and the first half of 1998, retail sales plunged abruptly in the third and fourth quarters of the year (chart 3.3.2). In addition,

a miserable grain harvest[295] led to a substantial decline in gross agricultural output (table 3.3.6). With IMF financing on hold, and growing uncertainties about macroeconomic stability (especially in view of the forced devaluation of the hryvnia), the negative trend in output intensified in the fourth quarter when industrial output declined, year-on-year, by 4.1 per cent (chart 3.3.1). As in the case of Russia, the key to the rehabilitation of Ukraine's economy lies in putting together a comprehensive and credible action plan, backed by sufficient resources, which will address not only the issue of macroeconomic stability proper but also the

_____

[295] Ukraine harvested just 26.5 million tons of grain in 1998, some 25 per cent less than the 35.5 million tons collected in 1997. Interstate Statistical Committee of the CIS, *Commonwealth of Independent States in 1998. Statistical Abstract* (Moscow), 1999, p. 78.

fundamental structural and institutional weaknesses of the economy.

The economic situation in Belarus and the Republic of Moldova has been precarious for quite some time. Both countries have been conducting a rather hazardous and inconsistent course of economic policy; they were also among the countries that were strongly affected by fallout from the Russian crisis. However, it appears that most of their current woes stem from their chronic domestic economic problems.

Despite the fact that the reliability of the official output figures in Belarus has often been questioned by outside observers,[296] the economy was undoubtedly recovering strongly in 1997 and until mid-1998 (table 3.3.1). However, this performance was based on unsound fundamentals, in particular, the resurrection of many policy instruments that were typical of the era of central planning (such as price controls, ubiquitous public procurement and state orders, and directed soft credit).[297] The Russian crisis seems to have undermined the two most important driving forces of this recovery: the competitiveness of Belarussian exports on the Russian market and Russian import demand. The apparent (although not openly proclaimed) policy response in Belarus in the aftermath of the Russian crisis has been to let the domestic currency depreciate even further (see section 3.2(ii)). This response has softened (at least temporarily) the severity of the external shock on the real economy (the growth of industrial output reportedly only slowed down but still remained positive in the second half of the year). However, as domestic financial pressure continues to build up and macroeconomic instability continues to increase (reflected in a strong upsurge in inflation), the unsustainability of the present policy course is becoming increasingly evident and, as a result, a major macroeconomic adjustment will be difficult to avoid in the not too distant future.

In contrast, output in the Republic of Moldova fell sharply in 1998 as a result of the negative external developments coupled with acute domestic problems (especially the large, chronic twin deficits). In fact, the Republic of Moldova had the poorest growth record of all the transition economies in 1998 with GDP falling by 8.6 per cent on an annual basis (table 3.3.1). Industry was the worst affected sector: after a modest 2.3 per cent growth in the first half of the year, industrial output plunged in the second half (mostly due to the collapse of

exports to Russia) resulting in an annual fall of 11 per cent (table 3.3.1). Poor results in the important agricultural sector (table 3.3.6) also contributed to the bad overall outcome for the year. This disastrous economic performance led to the fall of the Moldovan government and to further political reshuffling in February. Given the very weak external position of the country and its looming foreign debt problems, the hopes for overcoming the current crisis are largely dependent on agreements being reached with the international financial institutions.[298]

The fallout from the Russian crisis on output in the *Caucasian rim* was generally less direct, especially in Armenia and Azerbaijan. Indeed, in both countries there were very strong GDP growth rates in 1998 (table 3.1.1), in fact the highest achieved since independence. However, despite the strong output growth, which would normally tend to suggest robust economic activity, the actual economic situation in the two countries is not so rosy.

The relatively strong recovery in Azerbaijan since 1997 has been almost exclusively driven by large investment projects (financed by foreign capital) in the Caspian oil fields. The implementation of these projects gave a major boost to construction activity and to consumer demand (through rising personal incomes). However, apart from oil-related business, there has been very little (if any) revival of activity in the other branches of industry (table 3.3.5). The Azerbaijan economy is thus greatly exposed to external disturbances, and the fall in global oil demand and oil prices is likely to have long lasting negative consequences on the economy, especially if these developments turn out to be persistent.[299]

Armenian GDP also grew strongly in 1998 (by 7.2 per cent) despite the fact that gross industrial output declined, largely as a result of the drop in exports to Russia. Similarly to Azerbaijan, the main driving force of economic growth during the year was investment: there was a notable upsurge in foreign direct investment in 1998.[300] Strong growth of agricultural output (table 3.3.6) was another factor that contributed to high GDP

---

[296] The concern that has been raised most frequently is that there might be overreporting of output at the expense of an underreporting of inflation. The reported high growth figures for 1997 and 1998 (table 3.3.1) have attracted the most scepticism.

[297] A recent IMF study identified four main factors that contributed to the acceleration of growth in that period: the existence of excess capacity in manufacturing industry; a sharp revival of exports to Russia, partly thanks to the depreciation of the Belarussian rouble; an expansionary credit policy directed towards selected sectors; and a certain amount of restructuring in some export-oriented enterprises. IMF, *Republic of Belarus. Recent Economic Developments* (Washington, D.C.), August 1998.

[298] There are some signs that relations with the IMF and the World Bank (which have been frozen since the suspension of IMF finance in mid-1997, after persistent failures to meet IMF conditionality) might be re-activated in 1999: in February the IMF signalled that it might resume disbursements from the 1996 stand-by agreement.

[299] Recently there has been a notable change in investors' attitude as regards future oil extraction in this region and a number of projects have been put on hold. For example, in January 1999, the Caspian International Petroleum Company announced that it would abandon the Karabakh field in Azerbaijan. Future prospects are also marred by the uncertainties related to the construction of new pipelines to export the oil from this region. In addition, as Azerbaijan's domestic and external balances are extremely sensitive to oil-related revenue, continued weakness in oil prices may endanger the country's macroeconomic stability.

[300] According to a statement by President R. Kocharyan, foreign investment in 1998 amounted to some $210 million and played a significant role in overcoming the crisis. *Reuters News Service*, 9 February 1999.

growth. However, with chronically large trade and current account deficits (table 3.1.2), the Armenian economy has become dependent on foreign official assistance. As a consequence, the country's foreign debt has been growing very rapidly in recent years.[301] If left unchecked, the increasing debt burden may become one of the constraints on future growth, especially in view of the deteriorating conditions on the international financial markets.

Compared to the other two Caucasian countries, the Georgian economy was rather more affected by the negative external developments in 1998. Apart from the devaluation of the currency, output growth was weakening throughout the year and after the second quarter GDP was actually declining. Industrial performance was rather uneven but the negative trend gained momentum in the last quarter and for the year as a whole output fell by 2.7 per cent (table 3.3.1). Agricultural output also suffered a setback dropping by 8 per cent from the previous year's level. Overall, GDP growth in 1998 (2.9 per cent) was much worse than in the previous two years, when it was growing at double-digit rates, and much below official expectations (table 3.1.1).

In 1998 economic activity in the *central Asian CIS countries* remained uneven and their output performance was mixed. All these countries are predominantly commodity exporters and they were severely hit by the weakening of global commodity markets. The collapse of Russian imports and financial contagion from Russia also had a destabilizing macroeconomic impact and strongly affected their economic activity. However, a relatively better harvest in some parts of the region gave a boost to the agricultural sector (which has a considerable weight in these economies) and this partly offset the negative impact of the crisis on aggregate output, in some of the central Asian countries.

Financial pressures have been increasing rapidly in the aftermath of the Asian and Russian crises and the current macroeconomic situation in the region is rather precarious. The currencies of all the central Asian states have weakened considerably due to the pressures generated by the Russian devaluation and, as noted in section 3.2(ii), this is likely to persist as long as the Russian currency continues to fall. On the other hand, the fall in export revenues has put increasing strain on both their external and domestic balances (since fiscal revenue is also sensitive to export prices). There are signs that some of the central Asian countries are already experiencing severe balance of payments constraints.[302]

Similarly to Russia, some of the central Asian CIS countries managed to reduce inflation in 1996-1997 primarily on the basis of tight monetary policies (exchange rate controls were also used in some cases). However, one of the side effects of these policies, as in Russia, has been the escalation of payments arrears which, according to anecdotal evidence, have started to approach exorbitant levels and proportions in some of these countries.[303] As indicated by the experience of other transition economies, the escalation of large payment arrears is by no means a harmless matter and, if left unchecked, they will become a real threat to financial and macroeconomic stability. Indeed, there are already some indications that financial indiscipline is becoming a serious problem in some of the central Asian states, adding to the pressure generated by external constraints.[304]

Among the central Asian CIS countries, Kazakhstan was most affected by the international financial crisis in terms of output performance. The modest recovery during the previous two years had generated expectations that growth might strengthen in 1998. However, already in the first half of the year the level of economic activity was remaining low with GDP increasing by a meagre 1.7 per cent (year-on-year). The rate of growth of industrial output decelerated rapidly and after increasing by 3.8 per cent in the first quarter output was falling for the rest of the year (chart 3.3.1). Unlike the situation in some of its neighbours, the agricultural sector performed rather poorly in Kazakhstan: for the year as a whole, gross agricultural output declined by 19 per cent (table 3.3.6).[305] This in turn helped to accelerate the decline of aggregate output in the second half of the year, and as a result annual GDP fell by 2.5 per cent (table 3.1.1).

After a strong recovery in 1996-1997, output in Kyrgyzstan was also disappointing in 1998, GDP increasing by a meagre 1.8 per cent (table 3.1.1). It should be noted that the growth figures for the previous two years have to be treated with some caution due to the fact that they incorporate a major one-off effect: the start

---

[301] At the end of 1998 the foreign debt was estimated at $740 million (some 40 per cent of GDP) and was expected to increase by 12 per cent, to $847 million, by the end of 1999. A. Markarian, "Armenia: foreign debt approaches dangerous limit", *RFE/RL Weekday Magazine*, 14 January 1999.

[302] In January 1999 the government of Kazakhstan initiated a package of austerity measures (in particular, a downward revision of the 1999 budget) aimed at counterbalancing the negative effect of the international financial crisis. *Agence France Presse*, 27 January 1999. In December

1998, faced with severe balance of payments problems, Turkmenistan imposed strict foreign exchange controls which, effectively, abrogated the (already limited) convertibility of the manat. Economist Intelligence Unit, *Country Report. Turkmenistan* (London), 1st Quarter 1999. Foreign exchange restrictions were tightened also in Turkmenistan.

[303] Thus, the overdue payables of the enterprise sector in Kazakhstan in June 1998 amounted to some 34 per cent of GDP which in relative terms was close to the situation in Russia (where it was 41 per cent) at the same time. UN/ECE secretariat calculations on the basis of data from: Government of Kazakhstan, European Commission, Directorate General for External Relations, *Kazakhstan Economic Trends*, *Monthly Update* (Akmola and Brussels), November 1998.

[304] President A. Akayev of Kyrgyzstan warned in January 1999 that the country risked defaulting on its foreign debt unless internal financial discipline improved and local companies cleared their arrears to the budget. *Reuters News Service*, 11 January 1999.

[305] This was largely due to a disastrous grain harvest: just 6.4 million tons of grain were collected in 1998, down from 12.4 million tons in 1997 (a drop of 48 per cent). Interstate Statistical Committee of the CIS, op. cit., p. 78.

of operations of the joint venture Kumtor gold mine, which boosted total industrial output by more than 50 per cent in 1997 (table 3.1.1). By mid-1998, the effect of this start-up was largely phased out and, with the rest of industry performing rather sluggishly and quite unevenly, total industrial output increased by just 4.6 per cent in 1998 (tables 3.3.1 and 3.3.5). Kyrgyzstan experienced a full-blown currency crisis in 1998 (see section 3.2(ii)) which also disturbed economic activity in the second half of the year.

The impact of the global crisis on economic activity in Uzbekistan was less pronounced: in 1998 GDP increased by 4.4 per cent which was close to the rate of the previous year (table 3.1.1). The growth of industrial output actually accelerated in 1998 thanks to the expansion of mining and quarrying,[306] which in turn gave a boost to some manufacturing branches, in particular, the chemical industry (table 3.3.5). Gross agricultural output also increased by 4 per cent in 1998 but within agriculture performance was mixed.[307] As cotton is one of the main export items, the sharp fall of cotton prices on international markets led to a large fall in export earnings and a forced cut-back of imports (table 3.6.7).

For several years until mid-1997, drawn out internal conflicts had caused major disturbances to Tajikistan's economy. Since the signing of the peace agreement in June 1997, the economy has started to recover and, according to the official data, GDP grew by 5.3 per cent in 1998 (table 3.1.1). Within industry, performance remained uneven but a marked recovery in some manufacturing branches (table 3.3.5) contributed to an increase of total industrial output by 8.1 per cent in 1998 (table 3.3.1). Gross agricultural output also increased by 6.5 per cent (table 3.3.6). Despite these positive developments, the economy of Tajikistan remains deeply depressed. Contagion from the Russian crisis generated a strong pressure on the Tajik rouble but in the absence of reliable data it is difficult to assess the actual impact with any pretence to accuracy. As in Uzbekistan, the sharp fall in the international price of cotton seems likely to have resulted in a de facto tightening of Tajikistan's balance of payment constraint.

Poor statistical reporting also makes it very difficult to assess properly the current economic situation in Turkmenistan.[308] The very limited data for 1998 suggest a partial recovery of output after the disastrous

performance in 1997 (table 3.3.1). The economic collapse in 1997 was caused by the suspension of gas deliveries to Ukraine[309] and the production of gas reportedly continued to decline in 1998.[310] With the signing of a new agreement in December,[311] gas exports to Ukraine resumed in the beginning of 1999 and this will contribute to some strengthening of economic activity. However, the Turkmen economy still remains in deep crisis. The fall in export revenue led to further restrictions on the convertibility of the currency and caused a severe liquidity squeeze in the final months of 1998.[312] The future prospects of the strategically important gas sector are also unclear mainly because of uncertainties and risks related to its transportation.[313]

(ii) Demand

(a) *The demand shock and its impact*

An external demand shock was one of the main factors behind the weakening of output performance in the transition economies in 1998. Due to the lags in statistical reporting (in particular, of national accounts) and to the fact that most of the output downturn occurred in the last quarter of the year, at the time of writing this *Survey* it was not possible to assess precisely the impact of weaker demand on growth performance. Thus, only a few signs of its negative impact can be traced in the partial and preliminary estimates of the contribution of the various components of final demand to GDP growth, as shown in tables 3.3.7 and 3.3.8.[314] For this reason, the discussion that follows on the transmission mechanisms of the demand shock in the transition economies is necessarily only tentative and mostly qualitative.

There were three main components of the 1998 demand shock: the direct impact from the weakening of global demand (which was most pronounced in primary commodities and intermediate products); the direct impact from the Russian crisis; and secondary effects

---

[306] Domestic extraction of gas increased by 7 per cent in 1998. Interstate Statistical Committee of the CIS, op. cit., p. 57.

[307] While official full-year figures for Uzbekistan were not available at the time of writing, some preliminary estimates indicate that the grain harvest was the largest in the 1990s. Economist Intelligence Unit, *Country Report. Uzbekistan* (London), 4th Quarter 1998. At the same time the cotton crop was the lowest in 20 years. Oxford Analytica, "Uzbekistan: poor harvest", *Oxford Analytica Brief*, 17 December 1998.

[308] Since the beginning of 1997 the officially released statistical information on Turkmenistan's economic performance has been extremely scanty even for basic economic indicators such as aggregate output or inflation.

[309] The stoppage was reportedly caused by a prolonged dispute with the Russian gas monopoly, Gazprom, over transit fees.

[310] According to estimates of the Turkmen Institute of Statistics and Forecasting, gas production in 1998 fell by 23 per cent. *Agence France Presse*, 28 January 1999.

[311] The issue of the transit fees paid to Gazprom was also settled in the framework of the new agreement. Oxford Analytica, *Oxford Analytica Executive Summaries*, 7 January 1999.

[312] Economist Intelligence Unit, *Country Report. Turkmenistan* (London), 1st Quarter 1999.

[313] For example, on 7 December 1997 the United States company Unocal announced that it was pulling out of the planned Turkmen-Afghan gas pipeline project. Oxford Analytica, "Turkmenistan: further decline", *Oxford Analytica Brief*, 15 December 1998.

[314] At the time of writing this *Survey* full-year national accounts (in preliminary and incomplete form) were only available for Kyrgyzstan, the Republic of Moldova and Romania; partial estimates on the basis of the preliminary national accounts for the first three quarters could be made for Bulgaria, the Czech Republic, Slovakia, Estonia and Latvia (tables 3.3.7 and 3.3.8).

