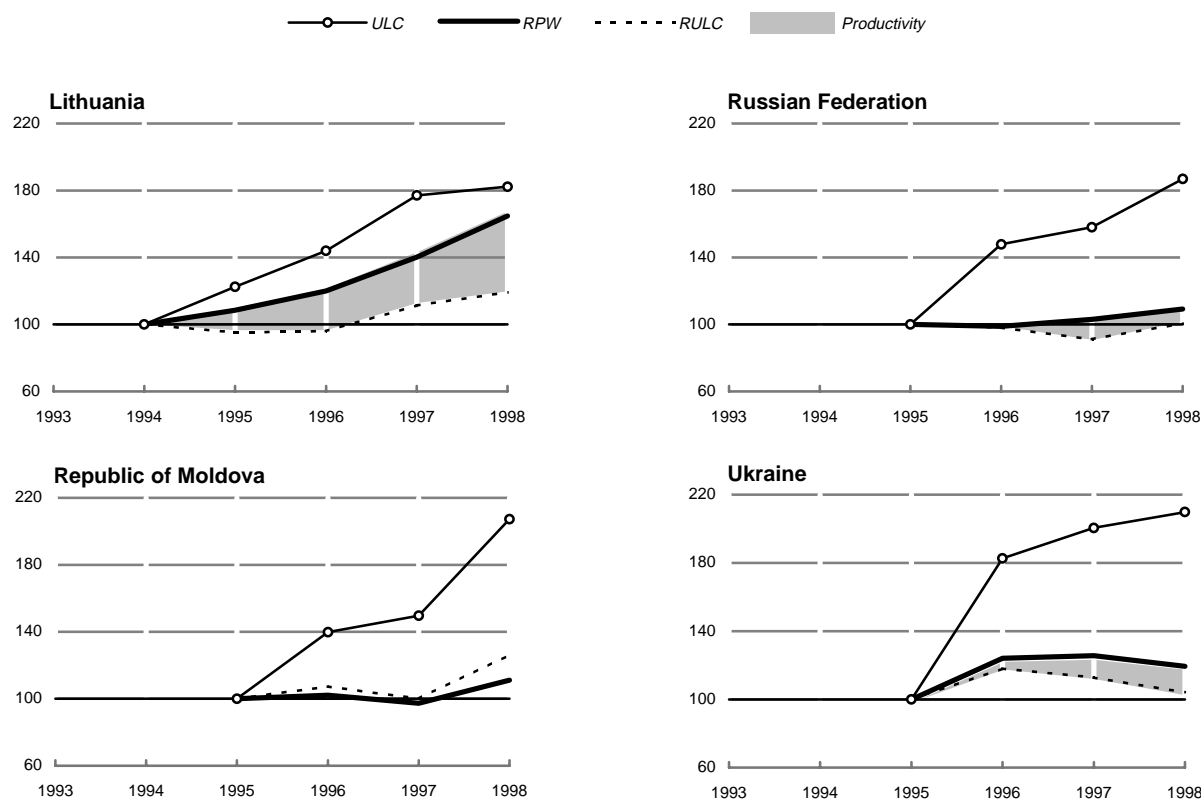


CHART 3.4.3 (concluded)

Real product wages and unit labour costs in selected transition economies, 1993-1998  
(Indices, 1993=100)<sup>a</sup>



Source: National statistics.

Note: ULC: unit labour costs, RPW: real product wages and RULC: real unit labour costs.

<sup>a</sup> Croatia and Baltic states: 1994=100, CIS: 1995=100.

Import prices in national currencies in 1998, however, generally continued to weaken as a result of falling world market dollar prices for primary and intermediate products,<sup>392</sup> combined with relatively stable or, appreciating currencies (except for a short period following the rouble crisis in mid-August). As a result, profit margins in eastern Europe and the Baltics were not squeezed as sharply as the increase in real unit labour costs might suggest. Nevertheless, compared with 1997, it is probably correct to conclude that the overall profit performance in most of these economies probably deteriorated in 1998, and especially in the last quarter, given the sharp deterioration in output growth and export prospects.

### (b) 1993-1998

The rate of fixed capital accumulation is one of the fundamental determinants of the potential for sustained growth in the medium term and in this respect, the growth of profits, via the influence of retained earnings on the investment decisions of enterprises, is one of the

key determinants of growth and employment in the medium term. Increased profits facilitate the financing of investment, which in turn increases productivity, productive capacity, competitiveness and employment.

Unfortunately national accounts data for economy-wide gross and net operating profits and unit profits are not available for most of the transition economies. However, one proxy for changes in the "profit margins" of industry<sup>393</sup> is the change in real unit labour costs, which reflects shifts in the relative income position of both wage and profit earners.<sup>394</sup>

Chart 3.4.3 shows the evolution of nominal and real unit labour costs since 1993 in selected transition

<sup>393</sup> In fact, as the UN/ECE, *Economic Survey of Europe, 1998 No. 1*, has shown, industry, particularly manufacturing, has been the major destination for investment during 1991-1996 in the most advanced transition economies.