TABLE 3.3.7

Contribution of final demand components to real GDP growth in eastern Europe and the Baltic states, 1994-1998

(Percentage points)

	1994	1995	1996	1997	1998[a]		1994	1995	1996	1997	1998[a]
Bulgaria						**Slovakia**					
Consumption	-4.1	-1.8	-5.8	-13.4	5.3	Consumption	-2.9	2.4	7.6	3.1	2.4
Fixed investment	0.1	2.2	-3.2	-3.0	1.0	Fixed investment	-1.4	1.5	10.9	5.2	4.3
Changes in stocks	-1.7	4.9	-5.1	5.8	3.2	Changes in stocks	-1.7	6.8	0.7	-7.0	-2.3
Net trade	7.5	-2.5	3.9	2.6	-6.6	Net trade	10.9	-3.7	-12.6	5.2	1.3
Exports	..	..	..	-0.1	-5.2	Exports	8.5	2.0	-0.2	3.6	5.6
Imports	..	..	..	2.7	-1.4	Imports	2.3	-5.7	-12.4	1.6	-4.3
GDP	1.8	2.9	-10.1	-6.9	4.3	GDP	4.9	6.9	6.6	6.5	5.8
Czech Republic						**Slovenia**					
Consumption	1.9	3.0	4.4	0.5	-1.9	Consumption	2.9	6.0	2.1	2.8	..
Fixed investment	4.9	6.2	2.9	-1.7	-1.0	Fixed investment	2.8	3.6	2.0	2.6	..
Changes in stocks	0.7	0.8	1.6	0.9	-1.3	Changes in stocks	0.4	1.6	-1.0	-0.2	..
Net trade	-5.3	-3.6	-5.0	1.4	2.1	Net trade	-0.8	-7.1	0.4	-0.6	..
Exports	0.1	8.5	3.1	6.0	9.7	Exports	7.6	0.7	1.8	6.2	..
Imports	-5.4	-12.1	-8.1	-4.6	-7.6	Imports	-8.4	-7.8	-1.4	-6.8	..
GDP	3.2	6.4	3.9	1.0	-2.1	GDP	5.3	4.1	3.5	4.6	..
Hungary						**Estonia**					
Consumption	-2.0	-5.6	-2.3	1.5	..	Consumption	0.9	7.3	4.5	6.9	4.7
Fixed investment	2.7	-1.0	1.3	1.9	..	Fixed investment	1.5	1.1	2.9	3.5	4.5
Changes in stocks	1.7	3.2	1.7	1.1	..	Changes in stocks	-1.4	0.2	0.4	3.0	-2.3
Net trade	0.5	4.9	0.6	0.2	..	Net trade	-6.1	-0.4	-4.4	-3.2	-2.2
Exports	4.3	4.6	3.1	10.4	..	Exports	2.6	3.9	1.6	21.6	11.9
Imports	-3.7	0.3	-2.5	-10.3	..	Imports	-8.7	-4.3	-6.0	-24.8	-14.1
GDP	2.9	1.5	1.3	4.6	..	GDP	-2.0	4.3	4.0	11.4	5.4
Poland						**Latvia**					
Consumption	3.2	2.6	5.6	4.8	..	Consumption	1.7	-0.8	6.9	3.4	0.8
Fixed investment	1.5	3.0	3.7	4.5	..	Fixed investment	0.1	1.2	3.4	2.0	1.1
Changes in stocks	–	1.3	0.2	0.1	..	Changes in stocks	2.6	-2.4	-2.3	-0.1	5.9
Net trade	0.6	0.1	-3.4	-2.6	..	Net trade	-3.8	1.2	-4.6	1.2	-1.4
Exports	2.7	5.4	3.1	3.0	..	Exports	-4.1	1.9	9.5	5.4	8.7
Imports	-2.1	-5.3	-6.5	-5.6	..	Imports	0.3	-0.7	-14.1	-4.2	-10.1
GDP	5.2	7.0	6.0	6.9	..	GDP	0.6	-0.8	3.3	6.5	6.4
Romania						**Lithuania**					
Consumption	2.9	8.3	5.7	-3.6	-3.2	Consumption	..	..	4.9	5.5	..
Fixed investment	3.7	1.4	1.2	-0.7	-4.0	Fixed investment	..	..	2.5	5.7	..
Changes in stocks	-6.3	-2.4	-0.6	-2.8	..	Changes in stocks	..	..	-0.1	1.2	..
Net trade	3.6	-0.2	-2.3	0.4	..	Net trade	..	..	-2.6	-6.3	..
Exports	4.4	4.2	0.6	3.2	..	Exports	..	..	10.3	13.3	..
Imports	-0.8	-4.4	-2.9	-2.8	..	Imports	..	..	-13.0	-19.6	..
GDP	3.9	7.1	3.9	-6.9	-7.3	GDP	..	..	4.7	6.1	..

Source: National statistics and direct communications from national statistical offices to UN/ECE secretariat.

Note: The sum of component changes may not equal the GDP change for some countries due to reported statistical discrepancies.

[a] January-September for Bulgaria, Czech Republic, Slovakia and Estonia; January-June for Latvia.

through the weakening of import demand in "third party" countries. These developments were interrelated and reinforced each other and their joint evolution in time resulted in a rapid acceleration of their combined negative effect on the transition economies.

The weakening of global demand started with the escalation of the Asian crisis in the second half of 1997 and continued in the course of 1998. It originated in a sharp contraction of import demand in South-East Asia caused by currency depreciation and the forced macroeconomic adjustment in the crisis-hit countries. The adverse effect on producers in the transition economies can be traced in the weakening of export performance in some transition economies already in 1997 and especially in 1998. For example, the sharp fall of exports from eastern Europe and other transition economies to developing countries, which began already in 1997 (table 3.6.2) and continued through 1998, is most probably a direct real impact of the Asian crisis.[315]

As discussed in several parts of this *Survey*, the real effect of the Russian crisis was equivalent to a second external demand shock for many of the transition economies, especially those with intensive trade links with Russia.[316] The mechanism was very similar to that

[315] Exports from eastern Europe to developing economies declined in dollar terms by some 10 per cent both in 1997 and in 1998 (table 3.6.2).

[316] For an assessment of the "export losses" due to the Russian crisis for some transition economies see sect. 3.6.

TABLE 3.3.8

Contribution of final demand components to real GDP growth in selected CIS economies, 1994-1998

(Percentage points)

	1994	1995	1996	1997	1998
Armenia					
Consumption	4.2	8.5	3.8	6.8	..
Fixed investment	5.5	-3.5	1.7	2.2	..
Changes in stocks	..	..	..	..	..
Net trade	-10.6	3.5	2.1	-6.2	..
Exports	15.3	-4.1	-1.3	4.4	..
Imports	-25.9	7.5	3.4	-10.6	..
GDP	5.4	6.9	5.9	3.1	7.2
Azerbaijan					
Consumption	-18.9	-2.8	7.9	10.5	..
Fixed investment	18.6	-4.7	17.4	19.5	..
Changes in stocks	..	..	..	..	..
Net trade	-2.3	-16.8	-19.9	1.1	..
Exports	4.3	-2.7	0.3	11.2	..
Imports	-6.6	-14.1	-20.2	-10.1	..
GDP	-19.7	-11.8	1.3	5.8	10.0
Belarus					
Consumption	-9.2	-7.6	2.6	7.6	..
Fixed investment	-4.6	-9.8	-0.8	5.1	..
Changes in stocks	-7.4	0.4	2.6	-0.9	..
Net trade	8.7	6.7	-1.6	-1.5	..
Exports	0.1	-19.9	4.3	11.6	..
Imports	8.5	26.5	-5.9	-13.1	..
GDP	-12.6	-10.4	2.8	11.4	8.3
Georgia					
Consumption	-7.3	9.1	..	..	..
Fixed investment	4.8	7.0	..	..	..
Changes in stocks	..	..	..	..	..
Net trade	-5.7	-1.4	..	..	..
Exports	5.3	-0.9	..	..	..
Imports	-11.0	-0.5	..	..	..
GDP	-10.4	2.6	11.0	11.3	2.9
Kazakhstan					
Consumption	-17.1	-16.5	-5.9	0.9	..
Fixed investment	-3.2	-9.9	-5.5	0.6	..
Changes in stocks	..	..	..	..	..
Net trade	-1.6	11.2	8.2	-1.8	..
Exports	-4.2	1.9	0.8	0.8	..
Imports	2.6	9.4	7.4	-2.6	..
GDP	-12.6	-8.2	0.5	1.7	-2.5
Kyrgyzstan					
Consumption	-18.8	-15.6	5.9	-8.2	-0.6
Fixed investment	-3.8	7.3	-2.6	-6.6	-1.8
Changes in stocks	-0.3	1.4	4.7	6.8	-7.5
Net trade	2.8	1.5	-0.9	17.9	11.7
Exports	-6.4	-5.9	2.0	6.5	3.9
Imports	9.1	7.4	-2.9	11.4	7.8
GDP	-20.1	-5.4	7.1	9.9	1.8
Republic of Moldova					
Consumption	-9.8	7.1	8.7	11.1	-5.5
Fixed investment	-6.8	-0.7	4.0	-0.9	–
Changes in stocks	-22.2	-2.0	-3.9	-0.4	-0.2
Net trade	7.8	-5.9	-14.6	-7.9	-2.9
Exports	11.5	17.9	-5.1	0.9	-10.6
Imports	-3.7	-23.7	-9.6	-8.8	7.7
GDP	-30.9	-1.9	-7.8	1.6	-8.6
Russian Federation					
Consumption	-1.9	-1.9	-1.5	1.1	..
Fixed investment	-5.2	-1.6	-3.4	-0.8	..
Changes in stocks	-3.1	-1.1	-0.1	0.8	..
Net trade	-1.0	0.1	0.7	-0.5	..
Exports	1.9	2.0	0.2	0.1	..
Imports	-2.9	-1.9	0.5	-0.7	..
GDP	-12.7	-4.1	-3.5	0.8	-4.6
Ukraine					
Consumption	-6.2	-2.5	-6.4	2.6	..
Fixed investment	-10.0	-7.2	-5.3	-1.4	..
Changes in stocks	0.1	-9.1	-1.6	-0.1	..
Net trade	-6.7	2.2	–	-1.7	..
Exports	2.7	0.4	7.9	-0.5	..
Imports	-9.4	1.8	-7.9	-1.2	..
GDP	-22.9	-12.2	-10.0	-3.2	-1.7

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

Note: The sum of component changes may not equal the GDP change for some countries due to reported statistical discrepancies.

experienced in the aftermath of the Asian crisis: the weakening of Russian exports led to a fall in imports from the transition economies already in early 1998 (chart 3.6.2); the subsequent collapse of the rouble in August provoked a plunge in Russian imports in the last months of 1998[317] and this had a severe impact on suppliers from many transition economies. In fact, the Russian crisis amplified the already deteriorating export conditions facing the transition economies and this process accelerated considerably in the second half of the year.

Also in the second half of the year, the negative impact of the weakening of the global economy (in addition to the Russian crisis) began to affect western Europe as well, causing a slowdown of economic activity in a number of countries. Although in terms of growth, the picture in western Europe remained mixed in the final months of 1998, the marked weakening of manufacturing output in several economies (Germany, Italy, the United Kingdom, among others) played an important role in the overall slowdown.

Because of the lag with which this secondary effect is felt, the data available at the moment of writing this *Survey* did not allow an accurate assessment of the actual magnitude of its impact on the transition economies. On the one hand, the available (preliminary and incomplete) export data for the fourth quarter of 1998 (table 3.6.1) do not suggest that all the transition economies experienced

---

[317] The average monthly dollar value of Russian imports during the last four months of 1998 were 44 per cent lower than their average monthly level during the first eight months of the year and 51 per cent lower than in the last four months of 1997. UN/ECE secretariat calculations on the basis of data from Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii* (Moscow), various issues.

an additional fall in exports in the final months of the year; however, this may well be due to the inherent lags in the execution of export contracts. On the other hand, indirect evidence (and especially the unexpectedly sharp deterioration in output performance in a number of countries in the fourth quarter) suggests that some of the transition economies were subject to an additional demand shock in the closing months of 1998.[318]

The mechanisms through which changes in certain components of demand may affect output performance – or macroeconomic performance in general – can be extremely complex due to the heterogeneous causal relations involved.[319] Such an analysis requires a detailed assessment of the actual transmission mechanisms; usually, the latter are country-specific and their analysis requires taking into account the interrelations of both macro and microeconomic factors. Even the simple measurement of the statistical contribution of the components of final demand to economic growth (as shown in tables 3.3.7 and 3.3.8) – which is a purely statistical operation and does not imply any direction of causality – can only be made on the basis of the annual national accounts data.

Nevertheless, although the compositional mix of the factors of growth may have been different in the individual transition economies, the direction of change in their output performance in 1998 (as discussed in section 3.3(i)) suggests that the externally induced demand-side shock started to play the dominant role in most of them from the beginning of the year; and virtually all the indicators suggest that this dominance strengthened in the course of the year.

It is difficult to judge how and to what extent domestic demand in 1998 in the individual countries was affected by the external shock, as its impact was often mixed with various domestic factors. As noted already, tight macroeconomic policies (aimed at improving external or domestic balance) had already resulted in the curbing of domestic demand in some transition economies (Croatia in 1998 is a case in point; the policy effort in the Czech Republic in 1997 also aimed at a similar adjustment but the crisis turned out to be much deeper than expected). Full-blown economic crises have recently forced cuts in domestic demand in a number of transition economies (Bulgaria in 1996-1997, Romania since 1997, Russia and a number of CIS countries in 1998). It is difficult in all these cases to separate domestic from external factors.

On the other hand, the basic conjecture about the transmission mechanisms of the external shock is that it would first affect output while the eventual impact on domestic demand would be mostly indirect, albeit with certain time lags (through the negative impact on incomes and expectations and the effect of the latter on spending and investment decisions). Obviously, due to the inherent lags in the transmission processes, the proliferation of such indirect effects may continue for some time in the future. Thus while the effects of the shock are not always reflected in the 1998 performance indicators, they are likely to continue to have a negative effect on domestic demand in the transition economies in 1999 as well.

The magnitude of the external shock (already reflected in a considerable worsening of output performance), coupled with the deteriorating conditions on the international financial markets, suggests that a number of transition economies are likely to face increasingly tough balance of payments constraints in the short run. The main problem is that a number of transition economies will be facing increasing difficulties in financing current account deficits (which in some cases have been a necessary element in their recent recovery and in others are a reflection of chronic economic weakness). As already indicated by the experience of some transition economies, the weakening of global markets has also had a negative impact on their fiscal position, especially in cases where fiscal revenue is highly sensitive to export revenue. If these imbalances are to be kept under control, some transition economies will face the necessity of a macroeconomic adjustment, largely by further cuts in domestic demand and thus a further weakening of output performance.[320]

In this regard it is illuminating to consider how similar adjustment efforts have taken shape in some of the transition economies in recent years. Thus the Hungarian experience of 1995-1997 reflects the outcome of a deliberate policy response to the emerging twin-deficit problem, the simultaneous enlargement of the fiscal and current account deficits. This experience may thus be relevant for other transition economies that are facing, or may expect to face, similar problems in the near future.

As can be seen from the statistics in tables 3.3.7, 3.3.10 and 3.3.12, the policy of macroeconomic austerity resulted in a severe contraction of domestic demand in Hungary in 1995 (the year when the policy correction was initiated). The principal demand-side factor of growth in that year was net trade, mostly thanks to the continued expansion of exports, as real imports declined (table 3.3.7). This net trade effect was partly due to the trimming of costs (resulting from restrictive policies) and to the one-time depreciation of the currency. The following year, 1996, when investors' confidence started to recover, it was fixed investment that started to make a notable contribution to growth; the net trade effect also remained positive while consumption (both private and

---

[318] As discussed in sect. 3.2(ii), the upsurge in real interest rates towards the end of 1998, amplified the magnitude of the external shock in a number of transition economies.

[319] For example, a distinction is sometimes made between "supply-driven" and "demand-driven" types of growth in order to emphasize the dominant role of causality in one or the other direction.

---

[320] As noted above, a number of transition economies are already undergoing such a process for the reasons discussed. In these cases, the unfavourable external environment is likely to amplify substantially the downside factors and risks.

government) continued to subtract from the overall growth in output. By the time a rapid recovery started in 1997, the negative impact of austere policies was diminishing while the positive impact of enterprise restructuring was beginning to pay off, and in 1997 as a whole all the components of final demand made a positive net contribution to growth (table 3.3.7). The preliminary data for 1998 suggest that the rapidly growing private consumption (chart 3.3.2) probably took the lead as the largest net contributor to growth.

When analyzing country-specific policy experience, it is notoriously difficult to draw general conclusions or to come up with general policy recommendations for other countries. Nevertheless, it is tempting to ask whether, given the economic circumstances likely to prevail in 1999, other transition economies will be able to repeat, at least partly, the policy success of Hungary in engineering a painful – but effectual – adjustment effort. While it may be difficult to come up with any definite conclusions, several important, policy-relevant factors need to be taken into consideration when making such an assessment.

The first refers to external conditions. Hungary embarked on its policy adjustment when the external environment was rather favourable. The recovery in western Europe and its strong import demand supported the rapid growth of Hungarian exports after they had been given a boost by the adjustment effort. The strong export performance then became a major factor not only in reducing the macroeconomic imbalances but also in providing the main engine of recovery and growth. In addition to this favourable environment, the Hungarian policy package of 1995 also included a one-time – but significant – currency devaluation (by 8 per cent) and a switch from fixed to crawling peg exchange rate regime, which undoubtedly gave an additional impulse to export performance and the improvement in the external balance. Finally, the Hungarian adjustment effort was successful largely because it built on the success in restructuring the Hungarian economy, and especially manufacturing industry. As noted in section 3.3(i), the export-led revival of this sector, underpinned by a steady inflow of FDI over a period of several years, was the main factor behind the strong recovery that started in 1997. Without this support from a restructured manufacturing sector, the Hungarian economy would hardly have been able to grow at such rates, despite the reduction in the external imbalance.

The situation in early 1999 – featuring weak global trade, depressed commodity prices and hesitant import demand in parts of western Europe – looks quite different. It is highly unlikely that the transition economies will be able to rely on a strong growth of exports to check their external imbalances in the short run. Even if some transition economies were to resort to currency depreciation to boost exports,[321] it is questionable whether

this would in fact achieve the expected result because of the general weakness in export markets.[322] Nevertheless, if sluggish export performance continues, it can be expected that many transition economies will be facing increasing domestic pressures to resort to a competitive devaluation in order to boost economic activity.

Thus, if the weakness in external demand persists, it may have a long-lasting negative impact on the general level of economic activity in many transition economies since there will be very limited potential for an export-led adjustment and recovery in the short run.[323] The resilience of individual countries to the repercussions of the external demand shock will again depend on the general state of their economy which, in turn, will reflect the progress made in economic reform, in strengthening institutions, and in microeconomic restructuring. A sustained and robust growth of domestic demand (which does not lead to overheating and macroeconomic imbalance, but instead reflects rising confidence in the future) can provide another defence for domestic economic activity against the unfavourable external environment.

(b) The components of domestic demand

The composition of final demand in many transition economies is still undergoing substantial change (table 3.3.9).[324] Both the transition shocks and the uneven pace of economic growth have contributed to significant fluctuations and shifts in final domestic demand and, in some cases, to abnormal proportions in the composition of demand. One striking example is the proportion of domestic consumption in GDP in some transition economies: in several of the CIS countries, this share is close to, or even exceeding, unity. The fact that domestic output hardly covers (or even fails to cover) the level of domestic consumption is a conspicuous indication of the general weakness of these economies and their inability to create the basis for sustained economic performance.

The transformation crises recently experienced in a number of transition economies has brought about further distortions and detrimental changes in the composition of their final demand (table 3.3.9). One of the regrettable consequences of these crises has been a further reduction of already low shares of investment in GDP (especially manifest in Bulgaria and, in 1997-1998, in Russia and in a number of other CIS countries). This change in the

---

[321] Some transition economies were already forced to devalue as a result of the global financial and Russian crises (see sect. 3.2(ii)).

[322] For example, the Czech Republic introduced a policy package in 1997 that was similar to the Hungarian one of 1995; however, largely due to the unfavourable external environment, the adjustment process has been rather difficult and the accompanying recession has turned out to be much deeper than expected.

[323] As many of the transition economies are less advanced than Hungary in the reform process and few have enjoyed similar inflows of FDI, it is not very likely that the Hungarian experience of fast post-adjustment recovery and growth can be repeated in many other countries.

[324] The statistical offices in many transition economies started compiling national accounts only very recently. Despite an obvious improvement in statistical practices in recent years, the quality of the data often remains questionable; they often contain inconsistencies and/or puzzling discrepancies.

Composition of final demand in current prices in selected transition economies, 1996-1998

(Percentage of GDP)

	Consumption			Fixed investment			Change in stocks			Net trade		
	1996	1997	1998 [a]	1996	1997	1998 [a]	1996	1997	1998 [a]	1996	1997	1998 [a]
Bulgaria	88.5	84.1	84.9	13.6	11.3	10.9	-5.2	0.5	3.5	3.1	5.5	2.4
Croatia	87.5	86.9	..	21.9	28.3	..	1.5	3.9	..	-9.5	-15.2	..
Czech Republic	71.5	71.6	70.8	33.0	30.7	25.9	2.5	3.2	3.8	-7.0	-5.5	-0.5
Hungary	74.3	72.3	..	21.4	22.1	..	5.4	6.1	..	-1.1	-0.5	..
Poland	79.6	79.6	83.1	20.9	23.6	22.2	1.1	1.1	0.9	-1.6	-4.3	-6.2
Romania	82.6	85.3	90.8	23.0	22.0	18.1	2.9	0.2	–	-8.4	-7.1	8.5
Slovakia	72.6	71.6	71.4	36.9	38.6	36.8	2.4	-3.2	2.7	-12.0	-7.1	-10.8
Slovenia	77.5	76.9	77.0	22.6	23.5	24.0	0.9	0.7	0.3	-1.0	-1.2	-1.3
The former Yugoslav Republic of Macedonia	90.2	..	..	17.4	..	..	2.7	..	..	-10.3	..	..
Yugoslavia	94.5	91.0	..	11.9	12.0	..	4.9	6.1	..	-11.6	-9.0	..
Estonia	84.8	81.4	81.3	26.7	26.5	29.0	1.1	3.4	0.6	-11.5	-11.4	-8.8
Latvia	89.3	90.4	84.9	18.1	19.3	15.7	0.7	0.4	8.2	-8.1	-10.1	-8.8
Lithuania	85.3	84.0	84.0	23.0	24.4	26.0	1.5	2.2	2.6	-9.8	-10.6	-12.6
Armenia	111.7	..	..	17.9	..	..	2.1	..	..	-32.8	..	..
Azerbaijan	99.7	90.4	93.0	29.1	37.8	45.2	-0.1	0.5	–	-31.0	-27.4	-35.9
Belarus	79.4	77.2	82.8	22.0	25.0	22.3	2.5	1.7	2.8	-3.9	-6.3	-7.0
Georgia	93.2	100.0	..	13.6	12.3	..	4.3	4.2	..	-7.4	-16.2	..
Kazakhstan	79.9	82.6	..	17.2	16.3	..	-1.1	-0.7	..	-0.7	-2.1	..
Kyrgyzstan	100.6	86.2	99.3	22.4	12.4	10.8	2.8	9.3	2.6	-25.8	-7.9	-26.9
Republic of Moldova	94.4	97.5	102.3	19.6	19.9	21.9	4.5	3.8	4.0	-18.8	-21.1	-28.3
Russian Federation	71.6	75.3	76.8	20.6	18.5	17.3	1.9	2.8	1.1	3.9	2.8	6.4
Tajikistan	62.0	..	..	12.5	..	..	9.0	..	..	9.7	..	..
Turkmenistan	56.3	81.7	..	41.3	40.9	..	8.2	7.3	..	-1.3	-31.1	..
Ukraine	79.9	83.7	..	20.7	18.3	..	2.0	1.8	..	-2.6	-3.8	..
Uzbekistan	..	..	85.0	..	..	33.7	..	..	-19.0	..	..	0.2

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

Note: The sum of components does not add up to 100 per cent for some countries due to reported statistical discrepancies.

[a] January-September for Bulgaria, the Czech Republic, Poland, Slovakia, Estonia, Lithuania, Azerbaijan, Belarus and Uzbekistan and January-June for Latvia.

composition of final demand is among the factors contributing to the new dividing line among the transition economies. The proportionate decline in current investment in some transition economies (which are not among the advanced reformers anyway) is not improving their chances of catching up with the higher income levels prevailing elsewhere in Europe; on the contrary, it is likely to lead to a lower growth rate of output and a further falling behind in the future.

Due to the delays in compiling the national accounts, the assessment of changes in the various components of domestic demand in 1998 can only be tentative and partial at present. It is largely based on some surrogate indicators that are compiled and published by the statistical offices in their current (monthly and quarterly) statistical reviews.[325]

Consumption

The recent recovery of economic growth in many *east European and Baltic countries* has often been accompanied by very rapid growth of private

_____

[325] Such as the volume of retail sales which is taken as a proxy for private consumption and the volume of investment outlays which is taken as a proxy for fixed investment.

consumption. In a number of cases (notably Poland, Slovakia and the three Baltic states),[326] the strong recovery of final consumption in 1996-1997 was a major support of economic growth (table 3.3.7). As the expansion of consumer spending was often accompanied by an upsurge in household credit, this started to give rise to fears of overheating in some of these countries. In fact, such concerns were among the arguments for the tightening of monetary policy that occurred in several transition economies in the second half of 1997.

The prevailing change in private consumption in the east European and Baltic countries in 1998 – as depicted by retail sales volumes (chart 3.3.2 and table 3.3.11)[327] –

_____

[326] Croatia probably falls into this category as well, although the lack of full national accounts data do not allow this to be confirmed.

[327] Some words of caution are needed as regards the use and interpretation of retail sales as a proxy for private consumption. There are sometimes puzzling anomalies in the data which presumably are due to country-specific differences in statistical methodology and practice but which are not always explicitly spelled out in the publications of the national statistical offices. There are notable discrepancies between the reported rates of growth of retail sales and of private or total consumption for some countries (for example Latvia and Lithuania in 1997 and 1998; Romania and Estonia in 1998, among others – see tables 3.3.10 and 3.3.11). In some cases (Poland is an example – see the note to table 3.3.11), there are considerable discrepancies between monthly and annual

TABLE 3.3.10

Real consumption in selected transition economies, 1995-1998

(Annual percentage change)

	Private consumption expenditure [a]				Government consumption expenditure [b]				Total			
	1995	1996	1997	1998[c]	1995	1996	1997	1998[c]	1995	1996	1997	1998[c]
Bulgaria	-0.5	-1.9	-15.7	8.2	-8.2	-28.9	-11.5	-4.2	-1.9	-6.7	-15.1	6.4
Czech Republic	7.0	7.1	1.7	-3.1	-2.0	4.1	-2.1	-1.3	4.2	6.2	0.6	-2.6
Hungary	-7.6	-3.2	2.3	3.3	-5.7	-2.3	1.2	..	-6.6	-2.9	2.0	..
Poland	3.3	8.3	6.8	..	2.9	3.4	3.2	..	3.2	7.2	6.1	..
Romania	12.9	8.1	-2.9	-6.5	1.0	1.5	-11.6	..	10.8	7.0	-4.3	-3.7
Slovakia	4.3	6.3	6.4	3.2	0.9	22.3	-0.4	-0.5	3.3	10.9	4.2	2.1
Slovenia	9.1	2.4	3.3	..	2.5	3.7	4.3	..	7.4	2.7	3.6	..
Estonia	5.4	8.1	8.9	7.0	18.8	-0.8	5.9	1.9	9.1	5.4	8.0	5.6
Latvia	-1.7	10.3	3.9	4.6	1.3	1.8	3.8	-9.8	-0.9	8.1	3.9	0.9
Lithuania	..	8.4	7.6	..	..	-4.0	0.9	..	..	5.6	6.2	..
Armenia	9.0	3.8	7.5	..	0.2	-2.4	-4.7	..	8.0	3.2	6.1	..
Azerbaijan	-2.9	9.4	11.7	..	-2.4	-0.5	1.8	..	-2.8	8.1	10.5	..
Belarus	-11.7	4.3	9.7	..	-2.9	-0.2	8.9	..	-9.5	3.2	9.5	..
Georgia	5.8	..	..	..	52.2	..	..	..	8.6	..	..	..
Kazakhstan	-20.6	-5.2	3.1	..	-16.7	-16.7	-10.0	..	-18.7	-7.0	1.1	..
Kyrgyzstan	-16.7	6.0	-8.9	-1.7	-13.4	7.3	-4.5	3.3	-16.1	6.3	-8.1	-0.7
Republic of Moldova	7.4	19.2	13.7	6.6	14.2	-8.6	6.7	-38.7	9.4	10.5	11.8	-5.7
Russian Federation	-4.6	-3.0	2.1	-3.6	1.1	0.2	0.5	0.2	-2.7	-2.1	1.6	-2.5
Ukraine	-1.9	-9.5	5.4	..	-7.9	-5.4	-2.4	..	-3.6	-8.4	3.3	..

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE 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] January-September for Bulgaria, the Czech Republic, Hungary and Estonia and January-June for Slovakia and Latvia.

was for a general weakening. In most countries, the rates of growth of retail sales gradually decelerated in the course of the year and in some (Croatia, Yugoslavia, Estonia and Lithuania) the quarterly sales volume started to fall (in relation to the same period of 1997) in the second half of the year or in the last quarter. Despite the overall weakening of consumer demand, the actual pattern differed widely among individual countries.

Thus Hungary was the notable exception among the central European transition economies in 1998. After several years of restraint, there was a real consumer boom which accelerated in the course of the year (chart 3.3.2). The sharp rise in private consumption in 1998 was especially pronounced in consumer durables,[328] which probably reflects, at least in part, the effect of previously deferred purchases. As these are probably one-time effects, the average growth of private consumption in Hungary is likely to moderate somewhat in the course of

1999 even if economic growth in the country is maintained. In contrast, consumer demand in the Czech Republic weakened further in 1998 as the unexpected depth of the recession began to take its toll. In fact, the dynamics of private consumption in the Czech Republic in 1998 were almost a mirror image of those in Hungary,[329] with substantial declines in the sales of consumer durables.[330]

Since 1989, Poland is the transition economy that has had the longest, uninterrupted rate of recovery. The high rates of economic growth during a period of six years has led to notable progress in living standards which is also reflected in the recent growth of private consumption. Due to a somewhat confusing discrepancy in statistics of retail trade in Poland,[331] it is difficult to assess precisely the actual change in consumer demand in 1998; but both the annual and the monthly data point to a

_____

data for the volume of sales due to the different coverage of the statistical samples. The reported retail sales volumes for many CIS countries have traditionally raised suspicion of distortion due to improper deflation. As can be seen in tables 3.3.10 and 3.3.11, the inconsistencies in the reported growth rates of retail trade and private consumption for some CIS countries are quite confusing, as even the signs are opposite in some years.

[328] While the total volume of retail sales in 1998 increased on average by 8.4 per cent, the growth of its components was rather heterogeneous: thus, sales of motor vehicles increased by 76.3 per cent and purchases of furniture by 13.9 per cent; at the same time sales of food, beverages and tobacco increased by only 3.8 per cent. Hungarian Central Statistical Office, *Monthly Bulletin of Statistics*, No. 12 (Budapest), 1998, p. 133.

_____

[329] The comparison of consumer behaviour in Hungary and the Czech Republic in 1998 is almost a textbook illustration of the high income elasticity of consumer demand for luxuries (or durables).

[330] According to estimates of the Czech Car Industry Association, the sales of new cars in the first 11 months of 1998 fell by more than 17 per cent from the same period of 1997. *Central Europe Online*, 21 December 1998 (internet edition).

[331] As indicated in the note to table 3.3.11, the growth of retail sales in Poland as reflected in the monthly data apparently overstates the actual rate of growth. Thus according to the preliminary annual figures, annual retail sales in 1998 increased by 3.6 per cent, while the aggregation of the monthly data (used on chart 3.3.2) suggests an increase of 12.9 per cent.