<sup>394</sup> For a broader discussion and comparative analysis of real unit labour costs, see H. Gabrisch, "Transformation, integration and wage convergence: a comparison of east German and central and eastern European economic problems", *Moct-Most*, No. 8 (Bologna), 1998, pp. 35-50.

<sup>392</sup> See chap. 2.1.

economies.<sup>395</sup> It also shows the cumulative growth in real product wages and the implied cumulative productivity gains (i.e. the difference between the growth in real unit labour costs and real product wages) in these economies. As suggested by the chart, real unit labour costs in 1998 were below their levels in 1993 (i.e. *ceteris paribus* “profit margins” were higher)<sup>396</sup> only in Poland (6.5 per cent) and particularly in Hungary (32 per cent). They remained, albeit with some fluctuation, at their initial levels in Slovakia, Slovenia and Russia. In the rest of the countries, real unit labour costs in 1998 remained above their initial levels.

These findings match the investment performance of these countries during 1993-1998. During the last several years there was a rapid expansion of investment in Poland, principally in the private manufacturing sector. Investment growth was also buoyant in Hungary, particularly in 1997-1998, reflecting rising business confidence following the successful adjustment programme. In Slovakia, there was also a strong growth of investment in recent years, but most of it was in large public infrastructure projects financed by the state budget.

In addition to the cumulative changes in real unit labour costs and the implied performance in “profit margins”, the chart demonstrates that the rate of change in nominal labour costs are informative only if they are assessed in relation to the change in output prices. That is, if the increase in unit labour costs can be passed on to output prices (both on the domestic and foreign markets), then, *ceteris paribus*, “profit margins” are not squeezed even if the nominal wage growth exceeds the gains in productivity. In contrast, if real product wages rise faster than productivity then, *ceteris paribus*, “profit margins” will suffer. Therefore, in an economy where the priority is to achieve rapid disinflation, larger gains in productivity become an important determinant of the success of macroeconomic policies. In this respect, the conclusion must be that the main task of an economic policy geared towards stability in the medium term is to create the conditions for economic growth. In fact, sequencing disinflation and growth, in that order, rather than dealing with them simultaneously has recently been proven to be mistaken in many of these economies.<sup>397</sup>

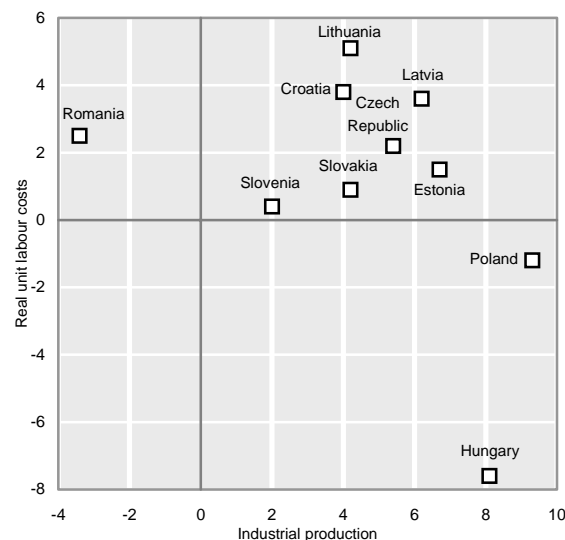
<sup>395</sup> The chart allows for differences in the date at which the reforms started.

<sup>396</sup> Here the unit material cost of production is assumed to be constant.

<sup>397</sup> A relatively early article on the Hungarian economy is still relevant to an understanding of the causes of the various recent crises in some of these economies, J. Kornai, *Lasting Growth as the Top Priority: Macroeconomic Tensions and Government Economic Policy in Hungary*, EBRD Working Paper, No. 15 (London), December 1994. “So the sequence of *first* stability, *then* growth is not correct. These are two parallel tasks ... the creation of stability is ... [a] task [that] is not one which is ever over and done with. It can reasonably be expected that as soon as one macroeconomic tension has been overcome, the same or another tension will re-emerge. This is not a war in which there can be victory once and for all ... Problems with inflation, unemployment, budget and current account deficits recur all over again. If we want to postpone growth until all these have been resolved, we shall be waiting for ever”, p. 31.

CHART 3.4.4

Average annual rate of change in industrial production and real unit labour costs<sup>a</sup> in selected transition economies, 1995-1998<sup>b</sup> (Percentages)



Source: National sources.

<sup>a</sup> Unit labour costs in industry deflated by industrial producer prices.