TABLE 3.3.11

Retail trade in the transition economies, 1996-1998
(Percentage change over same period of previous year)

			1998			
	1996	1997	Jan.-Mar.	Jan.-Jun.	Jan.-Sept.	Jan.-Dec.
Bulgaria	0.5	-39.3	6.3	8.8	5.9	5.1
Croatia	-3.5	14.9	2.4	3.2	1.7	-0.6
Czech Republic	9.6	-2.0	-4.3	-5.8	-6.0	-6.8
Hungary	-5.0	-1.0	0.2	3.3	5.2	7.5
Poland [a]	4.5	6.8	13.2	14.3	14.3	12.9
Romania	15.3	-12.1	-3.0	6.2	5.6	4.1
Slovakia	6.9	4.6	7.3	9.6	9.1	7.9
Slovenia	14.1	5.4	3.2	–	1.4	1.9
The former Yugoslav Republic of Macedonia	-10.2	4.3	5.2	3.3	3.5	3.2
Yugoslavia	7.4	9.0	22.0	18.8	9.3	2.7
Estonia	6.0	8.0	3.4	2.4	0.2	-2.8
Latvia	-9.0	18.6	21.5	25.4	24.8	21.8
Lithuania	5.0	12.9	23.6	20.4	16.9	11.1
Armenia	12.5	5.2	2.1	8.3	5.2	6.1
Azerbaijan	14.1	14.9	12.0	13.0	9.7	9.1
Belarus	30.5	17.9	44.0	41.0	39.0	21.0
Georgia	22.5	27.5	20.1	15.1	13.2	11.7
Kazakhstan	33.3	29.3	31.0	23.0	20.0	18.0
Kyrgyzstan	1.8	8.8	12.4	9.3	8.6	8.4
Republic of Moldova [b]	17.7	-3.5	-13.0	-10.0	-8.0	-13.0
Russian Federation	-3.7	2.3	-0.4	-1.0	-0.7	-4.5
Tajikistan	-6.1	9.0	-35.6	-26.3	-9.3	8.2
Turkmenistan	-1.9	13.7	9.0	..	..	..
Ukraine [b]	-5.1	1.9	0.4	0.4	-3.1	-4.5
Uzbekistan	22.2	12.6	17.1	12.1	13.1	14.0

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

Note: Retail trade covers goods and catering in Hungary and the CIS countries; mainly goods in Bulgaria, the Czech Republic, Croatia, Poland, Romania, Slovakia, Slovenia, The former Yugoslavia Republic of Macedonia, Yugoslavia and the Baltic states. The coverage in 1998, based on current reporting, may differ from the coverage in the annual statistics.

[a] There is a considerable discrepancy between the monthly and the annual data on retail sales in Poland due to differences in coverage. For example, according to the cumulative monthly figures (which cover enterprises with more than 5 employees) annual retail sales in 1997 increased by 15.0 per cent whereas the annual data indicate only 6.8 per cent growth. There is a similar discrepancy in 1998: the preliminary annual figure is 3.6 per cent growth, which is much below the figure from the monthly data (12.9 per cent).

[b] Registered enterprises (for the Ukraine 1996).

certain deceleration in the growth of consumer spending. With the tightening of monetary policy, the boom in household credit (that had become a source of concern for the monetary authorities in 1997) also slowed down considerably in 1998.[332]

As already noted, monetary and fiscal restraint aimed at curbing domestic demand resulted in a weakening of consumer spending in Croatia in 1998. However, the sharp drop in retail sales in Croatia also partly reflects the fact that consumer spending was

_____

[332] Central Statistical Office, *Poland*, Vol. 6, No. 3 (Warsaw), December 1998, p. 5.

probably abnormally high in 1997 due to special factors.[333]

Among the Baltic countries, the weakening of consumer demand in 1998 appears to have been most pronounced in Estonia where retail sales started to decline rapidly in the second half of the year (chart 3.3.2).[334] It is difficult though to compare directly the retail sales volumes for the three countries or to draw more general conclusions about the most recent changes in private consumption due to the problems mentioned above.

Both in Bulgaria and in Romania, there was some moderate growth of retail sales during 1998 after their disastrous fall in 1997 (table 3.3.11). Due to the collapse of the previous two years, it is difficult to speak of a recovery of personal consumption in these two countries: in both of them the absolute level of retail sales in 1998 remained considerably below that in 1996 (in Bulgaria by 27 per cent and in Romania by 22 per cent).[335] Moreover, with the renewed deterioration of the economic situation in Romania, the growth in the volume of retail trade abated in the course of 1998 and in the fourth quarter of the year its level was practically the same as in the same period of 1997 (chart 3.3.2). The preliminary 1998 national accounts also point to a considerable fall in personal consumption (table 3.3.10) and a negative contribution of consumption to GDP growth (table 3.3.7).

There are no reliable current statistics on consumer demand for most of the *CIS countries* in 1998. Among them, Russia and Ukraine are probably the only two where the current retail trade statistics are a relatively more accurate reflection of changes in private consumption.

As noted in section 3.3(i), there was a considerable lag before the negative impact of the crisis in Russia started to affect consumer demand: the actual shock occurred only in the fourth quarter of 1998 when quarterly retail sales plunged by 14.8 per cent, year-on-year (chart 3.3.2). There are two principal factors which appear to be behind this development. First, despite the persistent escalation of financial turmoil in Russia (which had started already in the final months of 1997), the major negative shock to real incomes occurred after the collapse of the rouble.[336] And secondly, in the period immediately preceding the August crash, there was an

_____

[333] Such as the large precautionary purchases in the final months of 1997 in anticipation of the introduction of VAT in 1998.

[334] In the fourth quarter alone, the quarterly volume of retail sales was 10.4 per cent below its level in the same period of 1997 resulting in a total decline of annual sales by 2.8 per cent (table 3.3.11).

[335] UN/ECE secretariat calculations, based on national statistics.

[336] In terms of 12-month moving averages, the rate of growth of real per capita money incomes in Russia was positive throughout the 18-month period beginning in December 1996 and ending in May 1998 (UN/ECE secretariat calculations, based on Goskomstat data). Real incomes only started to decline in June 1998 but they plunged abruptly with the upsurge of inflation in September.

upsurge in precautionary purchases, notably of consumer durables, which gave a boost to the total volume of retail sales.[337] However, the deep downturn in consumer demand that occurred in the fourth quarter of 1998 probably indicates a major shift in aggregate demand in Russia which is unlikely to be reversed in the short run: at the beginning of 1999 the steep decline of retail sales was still continuing and there were no apparent signs of it coming to an end.[338]

After a modest recovery in 1997, private consumption in Ukraine fell again in 1998, especially in the second half of the year (chart 3.3.2). The renewed decline of retail sales reflected the general weakening of economic activity in Ukraine due to the shock from the Russian crisis. One important negative influence on private consumption was real income which started to decrease rapidly in the final months of the year due to the upsurge in inflation that followed the devaluation of the hryvnia in September.[339]

Investment

The level of business investment is generally regarded as one of the most reliable indicators of the overall economic perspectives of a country as it mirrors the collective perception of investors as to the prospects for profitable business. Each investment decision reflects a balance between the individual assessment of the overall business and economic risk and the expected return on the investment. Thus the aggregate level of current business investment can be regarded as representing an aggregate "consensus forecast" of the future economic prospects of a country made by the circle of prospective individual investors. In general, investment activity can be regarded as a lead indicator with respect to economic activity and growth; moreover, as regards mature market economies, there are well-documented cyclical elements in this relation.

It should also be borne in mind that, in purely statistical terms, the relation between investment and growth may be somewhat equivocal because of the presence of lags. Thus the "lead" of investment may not necessarily be reflected in the actual statistics on investment outlays, as there may be a long interval between the investment decision and its implementation depending on the scale of the project, technological complexity, etc. In such cases, recorded investment outlays (reflecting past investment decisions) may de facto be lagging behind actual changes in the level of economic activity (and may, for example, appear to be out of line with what might be expected given the current position in the business cycle). This can partly be observed in the pattern of investment in the transition economies in 1998.

Investment varied considerably among the transition economies in 1998. Although only partial and preliminary information was available at the time of writing this *Survey*, it allows some clear distinctions to be drawn about the investment pattern in a number of transition economies. Thus, in 1998, investment demand continued on average to be quite high in many central European and Baltic economies (with the notable exception of the Czech Republic) despite the slowing down of economic growth. In most cases (Hungary, Poland, Slovakia, Slovenia, Estonia and Lithuania, among the countries for which investment data were available)[340] investment grew at higher rates than GDP (table 3.3.12) and made significantly positive contributions to growth (table 3.3.7).

Business investment has been very buoyant in Poland since 1995: investment outlays have been growing at double-digit rates for four consecutive years and in 1997-1998 they increased by more than 20 per cent (table 3.3.12). There were also very high rates of investment in Slovakia in this period; however, as already noted, large-scale infrastructure projects, financed from public funds, accounted for a considerable share of the total.[341] In view of the post-election change in economic policy, it can be expected that this type of investment will be reduced substantially in the future (some deceleration was already visible in 1998 – table 3.3.12).

In contrast, the deteriorating economic situation in the Czech Republic led to a further marked weakening of investment in 1998: the volume of outlays and of investment in fixed capital fell for a second year running (table 3.3.12). Despite some recovery in 1998, investment remained rather weak in Bulgaria in absolute terms: the share of fixed investment in GDP in Bulgaria is the lowest among the east European and Baltic countries (table 3.3.9), a reflection of the sharp contraction in 1996 and 1997 (by over 20 per cent in both years). The preliminary 1998 national accounts figures for Romania indicate a similar process of collapse in fixed capital formation (table 3.3.12). Although the background to the current downturn of investment activity in these countries may be different (in the Czech Republic it reflects mostly uncertainties about the prospects of recovery in the short run, while in the other two countries, especially in Bulgaria, it is more the outcome of a persistent lack of investors' confidence)

---

[337] In August alone, the volume of retail sales of non-food items increased by 8.8 per cent from its level in July and by 6.6 per cent from August 1997. Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii*, No. 12 (Moscow), 1998, p. 122.

[338] According to preliminary Goskomstat data, retail sales in January continued to decline at double-digit rates year-on-year. Due to a methodological change in the reporting of the volume of retail sales, it was difficult to compare the actual rate with those in the preceding months.

[339] The largest decline in real incomes occurred between August and November 1998, real wages plunging by more than 10 per cent. UN/ECE secretariat calculation, based on national statistics.

---

[340] In Latvia, after strong growth during the first two quarters, investment slowed down in the second half of the year (table 3.3.12).

[341] Mostly highways, but also including the construction of the nuclear power station in Mohovce.

TABLE 3.3.12

Investment in selected transition economies, 1995-1998
(Annual percentage change)

	Gross capital formation				Gross fixed capital formation				Investment outlays			
	1995	1996	1997	1998 [a]	1995	1996	1997	1998 [a]	1995	1996	1997	1998 [b]
Bulgaria	75.4	-53.2	32.8	36.8	16.1	-21.2	-22.1	9.5	..	..	..	..
Czech Republic	23.1	13.0	-2.2	-6.4	21.0	8.7	-4.9	-3.3	30.3	18.1	-9.5	-5.0
Hungary	8.2	12.8	11.0	..	-4.3	6.7	8.8	13.7	-5.3	5.2	8.5	10.2
Poland	24.1	19.5	20.8	..	16.5	19.7	21.7	..	17.1	19.2	22.2	23.9
Romania	-4.2	2.5	-14.4	..	6.9	5.7	-3.0	-18.1	10.7	3.1	-19.0	0.8
Slovakia	29.1	40.8	-4.7	12.0	-0.2	39.8	14.5	10.6	9.4	39.6	11.7	10.3
Slovenia	23.0	4.2	10.1	..	16.8	9.2	11.3	..	..	..	..	..
Yugoslavia	..	..	..	..	..	..	..	..	-3.7	-5.7	..	..
Estonia	4.8	12.5	22.4	7.0	4.0	11.4	12.5	15.6	..	..	..	..
Latvia	-6.6	6.0	10.3	44.8	8.7	22.3	11.1	6.8	8.5	55.5	20.6	2.0
Lithuania	..	10.0	26.6	..	..	10.9	23.5	..	14.3	12.0	14.6	16.8
Armenia	-16.0	7.8	8.6	..	-17.3	10.3	12.4	..	..	..	..	..
Azerbaijan	55.2	111.4	67.0	..	-18.0	111.4	67.0	..	-18.0	110.0	39.0	45.0
Belarus	-28.7	7.2	17.2	..	-29.6	-3.1	23.1	..	-31.0	-4.8	19.5	16.0
Georgia	41.0	..	..	..	64.8	..	..	..	38.0	11.0	36.0	80.0
Kazakhstan	-42.5	-29.5	5.7	..	-37.9	-23.9	3.3	..	-37.0	-39.0	12.0	12.8
Kyrgyzstan	96.3	11.4	0.7	-42.9	60.7	-13.0	-29.6	-14.5	81.7	19.0	-4.0	-53.0
Republic of Moldova	-9.1	0.2	-5.5	-1.0	-3.4	24.9	-4.7	-0.2	-16.0	-8.0	-8.0	-0.2
Russian Federation	-10.8	-17.7	0.3	-12.9	-7.5	-16.9	-4.6	-7.0	-10.0	-18.0	-5.0	-6.7
Turkmenistan	..	..	..	..	..	..	..	..	-45.0	63.0	-53.0	17.0
Ukraine	-46.4	-25.7	-6.5	..	-30.8	-22.7	-6.7	..	-28.5	-22.0	-7.3	5.0
Uzbekistan	..	..	..	..	..	..	..	..	4.0	7.0	17.0	15.0

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE 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 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 Bulgaria, the Czech Republic, Hungary and Estonia; January-June for Slovakia and Latvia.

[b] January-September for the Czech Republic, Poland, Slovakia and Latvia; January-June for Romania.

these developments indicate the scale of the problems standing in the way of efforts to achieve a sustainable recovery of economic activity.

As has been repeatedly argued in previous issues of this *Survey*,[342] investment in the manufacturing sector is one of the key factors for success in the whole transformation process. Since most transition economies embarked on the process with over-large industrial sectors and underdeveloped services, it was widely expected that the latter would attract most of the new investment, but in reality things have worked out somewhat differently. The greatest progress in economic restructuring (and in economic transformation in general) has in fact been achieved in the countries where a process of de facto reindustrialization was initiated and where it has advanced most. This process of reindustrialization was based on a combination of large, new (predominantly greenfield) investments, a gradual upgrading of the product mix of manufacturing industry, and a rapid expansion of exports of manufactured goods to new (mostly west European) markets; in the most successful reformers, this last development was accompanied by an increasing share of products of higher quality and technological content in total exports.

The most recent changes in the transition economies continue to provide evidence in support of this development. It is noteworthy, that both Hungary and Poland – two of the transition economies that have made the most progress in transforming their economies – have done so through such a process of reindustrialization. As already noted in section 3.3(i), since 1993 these two countries have had the highest rates of growth of manufacturing output among the transition economies. The revival of manufacturing, in turn, was based on large-scale new investment in the processing industries: while total investment was growing throughout this period,[343] in both countries there were substantial increases in the share of manufacturing in total

_____

[342] UN/ECE, *Economic Survey of Europe in 1996-1997*, pp. 105-106; *Economic Survey of Europe*, *1998 No. 1*, pp. 101-103.

[343] With the exception of Hungary in 1995 when real investment declined (table 3.3.12).

investment outlays.[344] This development may also partly be related to the substantial inflow of FDI to the two countries as manufacturing apparently has been attracting relatively larger shares of incoming FDI compared with other sectors of economic activity.

It should be added that this structural change in the composition and direction of investment (and especially this clear shift towards the leading role of manufacturing investment) are either less pronounced among the other transition economies or not to be found at all.[345] Moreover, in some countries where there have been transformation crises (Bulgaria is a case in point), not only were total investment outlays falling during the past several years but, within the total, the share of manufacturing investment also was shrinking. In many of the CIS countries where there has been prolonged distress during the transition, investment (including investment in manufacturing) has fallen to a small fraction of its pre-transition level.[346]

Despite the fact, noted above, that a predominantly export-led growth also carries risks, the experience of successful economic restructuring in some of the transition economies, and particularly the role of manufacturing investment, may well be a source of useful policy lessons for policy makers in other countries that are still going through a painful process of reform.

3.4 Costs and prices

(i) Introduction

Disinflation continued in most transition economies in 1998. The slowdown in inflation in 1998 was not only widespread, the main exception being a few CIS economies, but also remarkably rapid. In several transition economies, inflation performance overshot the *ex-ante* targets and official forecasts for the first time since the start of the reforms.

Some of the domestic but mainly the external inflationary pressures weakened considerably. In the majority of the countries, domestic demand was dampened, albeit to varying degrees, by a deliberate or de

facto tightening of monetary policy,[347] and in some cases by a tight fiscal stance. Wage increases, in general, have continued to moderate, albeit to rates still outpacing the increase in output prices. The growth in labour productivity, however, which had risen remarkably since 1995 in most of the transition economies, slowed down sharply after mid-1998 and in a few countries it even fell during the fourth quarter. Given this weakening in productivity growth, the deceleration in the growth of unit labour costs lost momentum for the year as a whole, and in many countries there was even a sharp reversal of the downward trend, particularly in the fourth quarter, a reflection in the main of the collapse in the growth of industrial production rather than wage rigidity or labour market inflexibility.

Import price pressures, on the other hand, which had already weakened in 1997, continued to fall during the course of 1998. Reflecting both world demand and supply conditions, international commodity prices in dollar terms fell by more than one quarter in 1998. Given the intense competitive pressures on world markets, the prices of manufactured goods also continued to fall. In addition, many of the transition economies' currencies were relatively stable in nominal terms and even appreciated against the major currencies, except during the few months following the rouble crisis. This strong exchange rate appreciation had two contrasting effects on producer price inflation: on the one hand, it amplified the positive terms of trade effect on the material costs of domestic production, but on the other, by depressing exports, it weakened output growth which in turn exacerbated the unfavourable effect of domestic demand on unit labour costs. Given the enfeebled pricing power of producers due to intensified competition, both on domestic and international markets, it was not possible in general to pass these increased unit labour costs on to producer prices. Therefore, in contrast to 1997, profit margins in many transition economies were probably squeezed significantly in 1998.

(ii) Consumer prices

(a) Total consumer price inflation (CPI)

Consumer price inflation continued to fall in most transition economies in 1998, albeit at very different rates and influenced by various underlying causes (table 3.4.1). In *eastern Europe,* inflation in 1998 accelerated only in Yugoslavia and, at a much lower rate, in Croatia. In Croatia this was due essentially to the one-off effect of the introduction of VAT (22 per cent flat rate) in January when consumer prices increased by 2.4 per cent. After January the average monthly rate fell to less than 0.3 per cent for the rest of the period despite the slow but continuous depreciation of the kuna, mainly because domestic demand was suppressed by tight monetary and fiscal policies. In Yugoslavia, however, where all

---

[344] Thus, the share of manufacturing in total investment in Hungary increased from 20.9 per cent in 1993 to 27.8 per cent in 1998; in Poland it increased during the same period from 20.1 to 37.1 per cent (the data for Poland are for the first three quarters of 1998). UN/ECE secretariat calculations, based on national statistics.

[345] For example, the share of manufacturing in total investment outlays in the Czech Republic declined from 27.2 per cent in 1993 to 20.8 per cent in 1998 (the data are for the first three quarters of 1998) and in Slovakia, despite the strong growth of total investment, it decreased from 30 per cent in 1993 to 19.9 per cent in 1997 (UN/ECE secretariat calculations, based on national statistics). It should be noted, however, that direct cross-country comparisons are notoriously difficult due to serious methodological differences in the reporting of investment.

[346] Between 1991 and 1997 investment in mining and manufacturing in Russia decreased by 70 per cent while in Ukraine, between 1991 and 1996, it fell by 73 per cent. UN/ECE secretariat calculations, based on national statistics.

---

[347] See sect. 3.2(ii) for discussion on monetary policies in 1998.

TABLE 3.4.1

Consumer prices in the transition economies, 1997-1998

(Percentage change)

	Annual average, all items		December over previous December				
			1997	*1998*			
	1997	*1998*	*All items*	*All items*	*Food*	*Non-food goods*	*Services*
Albania	33.1	20.3	42.0	7.8	7.1	..	..
Bosnia and Herzegovina	11.8	4.9	12.2	2.2	-6.7	1.5	7.5
Bulgaria	1 082.6	22.2	578.7	0.9	-4.7	–	22.0
Croatia *ᵃ*	3.7	5.9	4.0	5.6	4.0	4.7	10.2
Czech Republic	8.4	10.6	9.9	6.7	-0.5	..	..
Hungary	18.4	14.2	18.4	10.4	8.0	9.7	15.0
Poland	15.1	11.7	13.2	8.5	2.9	9.6	14.7
Romania	154.9	59.3	151.7	40.7	26.0	46.9	68.1
Slovakia	6.2	6.7	6.5	5.5	4.5	5.7	6.4
Slovenia	8.4	7.9	8.8	6.6	4.5	..	9.5
The former Yugoslav							
Republic of Macedonia *ᵃ*	3.6	..	4.5	..	..	..	..
Yugoslavia	23.2	30.4	10.3	45.7	43.2	48.4	47.3
Estonia	11.1	10.6	12.3	6.8	0.5	6.1	12.5
Latvia	8.5	4.7	7.0	2.8	0.8	2.8	7.0
Lithuania	8.8	5.1	8.5	2.4	-1.3	5.2	10.9
Armenia	13.8	8.7	21.8	-1.2	-4.3	1.0	6.5
Azerbaijan	3.6	-0.8	0.3	-7.6	-9.0	-3.0	-0.6
Belarus	63.9	73.2	63.4	181.6	187.3	197.6	126.6
Georgia	6.9	3.6	7.3	11.0	..	14.1	9.5
Kazakhstan	17.4	7.3	11.3	1.9	-0.5	–	9.2
Kyrgyzstan	25.5	12.1	14.7	18.3	17.2	15.2	29.8
Republic of Moldova	11.8	7.7	11.1	18.3	11.3	20.7	34.1
Russian Federation	14.7	27.8	11.0	84.5	96.1	99.5	18.5
Tajikistan	85.4	43.1	159.9	2.7	-3.0	19.2	31.9
Turkmenistan	83.7	16.8	21.5	19.8	22.7	12.6	23.6
Ukraine	15.9	10.6	10.1	20.0	22.1	24.1	13.0
Uzbekistan....................................	73.2	..	27.5	..	..	..	..

Source: UN/ECE secretariat estimates, based on national statistics.

ᵃ Retail price index. For Croatia the food price index is from the cost of living index.

attempts to achieve price stability in recent years have proved to be unsustainable, the sharp acceleration in the inflation rate reflected the devaluation of the dinar (by 45 per cent at the end of March and again in May), the lagged effect of monetary expansion in the second half of 1997 and, particularly in the last quarter, the monetary emission which had been increased in order to finance a rapidly growing budget deficit and to alleviate a growing stock of wage and pension arrears. Furthermore, in October the government introduced a new sales tax in order to raise revenue to support its increased military expenditure. These factors, in addition to increased cost pressures during the second half of the year from the renewed downward pressure on the dinar and significantly weaker industrial production, prepared the ground for another period of soaring inflation in Yugoslavia, in spite of tighter price controls.

In Romania, the inflation rate continued the downward trend which had started in the second quarter of 1997, but the deceleration has been slow and was achieved largely through the depression of consumer demand, a result of shrinking real incomes. The very high interest rate policy pursued by the central bank in order to control inflation through a stable leu (which in fact appreciated

strongly in real terms),[348] has not only continued to choke production, but has also increased the cost of borrowing to an already heavily-indebted industry, which is under intense pressure to restructure and increase efficiency.[349] The desired effect of high interest rates in dampening price increases, which were already being stimulated by new taxes and tariff increases designed to limit the growing fiscal deficit, was thus partly offset by their negative effect on output and on production costs. Nevertheless, the actual year-end rate of inflation (40.7 per cent) was still lower than the original target agreed with the IMF (45 per cent).

In Bulgaria, after the severe financial crisis in 1996 and a period of hyperinflation in the closing months of that year and early 1997, a currency board was introduced in mid-1997 and the lev was pegged to the deutsche mark. Inflation started to fall rapidly and the monthly rate fell to

_____

[348] The leu appreciated in real terms (CPI deflated) by 29.5 per cent against the dollar and 34.5 per cent against the deutsche mark in the first half of 1998. Mainly due to the continued slowdown in inflation, the rates of change were 23.2 per cent and 25 per cent, respectively, for the year as a whole.

[349] For an extended discussion of the Romanian situation see sect. 3.2(iii).

less than 1 per cent in the last quarter of 1997; during 1998, prices rose by only 0.9 per cent for the year as a whole (equivalent to less than 0.1 per cent per month), the lowest rate among the east European and Baltic countries and which is well below the government's year-end target of 16 per cent (equivalent to a monthly rate of 1.2 per cent). However, these rather impressive improvements in macroeconomic stability have been achieved at the cost of a severe depression in aggregate demand and a collapse of output in 1997; there was only a slight recovery of GDP in 1998 while industrial production continued to fall sharply. Furthermore, the very small increase in the unemployment rate[350] suggests that most of the restructuring remains to be done and this will be particularly difficult to undertake without a strong recovery in aggregate demand and output. Therefore to sustain this recent achievement of near price stability in Bulgaria may prove to be costly in terms of overall macroeconomic performance and social cohesion.

Exchange rate targeting and weak demand have also been the crucial factors behind disinflation in 1998 in Albania, Bosnia and Herzegovina and, to a lesser extent, in The former Yugoslav Republic of Macedonia, where there was also a sizeable recovery in measured industrial productivity, due largely to output growth rather than employment contraction, as has been the case in recent years. In the second and third quarters consumer prices in The former Yugoslav Republic of Macedonia in fact fell, largely reflecting the combined effect of the waning of the effect of the July 1997 devaluation of the dinar and a significant increase in wage arrears which further depressed consumer demand.

In the Czech Republic and Slovakia the downward trend in inflation resumed in 1998 after reverses in 1997. In the Czech Republic, despite large increases in controlled prices and the imposition of VAT in January and again in July, consumer price inflation slowed significantly during 1998. The actual "net" inflation rate at the end of the year was 1.7 per cent compared with the central bank's target of 5.5-6.5 per cent.[351] Since the effective devaluation of the Czech koruna in May 1997, the central bank has pursued a very restrictive monetary policy, initially deliberate then, more recently, de facto,[352]

which has significantly dampened domestic demand, thus curbing both the growth of output and of prices. In recent years, in the absence of deep micro-level restructuring and with only slow rates of labour shedding, persistent wage growth in excess of productivity gains has been the major source of inflation in the Czech Republic. Since mid-1997 the factors which have helped to weaken inflationary pressures have come from both the demand and the supply sides. On the demand side, falling real incomes and growing uncertainties on the labour market[353] have led to reduced household expenditure.[354] Other components of domestic demand have also contracted mainly due to very high real lending rates, a problem emanating from the troubled and hesitant banking sector, and the tightening of fiscal policy after the exchange rate crisis of May 1997. On the supply side, cost pressures weakened considerably in 1998 thanks to weaker import prices, in national currency, for raw materials and food. Furthermore, in the first three quarters, there was also a relatively strong growth in labour productivity (5.4 per cent), which exceeded real product wage growth for the first time since the reforms started. However, in the last quarter, industrial production collapsed by 7 per cent and industrial labour cost pressures have started to increase.

In contrast, the expansive stance of fiscal policy continued in Slovakia in 1998, particularly before the September elections. However, as in recent years, the crucial factor behind the combination of relatively low inflation and a high growth rate in 1998 was again the employment of various price controls and a very slow pace of price deregulation. The dampening effect of an artificially strong Slovak koruna on import prices and a relatively tight monetary policy also helped the resumption of disinflation in 1998. However, after the elections, the central bank abolished the 7 per cent fluctuation band in October and allowed the Slovak koruna to float. The subsequent effective devaluation of the currency did not lead to a reversal of the downward trend in Slovak inflation in the closing months of 1998 thanks to a very tight monetary policy, which restrained both real wage growth,[355] and the removal of the import surcharge in October. The austerity package announced in January 1999, however, which includes a significant degree of price deregulation,[356] forecasts a year-on-year inflation rate in December of 10 per cent, up from 5.5 per cent in 1998. In January 1999, monthly inflation jumped to 3 per cent, a rate which may suggest that the government's inflation target is rather ambitious if further major increases in administered prices will be implemented as promised.

---

[350] In Bulgaria, the registered unemployment rate increased from 12.5 per cent at the end of 1996 to 13.7 per cent at the end of 1997 and then fell back to 12.2 per cent in December 1998. In Poland, for example, after seven years of high growth rates, the registered unemployment rate in December 1998 was still only 1.8 percentage points lower than in Bulgaria.

[351] In late 1997 the Czech central bank formulated a new "net" inflation indicator designed to screen out increases in regulated prices. In other words "net" inflation is that part of the price index which can be influenced by monetary policy, and since the beginning of 1998 this has been the measure used for inflation targeting. In July, due to the correction of energy prices and rents, the monthly rate of increase in the CPI was 1.9 per cent, but according to the net inflation index prices fell by 0.2 per cent. During the 12 months to December 1998, regulated prices increased by 20.4 per cent, accounting for 5.1 percentage points of the 6.8 per cent increase in consumer prices. Czech National Bank, *Monthly Bulletin*, No. 12 (Prague), 1998.

[352] On 15 January 1999, the Czech central bank cut interest rates for the eighth time since July 1998 in an attempt to stimulate growth and weaken the koruna.

---

[353] The Czech rate of unemployment, although still the lowest in eastern Europe, increased from 4 per cent in mid-1997 to 7.5 per cent in December 1998 (table 3.5.2).

[354] The volume of retail trade fell by 2 per cent in 1997 and almost 7 per cent in 1998; in 1996 there had been an increase of nearly 10 per cent (table 3.3.11).

[355] The new government lifted wage controls on 15 December 1998.

[356] Electricity prices were raised 30-35 per cent. Other items for which prices were increased include heating, water, sewage and fuels.

In Slovenia, where consumer prices continued to rise at around 9 per cent per annum during 1995-1997, the rate fell rapidly during 1998 and the *ex-ante* target was met, thanks to restrictive income policies, introduced in 1997, which somewhat checked wage increases in spite of strong union resistance.[357] Fiscal discipline was also maintained in 1998, while a strong tolar significantly alleviated external cost pressures and very high real interest rates kept domestic demand subdued.[358] However, as in Slovakia, the deregulation of controlled prices has been rather slow in Slovenia, although it has been precipitated recently in line with the preparations for the pre-accession negotiations with the EU. The introduction of VAT, because of its possible inflationary impact, has been delayed and will only be introduced in July 1999 under pressure from the EU to proceed with tax harmonization.[359] Also, complete price liberalization is due to be implemented by 2000, although the programme is still to be announced. These expected tax increases and the scale of price deregulation in Slovenia are bound to slow the disinflation process in 1999 unless there is a greater moderation in cost increases, and particularly in wage growth which is still increasing rather strongly in real terms in spite of the fact that Slovenian wage levels, in dollar terms, are still very high compared with other countries in the region.

Both in Hungary and Poland, consumer price inflation has been generally higher than in the other early reformers. Disinflation in both countries, however, was not interrupted in 1997 and it has continued in 1998, and even at a more rapid rate, particularly in Hungary where the year-on-year increase in December fell to 10.4 per cent, down from 18.5 per cent in 1997. In Poland the rate fell from 13.2 per cent in 1997 to 8.5 per cent in 1998, the first time it has been in single digits since the start of the reforms. In both countries, but particularly in Hungary, inflation for the year as a whole fell well below the initial targets set in early 1998 (14 per cent in Hungary and 9.5 per cent in Poland for the 12 months to December). In both countries prudent monetary policy and budgetary discipline combined with a carefully designed exchange rate policy and lower import prices all contributed to this favourable price performance. In contrast to most of the other transition economies, disinflation in Hungary and Poland has been achieved without either choking output or demand growth or by further worsening labour market conditions. However, the sustainability of lower inflation rates, supported by progress in reforms and strong growth,

may be more difficult in the near future given the recent weakening of industrial production, particularly in Poland, where economic growth has been one of the major factors behind significantly increased productivity and slower growth in unit labour costs despite slowing but still strong wage growth. In Hungary output growth has held up better than in Poland due to a stronger performance of both exports and domestic demand. In 1998 there was a sharp rise in household consumption, which had fallen precipitously in 1995-1996 and stagnated in 1997.[360] Real wage growth was moderate and real interest rates were high. This upswing in consumer demand can therefore be largely explained by rising consumer confidence emanating from the general improvement in the economic conditions of households, particularly employment.[361] However, a further weakening in exports and therefore of industrial production is likely to lead to a slowdown in measured productivity growth (assuming the usual lag in the employment response) and to an increase in unit labour costs in the short run. Furthermore, if the policy of a moderate depreciation of the real rate of the forint is maintained in 1999, in order to sustain export competitiveness, then the rate of disinflation might slow down unless commodity prices (mainly food and energy) remain weak, which is likely. The Hungarian budget assumes a 10-11 per cent annual average inflation rate in 1999, down from 14.2 per cent in 1998.

In Poland, the gradual slowdown in the economy gained considerable momentum during the last quarter of 1998[362] and the early months of 1999. Domestic demand is subdued, unemployment is rising, world commodity prices seem to remain weak. Furthermore fiscal policy is expected to be tighter and the Monetary Policy Council has adopted direct inflation targeting. Given all these factors, the central bank's inflation target of 8-8.5 per cent for 1999 seems to be easily in reach.

In the *Baltic countries* inflation rates continued to fall in 1998, for the fifth consecutive year. The average monthly rates in Latvia and particularly in Lithuania remain well below those in most of the east European countries and furthermore, in all three countries inflation in 1998 as a whole was well below the initial targets. The crucial factor in Latvia and in Lithuania has been a strong exchange rate which has further lowered both the material costs of production and the prices of imported consumer goods. In Latvia a prudent fiscal policy has also contributed to a subdued inflation rate despite relatively large increases in real wages and household spending.[363] Rapidly growing real wages, far in excess of productivity

---

[357] The Minimum Wage and Adjustment Act was activated in mid-1997 and will remain in force until mid-1999. Among other things, it shifts the indexation of wages from a quarterly to an annual basis, and reduces the compensation to 85 per cent of the annual change in the CPI. Furthermore, the increase in remuneration also takes into account productivity rises.