<sup>b</sup> 1998 data are for January-June.

Chart 3.4.4, in fact, despite an obviously large variance, tends to support the proposition that strong and prolonged growth (in industrial production) is positively correlated with a declining or low rate of growth in real unit labour costs in industry (i.e. industrial “profit margins” are rising or at least not being squeezed). Here again, the best “profits” performance was in Poland and Hungary which also had the highest average annual rates of output growth. Improving profits, and thus boosting investment and increasing productivity in the medium term, also facilitates disinflation without hampering the growth in demand. In turn these positive developments, by facilitating restructuring and improving resource allocation, are likely to lead to further output growth, i.e. to a virtuous circle in a lower inflationary environment. In other words, rapid and sustained growth is also a fundamental requirement for a persistently low rate of increase in prices.

### 3.5 Labour markets

#### (i) Recent developments

##### (a) Changes in employment in 1998

The available quarterly data suggest that in 1998, as a result of the deterioration of the general economic situation and the impact of the Russian crisis, the weak upward trend in employment in the last two years was halted in *eastern Europe*. In the first three quarters of

1998,<sup>398</sup> employment declined by 0.2 per cent, compared with a 0.9 per cent increase in the same period of 1997 (table 3.5.1).<sup>399</sup> Employment changes in individual countries remained heterogeneous reflecting the diversity of their overall macroeconomic situation, but in the first three quarters of 1998, there were relatively large increases only in Hungary and Poland; employment increased slightly in Slovakia and Slovenia and there was some recovery from very low levels in Bosnia and Herzegovina, but elsewhere the declines were general.

In Hungary, where the economy strengthened considerably in 1998,<sup>400</sup> employment increased by more than two per cent, much faster than in 1997. The marked increase in industrial employment (over 5 per cent)<sup>401</sup> has been followed by the expansion of new jobs in construction while employment in services stagnated and in agriculture continued to decline. A relatively high rate of growth (1.5 per cent) was maintained in Poland for a fourth consecutive year. The increase in total employment was largely concentrated in construction and, particularly, in the service sector where it increased by nearly 3 per cent,<sup>402</sup> in agriculture and industry there were further small declines.

In spite of the continued strong growth of output, employment increased only slightly in Slovakia and Slovenia, although, in the latter it was the first increase since the reforms started. Moreover, despite similar rates of growth, the situation in the two countries was quite different. In Slovenia, where the expansion of employment has been in the small-scale sector, the rate of growth was sustained during 1998. By contrast, in Slovakia, employment increased by 0.5 per cent in the first quarter of 1998, but then decelerated and in the third quarter it declined by 0.2 per cent.<sup>403</sup> The upturn in the Slovak economy in recent years has been mostly driven

by capital investment and improved labour productivity. However, overstaffing in large enterprises, a legacy of the past, is still a problem given the slow pace of restructuring. Therefore, the outlook for employment growth looks rather bleak given the marked slowdown of output<sup>404</sup> and the acceleration of privatization and long-delayed industrial restructuring envisaged by the new Slovak government. Generated by the postwar reconstruction of the economy, employment has increased also in Bosnia and Herzegovina, however, the increase in the first half of 1998 was much more modest than in the same period of 1997.

The situation has continued to deteriorate in the Czech Republic where employment declined by more than 1 per cent in the first three quarters of 1998. The intensification of labour shedding since mid-1997 reflects the overall contraction of activity<sup>405</sup> together with a faster rate of enterprise restructuring imposed by the substantial tightening of monetary and fiscal policy after the exchange rate crisis of May 1997. A fall of above 1 per cent has also been reported in Romania. However, this is a surprisingly small reduction given the depth of the recession in output.<sup>406</sup> It seems that, as in 1997, there has been a very specific response of employment to output decline in Romania. Indeed, falls of more than 5 per cent in industry, nearly 7 per cent in construction and more than 1 per cent in services have been largely offset by a rise of nearly 2 per cent in the number of workers engaged in agriculture. This implies that agriculture, the share of which in total employment in 1998 exceeded 40 per cent (greater than in industry or services) is acting as a shock absorber as workers displaced in other branches of the economy with generous redundancy payments return to their rural origins.<sup>407</sup>

In the other countries of the region for which data are available, employment continued to decline at similar rates to those in 1997, although more rapidly in Croatia, particularly after the first quarter when the growth of output slowed considerably in response to the more restrictive stance of fiscal and monetary policy adopted early in 1998.

In the *Baltic states*, the favourable trends in employment which had started in 1997 lost momentum in the first three quarters of 1998. Employment only continued to grow (by just above 1 per cent) in Latvia,

<sup>398</sup> At the time of writing, data for the fourth quarter of 1998 were still not available for most countries. However, rapidly increasing unemployment in many countries, suggests a further deterioration of employment in the fourth quarter.