[358] Retail trade volume increased by 1.9 per cent (year-on-year) in January-December 1998 compared with 5.4 per cent in 1998 (table 3.3.11).

[359] Institute of Macroeconomic Analysis and Development, *Slovenian Economic Mirror*, No. 11, Vol. IV, December 1998.

[360] Retail trade fell by 1.4 per cent in 1997 and increased by 7.5 per cent in 1998 (table 3.3.11).

[361] Total employment increased by 2.4 per cent and by 5.1 per cent in industry in the first three quarters of 1998 (table 3.5.1).

[362] Industrial output fell by nearly 3 per cent in the fourth quarter of 1998.

[363] Retail trade volume in 1998 increased by more than 20 per cent (table 3.3.11).

growth, was also the major domestic inflationary pressure in Lithuania. However, cheap imports and probably sharply reduced profit margins pulled down the 12-month inflation rate to 2.4 per cent in December, one of the lowest rates among the transition economies. Cheap imports also eased price pressures in Estonia where the tightening of monetary policy in mid-1997 had already contributed to the cooling of the economy and the resumption of the downward trend in inflation. In fact, in Estonia, in contrast to the two other Baltic states (particularly Latvia), consumer demand weakened considerably throughout 1998.[364]

In most of the *CIS economies*, inflation either continued to slow down or prices actually fell during the first three quarters of 1998. However, in the months following the Russian financial crisis, inflation picked up again strongly in many of these economies. The major exception throughout the year was Belarus, where expansionary monetary and fiscal policies have been maintained also in 1998. Moreover, without a number of price controls, inflation in this economy would have been even higher.

The financial crisis in Russia had a major effect on consumer price inflation as a result of the rouble's collapse and initial panic buying. The monthly inflation rate in Russia averaged some 0.5 per cent during January-July, and the year-on-year inflation rate was down to 5.7 per cent in July; the year-on-year rate reached 52.4 per cent in September, and even though it slowed sharply during the last quarter the year-on-year increase in December was 84.5 per cent compared with 11 per cent a year earlier.

After the Bank of Russia allowed the rouble to float effectively on 17 August, its exchange rate fell sharply from some 6.2 roubles per dollar to 16.1 by the end of September. The rate of depreciation slowed considerably during the last quarter but still reached nearly 21 roubles per dollar at the end of 1998. At the end of July, the Russian government had already imposed a 3 per cent surcharge on imports and increased VAT on all imports from 8 per cent to 20 per cent. Import prices therefore increased sharply. However, the actual impact of these increases on consumers is difficult to judge given the large fall in real incomes as well as the huge wage arrears which have probably forced consumers to change drastically the structure of their consumption baskets. Anecdotal evidence suggests that subsistence food consumption and the rate of substitution of cheaper domestic products for expensive imports have increased.

In addition to a severely restrictive monetary policy, a rigid exchange rate regime was a crucial tool of the Russian government in its pursuit of an overambitious price stabilization policy. Now that the rouble and the

output have collapsed[365] and the domestic banking system is in disarray, the present government is mainly concerned with solving day-to-day economic problems. Nevertheless, the monthly inflation rate in January and February fell to 8.5 per cent and 4.1 per cent, respectively, compared with 11.6 per cent in December.[366] However, this deceleration reflects, *inter alia*, the continuing fall in demand, increased import substitution and stabilization of the rouble since January.[367]

General macroeconomic instability and intense pressure on the exchange rate were already evident in some of the CIS countries in the first half of 1998. This was particularly true for Ukraine. The hryvnia was effectively devalued in September and its value fell by over 50 per cent against the dollar between mid-August and end-December despite the imposition of exchange controls. After achieving virtual price stability between January and August, the consumer price index climbed by more than 4 per cent a month during the rest of 1998 and the year-on-year increase in December was 20 per cent compared with some 7 per cent in August. There has also been a reversal of recent near price stability in the Republic of Moldova. At the beginning of November, the central bank stopped supporting the leu and its value fell from 6.4 per dollar to 10 per dollar. In most of the other CIS countries where Russia accounts for an important part of their trade turnover, there have been similarly large depreciations and hence some reversal of their recent low inflation rates can be expected.

(b) Components of CPI

Within the consumer price index, *food prices* in 1998 (table 3.4.1) declined or stagnated in many of the transition economies, thanks to falls in the prices of domestic produce during the summer and particularly to sharply lower import prices.[368] However, in those CIS countries where there was strong currency depreciation, food prices also rose sharply. *Non-food goods prices* either fell or increased slightly in many of the transition economies, reflecting cheaper industrial raw material and intermediary goods combined with falling import prices of finished consumer goods.[369] In some countries, there was also the disinflationary effect of weaker consumer demand. The *prices of services* in 1998 were again the fastest rising component of consumer prices in all the

_____

[364] Retail trade volume in 1998 shrank by nearly 3 per cent (table 3.3.11).

[365] In real terms the rouble depreciated by 292 per cent (CPI) and 430.5 per cent (PPI) against the dollar.

[366] The substantial increase in domestic prices in December was largely a lagged response to the considerable effective extra emission by the Russian central bank as it extended credit to commercial banking structures in August and September.

[367] Ministry of Economics, "Report on the current economic situation and forecast for the first quarter 1999", *Russian National News Service* (Moscow), 2 March 1999 (internet website).

[368] During 1998, world market prices for food, as measured by the HWWA Index, fell more than 16 per cent in dollar terms (sect. 2.1).

[369] Developed market economies' export unit values for manufactured goods in dollar terms fell in the first three quarters of 1998 by 3 per cent, after falling 6.6 per cent in 1997.

transition economies except Belarus, Russia and Ukraine. Apart from this sector's relatively slower productivity growth and lower exposure to import competition, the major contribution to relatively higher, and often still accelerating, service price inflation is often coming from adjustments to administered or controlled prices, most of which are concentrated in this sector and include rents, utilities, transport, health, education, etc.

(c)   Relative price changes within CPI, 1995-1998

Chart 3.4.1 shows the cumulative monthly rates of change in the three components of the CPI, namely food, non-food goods and service prices since the beginning of 1995 in selected transition economies. In the majority of the countries, food prices fluctuated more but increased more slowly than the other two components and pulled down the overall index, particularly in the Czech Republic, Hungary, Poland and the Baltic states. On the other hand, service prices, which have also fluctuated, often increased more rapidly than the other two components of the CPI. The extreme case is the CIS countries where service prices have increased at least twice as fast as the rest of the index since the beginning of 1995. In Russia, this differential narrowed sharply after the collapse of the rouble in August as the prices of both food and non-food goods surged by more than 80 per cent between September and December. The relative price changes compared with eastern Europe were also more significant in the Baltic states, which may partly reflect their relatively late start in the reform process and hence the larger relative price corrections required and undertaken for service prices. Furthermore, their exchange rates were more stable (currency board and fixed exchange rates) and appreciated significantly in real terms which dampened the imported inflation pressure on food and non-food goods prices.

Among the east European countries, the four-year cumulative rate of change in service prices was similar to that of non-food goods prices only in Hungary and Slovakia. This negligible relative price change in Slovakia, however, reflects the very slow pace of liberalization of controlled or administered prices which, in fact, is one of the major problems the economy faces in sustaining its artificially low inflation rate and overall macroeconomic stability in the near future. Whereas in Hungary, although at much higher rates of increase, the small relative price change within the consumer price index during the last four years is partly due to the fact that a large-scale correction of service prices took place during the early years of transition.[370] Secondly, the Hungarian economy started the transition process with a more developed service sector and a less distorted price

structure thanks to the gradual market reforms which had already started in the 1980s.[371]

(d)   Rents

One of the major service prices in the CPI basket, which has remained under widespread administrative control is *rent*, which in the early stages of the transition was considered as an element of the social safety net[372] and was typically set even below maintenance costs.

During the communist era the state was responsible for the housing system. Access to housing was usually controlled by local housing authorities and distribution was carried out according to needs and not incomes. Since the 1970s, mainly due to intensified internal migration (i.e. rural to urban), chronic shortages and "hidden homelessness"[373] has increased sharply in the urban areas. Therefore some governments expanded the share of the "market sector" by permitting cooperatives and individuals to provide housing for their own consumption, although the state retained control over access to and exchange of housing.[374] However, the subsidies allocated to owner-occupied housing, in order to cover the difference between the negligible house prices and their actual costs (including mortgages), grew constantly and their share in many government budgets exceeded 10 per cent.[375] On the other hand, rents were artificially low and being a tenant was even more attractive than being a homeowner, who still had to bear all the maintenance costs. This tenure structure, i.e. a polarization between public renting (state controlled housing) vis-à-vis subsidized home ownership, and a virtually non-existent private rental sector, was one of the major characteristics of the communist era.

[371] V. Koen and P. De Masi, *Prices in the Transition: Ten Stylized Facts*, IMF Working Paper WP/97/158 (Washington, D.C.), November 1997.

[372] For example see R. Buckley and E. Gurenko, "Housing and income distribution in Russia: Zhivago's legacy", *The World Bank Research Observer*, Vol. 12, No. 1 (Washington, D.C.), February 1997, pp. 19-32, where the authors conclude that "... the distribution of housing in Soviet Russia reduced income inequality and provided a strong cushion against the consequences of the transition ... when the imputed value of housing is added to household income, the increase in income inequality that occurred in recent years is significantly reduced ...". See also B. Renaud, "The real estate economy and the design of Russian housing reforms, Part I (and Part 2)", *Urban Studies,* Vol. 32, No. 8 (and No. 9) (Abingdon), 1995, where both the social (safety net) and economic (for example, resource/asset allocation, incentives, new investments, labour market mobility and overall success of the reform process) effects of voluntary privatization of the housing stock, at nominal cost or free in Russia, is analysed.

[373] Sharing accommodation with parents, relatives, etc.

[374] For an extended discussion on the trends and transformation of the housing sector in transition economies see, UN/ECE, *Human Settlement Trends in Central and Eastern Europe* (United Nations publication, Sales No. E.97.II.E.11) and also J. Huttman, "Housing allocation, tenure and mobility in eastern Europe", *Urban Law and Policy*, No. 9, 1988, pp. 277-294.

[375] J. Hegedüs, S. Mayo and I. Tosics, *Transition of the Housing Sector in the East-Central European Countries* (Metropolitan Research Institute, Budapest, 1996).

[370] "By 1993 more than 90 per cent of prices, weighted by their share in the consumption basket, had been freed of administrative controls", R. Moghadam, R. van Elkan, E. Ruggiero and P. Perone, *Hungary. Selected Issues*, IMF, 22 August 1997, p. 9.

CHART 3.4.1

Consumer prices of food, non-food goods and services in selected transition economies, 1995-1998
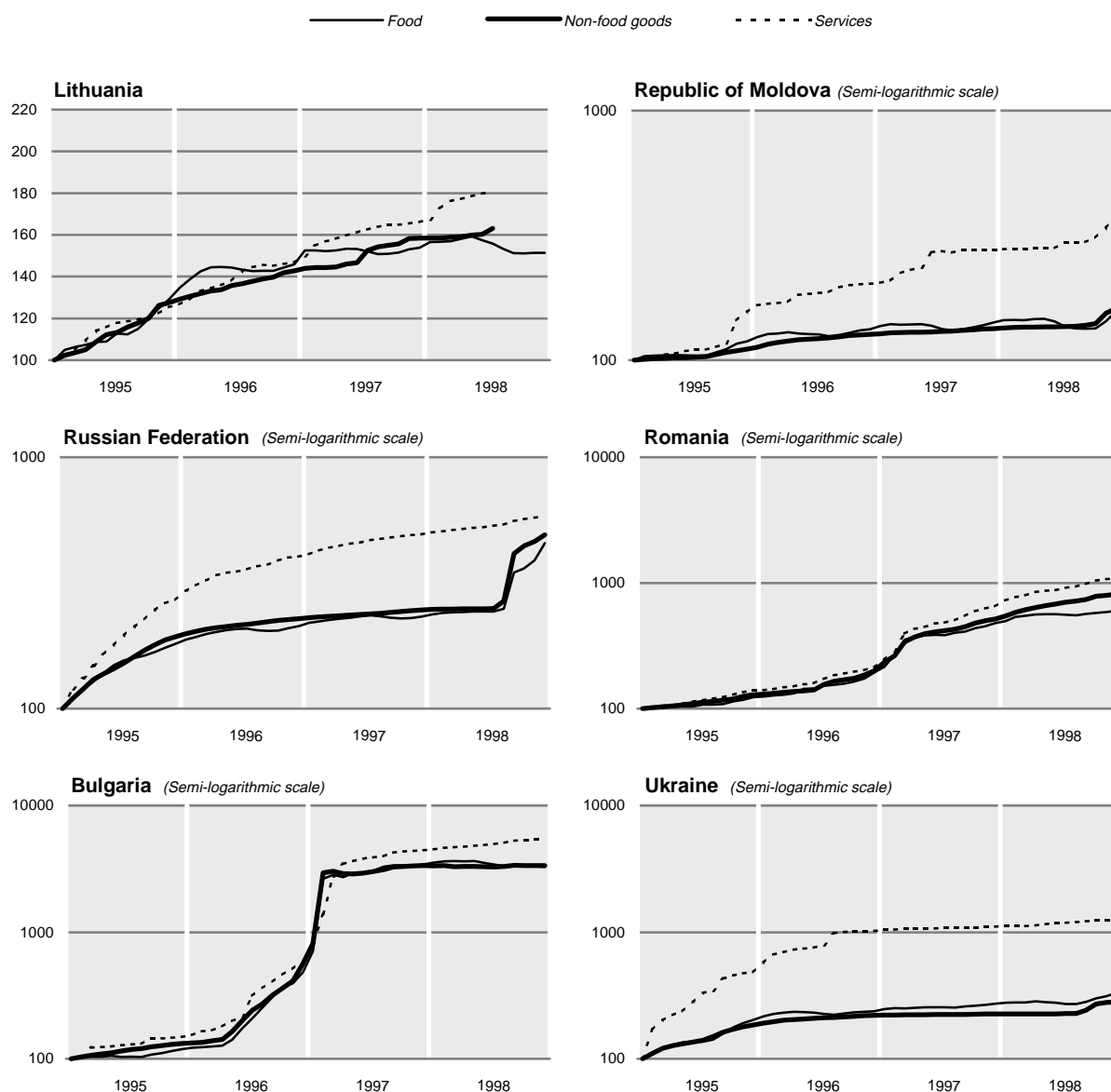*(Indices, January 1995=100)*

——— *Food*　　　——— *Non-food goods*　　　- - - - *Services*
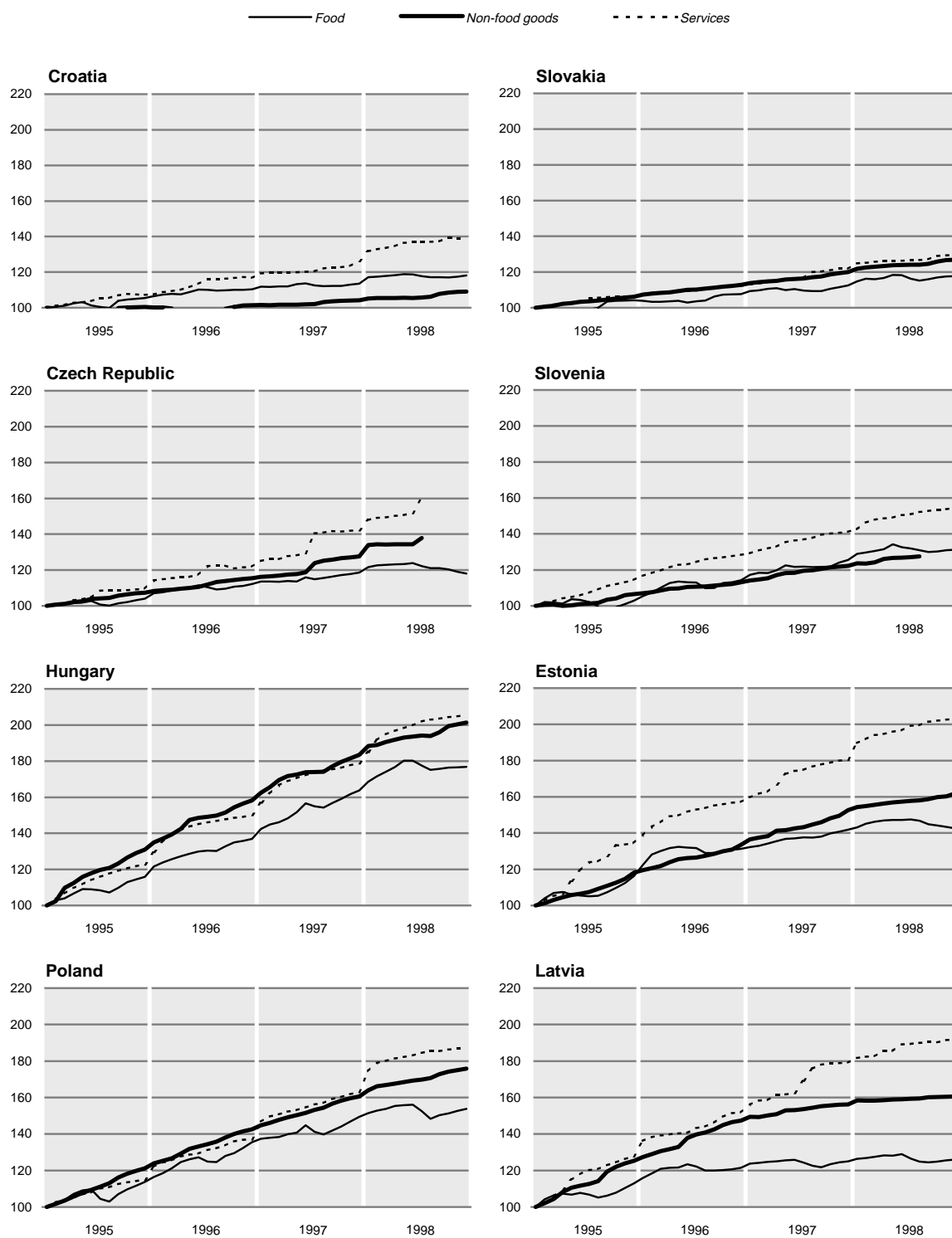
(For source see end of chart.)

CHART 3.4.1 (concluded)

Consumer prices of food, non-food goods and services in selected transition economies, 1995-1998
(Indices, January 1995=100)

——— *Food* ——— *Non-food goods* - - - - *Services*

Lithuania

Republic of Moldova *(Semi-logarithmic scale)*

Russian Federation *(Semi-logarithmic scale)*

Romania *(Semi-logarithmic scale)*

Bulgaria *(Semi-logarithmic scale)*

Ukraine *(Semi-logarithmic scale)*

Source: National statistics.

After 1989, various market oriented reforms were carried out to transform the housing sector, such as large-scale privatization of public housing (usually by transferring ownership to the occupants and often at nominal fees), the reduction and restructuring of subsidies, etc.[376] The share of owner-occupied housing in some countries increased sharply. In the mid-1990s it reached some 90 per cent or above in Albania, Bulgaria, Croatia, Hungary, Slovenia, Romania and Lithuania.[377] On the other hand, the public or semi-public rental sector

_____

[376] For example in Russia, the law "On Privatization of the RSFSR Housing Stock" passed by the Supreme Soviet in June 1991 which mandated the privatization of state owned rental units to registered tenants. However, most tenants refused the offer in order not to be liable for full maintenance and communal service costs, which have in fact increased frequently after 1992. By the end of 1996 about 55 per cent of the total housing stock (including the rural areas) was in private ownership, up from 33 per cent in 1990. R. Struyk, A. Puzanov and L. Lee, "Monitoring Russia's experience with housing allowances", *Urban Studies*, Vol. 34, No.

11 (Abingdon), 1997, pp. 1798-1818. Since early 1997 the Russian government has increasingly focused on housing reform which calls for, *inter alia*, gradual reduction of housing subsidies (for which both owners and tenants of privatized apartments are eligible), "with the goal of 100 per cent cost recovery by 2003 ... cost recovery has increased from less than 2 per cent in 1993 to about 30 per cent by late 1997". A. Guzanova, "The Housing Market in the Russian Federation: Privatization and its Implications for Market Development", World Bank Working Paper Series, No. 1891 (Washington D.C), December 1997.

[377] For example in Hungary, housing subsidies as a percentage of GDP fell from 6 per cent in 1989 to less than 2 per cent in 1994, UN/ECE, *Human Settlement Trends ...*, op. cit, p. 40.

remained large in others (the Czech Republic, Slovakia, Estonia, Latvia and Russia), as remaining a state tenant was still economically more attractive than being an owner.[378] However, the private rental market remained limited everywhere, mainly due to continued control of some rents (e.g. on those units obtained through restitution but with the old tenants as occupants) and/or punitive taxes.[379] Nevertheless, over time rents have been raised significantly to finance the upkeep. Table 3.4.2 shows that in most of the countries for which there are data, rent increased faster than the total CPI between 1990 and 1997, particularly in Latvia (more than five times) and Poland (more than double). Rents increased less than the overall rate of consumer price inflation only in Romania and, to a much lesser extent, in Hungary.

Even though rents were adjusted fairly frequently and usually rose faster than the overall consumer price index, their share in the consumption basket remained very low, and even declined between 1990 and 1997 in Hungary, where it was due to the rapid privatization of public rental units.[380] One general major reason for this very low share of rent in the consumer price basket is that there are no imputed estimates for the rental equivalent of owner-occupied housing in these countries. A second reason is that public rents are still very low, and therefore their share in total expenditure remain insignificant. And thirdly, the growing but still limited private rents are, to a considerable extent, either not declared or remain controlled.

In fact, due to explicit or implicit subsidies and other price distortions (such as controls), the weights in the CPIs in most transition economies do not accurately reflect the relative importance of certain sectors.[381] Expenditure on rent is one of these major items, if not the most important, in the CPI index and one that distorts the measurement of inflation both over time and across

TABLE 3.4.2

Relative rent changes within the consumer price index in selected transition economies, 1990-1997
(Percentages)

	CPI 1997 1990=100		Weight of rent		Relative rent change [a]
	Total	Rent	1990	1997	
Czech Republic [b]............	297.8	444.2	..	1.7	49.16
Hungary	453.0	383.9	1	0.3	-15.26
Poland	745.6	1 564.2	2.1	3.5	109.78
Romania	19 943.7	1 330.4	..	..	-93.33
Slovakia [c]	272.2	280.0	..	..	2.85
Slovenia	1 446.9	2 150.1	..	..	48.60
Latvia [d]	13 016.6	67 692.8	..	1.1	420.05
Russian Federation [e].......	327 452.1	602 222.0	..	..	83.90

Source: National sources and UN/ECE secretariat estimates.

a Relative rent change is calculated as: $[(r \div p) - 1] * 100$, where r is the rent index and p is the total CPI in 1997, with 1990=100.

b Net rent for rental flats set by the Ministry of Finance. Czech National Bank, *Monthly Bulletin*, No. 1 (Prague), 1998.

c 1995.

d Weight of rent: 1995.

e 1991=100; change in rent estimated by the change in "roubles per square metre of communal housing".

countries. Furthermore rents remain one of the major elements of "postponed inflation" in some of these countries, such as Slovakia, where rent controls and housing subsidies are still high. In addition, the artificially low rents in some countries, which do not even cover the maintenance costs, do not only increase the fiscal burden but also act as a disincentive to renovate housing and invest in new real estate, the lack of which is particularly important in reducing labour mobility. On the other hand, as mentioned above, these controls and subsidies, in some countries, still provide an in-kind social safety net and thus are an important element of the social cohesion needed to support the reforms.

(e) Inflation-output growth relationship

Many of the transition economies have succeeded in rapidly lowering their inflation rates from very high to moderate levels of about 20-40 per cent per annum.[382] However to reduce inflation further to one-digit annual rates has proved to be difficult in most countries. The persistence of inflation at so-called "moderate" rates cannot be easily explained by standard theories, such as insufficiently tight macroeconomic policies or excessive wage pressures,[383] because a large part of this inflation is caused by conditions peculiar to transition economies, such as the prolonged adjustment of relative prices,

_____

[378] Ibid, p. 46; and UN/ECE, *Trends in Europe and North America, 1996-1997* (United Nations publication, Sales No. E.97.II.E.5), p. 136. These shares are extremely high compared with the west, e.g. some 40 per cent in Germany, 50 per cent in Austria, etc. Nevertheless, before the reforms started, private ownership was already advanced in some countries. For example, in Bulgaria, the state sector accounted for only 9 per cent, in Hungary 20 per cent, in Poland 35 per cent and in Czechoslovakia 45 per cent. P. Baross and R. Struyk, "Housing in transition in eastern Europe: progress and problems", *Cities*, Vol. 10, No. 3, 1993, pp. 179-188.

[379] These taxes on rent income are one of the reasons also for underreporting, which introduces a downward bias for overall rent expenditure in household budgets.

[380] "On 1 January 1990, there were 721,000 dwellings in public ownership, 18.7 per cent of the housing stock. In 1995, 500,000 rental dwellings had been sold, approximately 69 per cent of the number of 1990 public dwellings". Z. Daniel, "The paradox in the privatization of Hungary's public housing: a national gift or a bad bargain?", *Economics of Transition*, Vol. 5 No. 1 (Oxford), 1997, pp. 147-170.

[381] For a detailed discussion of the statistical problems involved in the analysis of inflation and the measurement of relative price variability see S. Coorey, M. Mecagni and E. Offerdal, "Designing disinflation programs in transition economies: the implications of relative price adjustment", *IMF Papers on Policy Analysis and Assessment*, PPAA/97/1 (Washington, D.C.), February 1997.

_____

[382] For example, all of the early reformers had lowered inflation to moderate rates, albeit at varying rates of deceleration, by 1993 and the Baltics by 1995, from triple-digit (or near triple-digit) rates in 1989-1990 and 1992-1993, respectively.

[383] R. Dornbusch and S. Fischer, "Moderate inflation", *The World Bank Economic Review*, No. 7 (Washington, D.C.), 1993, pp. 1-44.

CHART 3.4.2

Average annual rate of change in GDP and consumer prices in selected transition economies, 1993-1998 [a]

(Percentages)
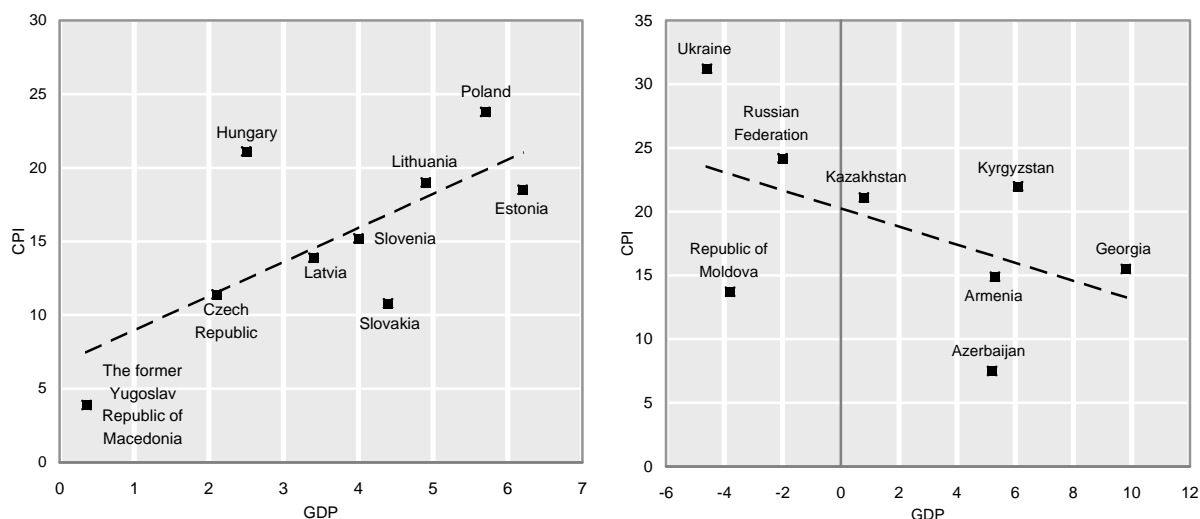
which cannot be influenced by the standard instruments of monetary policy. Even though a low inflation environment usually improves resource allocation and, *ceteris paribus*,[384] stimulates growth,[385] very rapid disinflation, at relatively low or moderate initial inflation rates may involve high costs in terms of lost growth in output. This may be especially true in a transition economy where large relative price adjustments are still needed in order to improve market mechanisms and which in turn are major conditions for sustaining macroeconomic stability, growth in fixed investment and in potential output and, eventually, increasing employment in a market economy.

The transition economies can be divided roughly into two major groups according to their choice or trade-off between a rapid achievement of low inflation at a high cost in lost output growth (most of the CIS) and acceptance of a gradual rate of disinflation, to accommodate the necessary changes in relative prices[386]

and sustain a relatively high growth rate (many of the advanced reformers).[387]

Chart 3.4.2 plots the average annual rates of change in the CPI against the growth in GDP in transition economies where the average annual inflation rates were around 30 per cent or below. The panel on the left supports the proposition of a positive correlation between moderate inflation rates and GDP growth in the east

_____

[384] There are, of course, other determinants of growth which may influence the relationship between disinflation and growth, such as the level of physical and human capital, the level and distribution of income, etc.

[385] For example see M. Bruno and W. Easterly "Inflation crises and long-run growth", *NBER Working Paper*, No. 5209 (Cambridge, MA), 1995, where the authors show that at very high initial inflation rates, growth resumes almost immediately after disinflation.

[386] Nevertheless, an increase in relative price changes (i.e. a greater variance) does not necessarily lead to a rise in inflation, if price increases in some goods (such as some services) are offset by price declines in others (such as food and some manufactures), as was the case in 1997-1998 in most of these economies.

[387] The IMF paper by S. Coorey, M. Mecagni and E. Offerdal, op. cit., empirically examined for a group of 21 transition economies between 1990 and 1995, the question of "whether the achievement of low inflation has been constrained by the adjustment of relative prices – a necessary aspect of the transition to a market economy – or whether inflation in these economies results only from the traditional factors of insufficiently tight financial policies and wage pressures". One of the key findings is that relative price adjustments continue, even in those countries that have undertaken comprehensive initial price liberalization, not only because of gradual adjustment of controlled prices of certain capital intensive, nontradeable prices, such as housing and utilities ("cost-recovery hypothesis") but also due to the changing composition of output and demand associated with the gradual movement towards a market economy. The "relative price variability has a statistically significant impact on inflation ... more than in the case of other explanatory variables" such as nominal wage growth. A more recent study, based on data from 145 countries, over the period 1960-1996, explored the bivariate relationship between inflation and growth and tried to answer the question "If inflation is bad for growth, is disinflation good?" The answer is "not necessarily". However, according to the statistical results of this study, it is only when the initial level of inflation is below 10 per cent that severe disinflations (at least a halving of the annual rate of inflation) are associated with a fall in GDP growth, at least in the short run. At all other inflation rates the results suggest a statistically and economically significant negative relationship between inflation and growth. However, the authors conclude, "exactly how far this negative relationship extends remains an open and difficult question", as relatively more moderate disinflations are also associated with higher GDP growth, depending on the initial level within the moderate inflation limits.

European and Baltic countries.[388]   All of these countries have combined relatively uninterrupted rates of output growth and of disinflation during the 1993-1998 period. Furthermore, the higher the average inflation rate, the higher was the average growth in GDP, the main exceptions being Hungary and Slovakia. In Hungary this reflects the sharp slowdown in GDP in 1995-1996 following the launching of the stabilization programme in March 1995. Whereas in Slovakia it reflects mainly the suppressed inflation which has resulted from postponing the deregulation of administered prices.

The right-hand panel in chart 3.4.2 plots the same relationship in the CIS countries: it displays an obviously larger variance but nevertheless it tends to support a negative correlation between the average inflation rate and output growth. In these countries disinflation was generally much faster than in eastern Europe between 1996 and the first half of 1998, and output growth was significantly lower, even declining (except in a few countries where there was significant growth in a few primary commodities such as cotton, metal mining, oil, gas, etc.). This part of the chart, and bearing the above qualifications in mind, shows that although low inflation is generally better for growth, it is not enough to ensure it;[389] on the contrary, a too rapid rate of disinflation may distort the functioning of both the capital and product markets, thus hampering growth and, eventually, macroeconomic stability itself, an outcome which was clearly demonstrated during 1998 by the Russian crisis and its spillover effects in the region.

(iii) Producer prices in industry

The rate of increase in industrial producer prices (PPI) also fell in 1998 (table 3.4.3), in the main reflecting cheaper imported raw materials and intermediate products and a squeeze on profit margins due to intensified competition. Compared with 1997, not only did the deceleration in producer prices gain significant momentum in many of the east European economies in 1998 but it was also much more general (the only exception was Yugoslavia).   In the Baltic countries producer prices actually fell markedly in Lithuania. In contrast, in many CIS economies producer price inflation picked up strongly in the second half of 1998 due to falls in productivity and exchange rate depreciation, and the 12-month rate in December was higher than a year earlier.

Producer price inflation, which is a rough indicator of production cost pressures in the economy, was higher

---

TABLE 3.4.3

Producer prices in industry [a] **in the transition economies, 1997-1998**
(Percentage change)

	Annual average		December over December	
	1997	*1998*	*1997*	*1998*
Bosnia and Herzegovina	3.2	3.6	9.2	9.0
Bulgaria	888.1	22.8	443.3	4.3
Croatia	3.7	-1.5	2.9	-2.1
Czech Republic	5.1	4.9	5.7	2.2
Hungary	20.9	11.4	19.4	7.1
Poland	12.2	7.2	11.3	4.9
Romania	150.5	33.6	143.8	20.0
Slovakia	4.6	3.3	4.6	1.5
Slovenia	6.1	6.0	6.8	3.6
The former Yugoslav Republic of Macedonia	3.8	4.6	8.5	-0.2
Yugoslavia	20.6	25.9	10.6	41.3
Estonia	8.8	3.8	7.7	-0.3
Latvia	4.3	2.0	3.8	-1.9
Lithuania	6.0	-3.8	0.9	-8.2
Armenia	21.7	4.7	19.2	3.4
Azerbaijan	11.4	-5.5	2.5	-8.4
Belarus	89.4	70.4	90.9	197.7
Georgia	..	2.0	..	3.7
Kazakhstan	15.6	1.0	11.7	-5.2
Kyrgyzstan	27.0	9.4	5.3	26.4
Republic of Moldova	14.9	9.7	13.6	13.6
Russian Federation	15.0	7.3	7.4	23.6
Tajikistan	107.2	28.4	133.2	5.9
Turkmenistan	260.6	-30.5	22.1	6.6
Ukraine	15.1	13.2	5.0	35.4
Uzbekistan.....................................	53.9	40.5	37.1	48.9

Source: UN/ECE secretariat estimates, based on national statistics.

a Industry = mining + manufacturing + utilities.

---

than the increase in consumer prices in most of the transition economies in 1997, but in 1998 the pattern was reversed as a result of upward pressure on consumer prices from new taxes and above all by the faster rate of deregulation of controlled prices of services.

(iv) Wages, unit labour costs and profit margins in industry

(a) 1998

Nominal wage growth in industry, which affects both consumer demand and the cost of production, decelerated in the first three quarters of 1998 throughout eastern Europe and the Baltic countries, except Croatia and Yugoslavia (table 3.4.4).   However, the rate of increase remained high and in some economies largely outpaced producer price inflation.

Real product wage growth,[390] thus remained high or even accelerated, particularly in Croatia and the three Baltic countries. The main exceptions were the Czech

---

[388] The chart allows for differences in the time at which the reforms, and thus the disinflation process, started.

[389] This has been recently supported by various studies. For example, see L. Valdivieso, *Macroeconomic Developments in the Baltics, Russia and Other Countries of the Former Soviet Union, 1992-1997*, IMF Occasional Paper, No. 175 (Washington, D.C.), 1988. The author emphasizes that to ensure growth these countries must reduce the structural weaknesses (mainly current account and/or fiscal deficits) that underlie their macroeconomic imbalances.

[390] Change in average nominal gross wages in industry deflated by the producer price index. *Ceteris paribus*, real product wage growth measures the wage pressure on producer prices.

Wages and unit labour costs in industry [a] **in the transition economies, 1997-1998**

(Annual average percentage change)

	Nominal wages [b]		Real product wages [c]		Labour productivity [d]		Unit labour costs [e]		Real unit labour costs [f]	
	1997	1998 [g]	1997	1998 [g]	1997	1998 [h]	1997	1998	1997	1998
Albania	..	..	..	..	-8.8	..	..	..	..	..
Bosnia and Herzegovina	49.2	34.3	44.6	29.7	11.3	7.7	34.0	24.8	29.9	20.4
Bulgaria	980.9	26.6	9.4	-2.9	-6.4	..	1 054.7	..	16.9	..
Croatia	10.4	13.1	6.5	14.4	11.2	9.2	-0.7	3.6	-4.2	4.8
Czech Republic	12.4	10.3	6.9	5.1	5.6	2.1	6.4	8.0	1.3	2.9
Hungary	21.6	17.0	0.6	4.4	9.3	7.6	11.3	8.7	-7.9	-3.0
Poland	20.0	14.9	7.0	7.2	11.2	5.8	7.9	8.7	-3.8	1.4
Romania	100.1	55.1	-20.1	16.1	-4.9	-12.2	110.3	76.6	-16.0	32.2
Slovakia	9.3	8.7	4.5	5.2	3.7	9.0	5.4	-0.3	0.7	-3.5
Slovenia	12.0	10.8	5.5	4.6	5.5	4.7	6.2	5.8	–	-0.2
The former Yugoslav Republic of Macedonia	2.3	..	-1.8	..	10.0	8.5	-6.9	..	-10.7	..
Yugoslavia	22.0	31.4	1.2	8.6	13.0	6.5	8.0	23.4	-10.5	2.0
Estonia	19.6	17.0	10.0	11.4	20.3	4.1	-0.6	12.4	-8.6	7.0
Latvia	18.7	18.0	13.8	15.7	10.0	1.0	7.9	16.8	3.5	14.6
Lithuania	23.8	13.1	16.8	17.6	3.3	9.7	19.8	3.0	13.0	7.1
Armenia	21.3	36.6	-0.3	27.1	12.4	1.4	7.9	34.7	-11.3	25.4
Azerbaijan	42.5	38.3	27.9	46.4	17.3	13.6	21.5	21.8	9.1	28.9
Belarus	87.5	104.5	-1.0	20.0	18.6	10.5	58.1	85.1	-16.5	8.6
Georgia	..	..	..	..	40.8	..	..	..	..	..
Kazakhstan	25.5	15.2	8.6	12.0	18.0	3.0	6.4	11.9	-7.9	8.8
Kyrgyzstan	27.1	25.0	–	14.3	60.2	5.6	-20.7	18.4	-37.6	8.2
Republic of Moldova	9.4	25.3	-4.8	14.3	2.4	-9.6	6.9	38.6	-7.0	26.5
Russian Federation	19.8	13.6	4.2	5.9	12.1	-3.9	6.9	18.2	-7.1	10.2
Tajikistan	76.3	79.5	-14.9	39.7	13.0	9.8	56.0	63.4	-24.7	27.2
Turkmenistan	214.5	47.7	-12.8	112.5	-38.1	..	408.0	..	40.9	..
Ukraine	16.5	7.6	1.2	-4.9	8.9	2.9	6.9	4.6	-7.1	-7.6
Uzbekistan	69.3	47.3	10.0	7.1	3.9	4.9	62.9	40.3	5.9	2.1

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

[a] Industry = mining + manufacturing + utilities.

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

[g] January-September 1998 over January-September 1997, except in Poland, Romania, Slovakia, Lithuania, Belarus, Kyrgyzstan and the Russian Federation.

[h] Estimated on the basis of January-December output data and January-September employment data.

Republic and Slovenia where the downward trend that started in 1997 accelerated, and Bulgaria where they actually fell by nearly 3 per cent. In the Czech Republic the deceleration both in nominal and real wage growth in 1998 was a consequence of tighter monetary policy and the wage freeze in the government sector. In Slovenia, restrictive income policies, introduced in 1997, kept nominal and particularly real wage growth subdued.

Real product wage growth in 1998, as in 1997, remained in double digits in all three Baltic economies and remains a major domestic source of inflationary pressure in these economies. It is not only damaging their export competitiveness during a period of already faltering demand, but also their enterprise profitability,

which in the medium term can lead to a sharply lower growth of investment and thus hinder restructuring.

In most of the CIS countries, compared to the majority of east European and Baltic economies, nominal wage growth in 1998 remained considerably higher, or even accelerated, compared with 1997 (except in Kazakhstan, the Russian Federation and Ukraine). Furthermore, given the significant fall in producer price inflation, real product wages, which had still been declining in 1997 in many of these countries, generally rose sharply; the exceptions are Ukraine where they actually fell and Russia and Uzbekistan where the rate remained in single digits. However, given the huge wage arrears in most of the CIS economies, these data should

not be taken as indicating any more than the possible orders of magnitude of industrial wage pressure in some of these countries. In addition, producer price inflation picked up sharply in some of them during the fourth quarter, following the exchange rate crisis, which had a significant dampening effect on real product wages in the same quarter.

In many of the east European and Baltic economies *measured labour productivity growth* slowed down significantly in 1998. The main exceptions were Slovakia and especially Lithuania, where it increased at almost double-digit rates, in spite of the slowdown in the fourth quarter. Also in Croatia and The former Yugoslav Republic of Macedonia, albeit less than in 1997, productivity gains in 1998 were still significant (some 9 per cent). After Slovakia, the largest gain in labour productivity in 1998 among the early reformers was in Hungary. However, while in Slovakia this partly reflected a 4 per cent decline in the industrial work force, in Hungary the large increase in industrial production (12.6 per cent) was distributed between gains in both productivity and increased employment in industry, 7.5 and 5.5 per cent, respectively. The growth of industrial employment in Hungary had already started in 1997 but accelerated in 1998 in the wake of a combination of strong growth in fixed investments and an intensification of enterprise restructuring since 1995. However, by end 1998, the level of industrial employment in Hungary was still one third below its pre-reform level.

In Poland, measured labour productivity in industry, which started to improve in late 1991 and then increased rapidly until early 1998, slowed sharply during the second and third quarters and actually fell in the last quarter, when there was a 1.5 per cent fall in industrial production. Nevertheless, labour productivity in Poland at the end of 1998 was nearly double its level in 1991**.** This was the result of a persistently high rate of growth of output supported by a strong recovery in fixed investment rather than through the continued shedding of labour, which had been the case in the very early stages of the reform process. In December 1998, employment in industry was only 2 per cent less than in 1992 and one quarter below its pre-reform level. At the end of 1998, measured industrial labour productivity both in Hungary and Poland was nearly 60 per cent above its pre-reform level.

In the Czech Republic the weakening growth of industrial production, which actually fell by some 7 per cent in the last quarter, wiped out nearly three quarters of the productivity gains during the first half of the year. At 2 per cent, it was the lowest rate of productivity growth in eastern Europe. In Slovenia also, productivity gains slowed down during the fourth quarter, although by much less than in the Czech Republic, and the increase for the year as a whole remained at a little below 5 per cent, compared with 5.5 per cent in 1997.

Among the Baltic countries, labour productivity growth in industry during 1998 only accelerated in Lithuania, mainly due to a significant pick-up in energy production and a sharp fall of employment in other branches. In the other two Baltic states, there was a marked slowdown in productivity gains as a result of the collapse of output growth in the second half of the year. Nevertheless, despite the general slowdown in productivity growth in 1998, it was only in Romania where it actually fell, and by even more than in 1997 (12 per cent compared with 5 per cent). Industrial labour productivity probably also fell in Bulgaria in 1998 given the decline in industrial production, particularly during the first half of the year.

Productivity growth slowed down considerably in most of the CIS countries in 1998, particularly during the second half, reflecting the marked deterioration in their industrial production performance. The slowdown was particularly significant where competitive currency devaluations led to very large increases in the prices of necessary industrial raw material imports. It was only in Uzbekistan where productivity gains improved, albeit slightly, and mainly a reflection of relatively robust output growth in the energy sector.
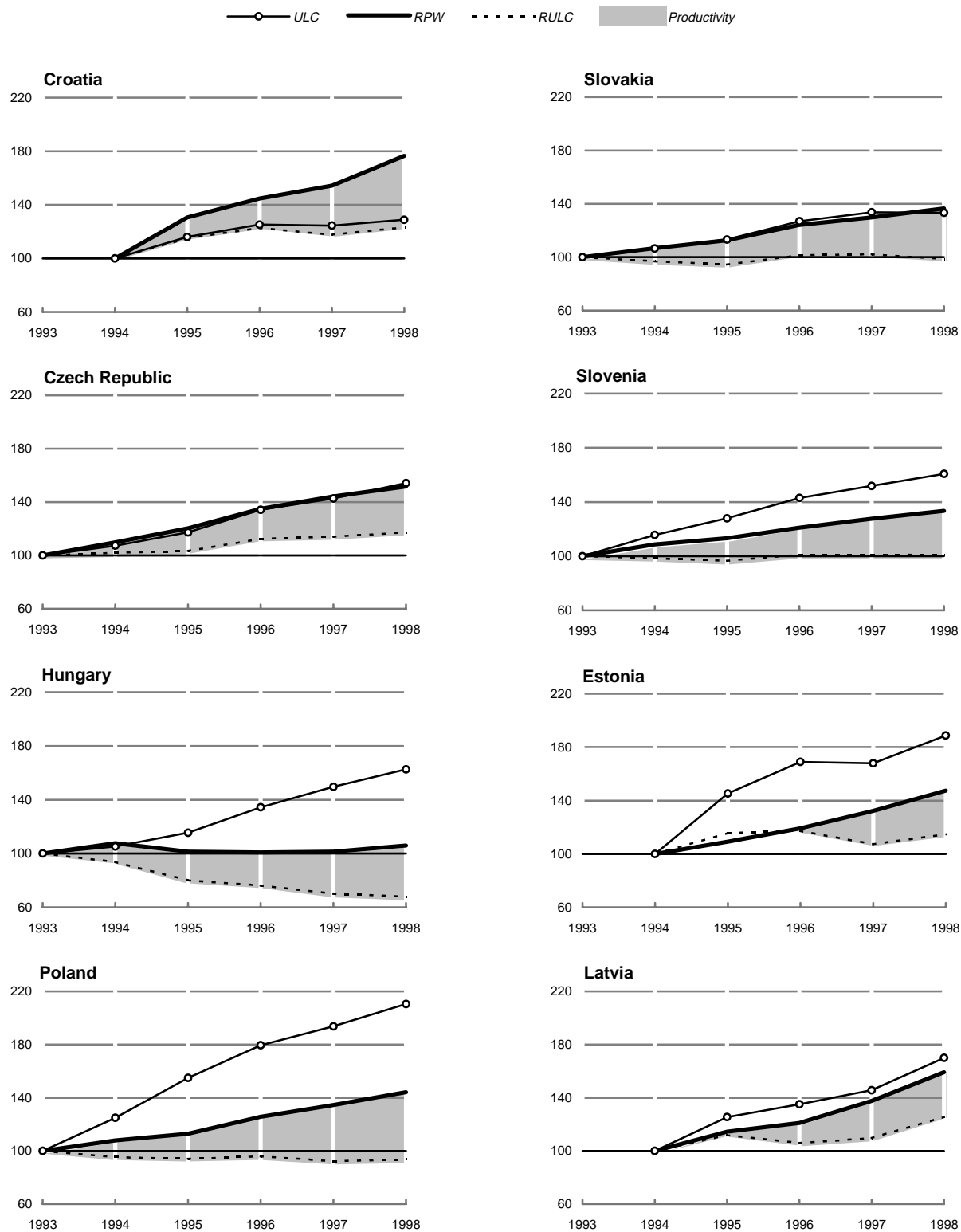
The growth of *unit labour costs* in industry in the transition economies has been moderating, albeit at different rates, since early 1997, and this continued in most countries during the first half of 1998. However, during the third and, particularly, the fourth quarters, this downward trend was reversed in the majority of these economies as the sharp slowdown in output growth was not immediately accompanied either by a moderation in wage increases nor by a fall in employment. Unit labour costs in 1998, for the year as a whole, therefore generally increased at similar or even higher rates than in 1997, the main exceptions being Slovakia (a slight fall), Hungary and Lithuania, thanks to strong productivity growth.

The rate of change in *real unit labour costs,*[391] measures the difference between the growth rates of real product wages and labour productivity. It therefore roughly measures the change in the relative wage share and, *ceteris paribus*, the change in "profit margins". These real unit labour costs fell in most of the transition economies in 1997 and continued to do so in the first half of 1998. Their development was particularly favourable in the Czech Republic and Slovakia, where the growth of real unit labour costs had been climbing in recent years. However, during the second half of 1998, they rose sharply particularly in the Baltic states. For the year as a whole they declined only in Hungary and Slovakia, and stagnated in Slovenia.

---

[391] The rate of change in unit labour costs deflated by the producer price index.

CHART 3.4.3

Real product wages and unit labour costs in selected transition economies, 1993-1998
(Indices, 1993=100)[a]

Croatia

Slovakia

Czech Republic

Slovenia

Hungary

Estonia

Poland

Latvia

(For source and notes see end of chart.)