<sup>399</sup> Assessing recent changes in employment in the transition economies is particularly difficult as quarterly employment data are not comparable with the annual data which have a broader coverage. (The quarterly data are not only different from the annual data but the size of the difference also varies among countries.) Therefore, these data should be interpreted with caution and should not be considered as indicating more than orders of magnitude.

<sup>400</sup> GDP grew by some 5 per cent and industrial output by nearly 13 per cent.

<sup>401</sup> The increase was entirely due to developments in manufacturing where employment grew by nearly 6 per cent. In textiles, clothing and leather, and also in engineering, the expansion of new jobs was even more pronounced at some 10-11 per cent, respectively. Hungarian Central Statistical Office, *Statistical Report*, 1998/99, p. 27.

<sup>402</sup> The increase was particularly pronounced in real estate, rental and business services (15.3 per cent) and in wholesale and retail trade and repairs (8.7 per cent). GUS, *Wstępna informacja o gospodarce w 1998 r.*, (Warsaw), 21 January 1999, p. 3.

<sup>403</sup> The sharp rise in unemployment occurred in the fourth quarter of 1998 (the rate increased from 13.8 per cent in September to 15.6 per cent in December) suggesting a further fall in employment.

<sup>404</sup> Industrial output fell in the fourth quarter of 1998 by 0.1 per cent, year-on-year basis, compared with an 8.6 per cent increase in the third quarter.

<sup>405</sup> In 1998, GDP fell by 2.7 per cent.

<sup>406</sup> In the first three quarters of 1998, GDP fell by nearly 6 per cent and industrial output by more than 17 per cent.

<sup>407</sup> The generous redundancy payments to workers dismissed from loss-making state owned enterprises (amounting to 12-20 times their monthly salaries according to their length of service) have been one of the reasons for the growing government budget deficit which in September 1998 amounted to 3.6 per cent of GDP. National Bank of Romania, *Quarterly Bulletin*, No. 3, 1998, p. 28.

TABLE 3.5.1

**Total employment in transition economies, 1995-1998**  
(Percentage change over the same period of preceding year)

	Total employment					Employment in industry				
	1995	1996	1997	Q1-QIII 1997	Q1-QIII 1998	1995	1996	1997	Q1-QIII 1997	Q1-QIII 1998
<b>Eastern Europe<sup>a</sup></b> .....	-0.5	0.6	0.9	0.9	-0.2	-0.6	-0.5	-1.2	-1.2	-1.5
Albania .....	-2.0	-2.0	-0.7	-0.4	-0.4	..	-10.2	3.5	..	..
Bosnia and Herzegovina .....	10.8	123.0	38.3	41.1	5.0 <sup>b</sup>	104.2	17.4	21.9	4.5	16.0 <sup>b</sup>
Bulgaria .....	1.3	0.1	-2.7	..	..	-2.2	-1.2	-4.1	..	..
Croatia .....	1.3	-	-0.7	-0.7	-2.0	-11.6	-0.9	-4.0	..	-5.1
Czech Republic .....	2.6	0.7	-1.0	-0.9	-1.2	0.5	-0.8	-1.0	-1.2	-0.4
Hungary .....	-1.9	-0.5	0.1	0.1	2.4	-5.4	-0.9	1.7	1.3	5.1
Poland .....	1.8	1.9	2.8	1.4	1.5	3.2	-0.7	0.3	-0.5	-0.7
Romania <sup>c</sup> .....	-5.2	-1.2	1.0	1.5	-1.4	-5.8	1.0	-2.5	-1.8	-5.3
Slovakia .....	2.2	0.8	-0.4	-0.4	0.2	-0.1	-	-2.0	-1.8	-3.6
Slovenia .....	-0.2	-0.5	-0.2	-0.3	0.4	-3.8	-1.0	-4.2	-4.6	-1.2
The former Yugoslav Republic of Macedonia .....	-9.5	-4.4	-5.4	-5.6	-3.6	-13.2	-6.5	-7.6	-6.7	-3.0
Yugoslavia .....	-1.4	-0.5	-1.5	-1.5	-1.7	-2.5	-2.3	-3.1	-3.3	-2.7
<b>Baltic states</b> .....	-3.1	-0.7	1.0	0.7	-0.4	-3.6	-4.6	-0.5	-0.1	-1.3
Estonia .....	-5.3	-1.6	-0.2	0.4	-0.6 <sup>b</sup>	8.1	-4.4	-5.7	-5.8	-2.4 <sup>b</sup>
Latvia .....	-3.5	-2.7	1.9	1.5	1.2	-5.7	-5.6	3.5	3.5	1.3
Lithuania .....	-1.9	0.9	0.6	0.3	-1.2	-7.7	-4.2	-	0.9	-2.4
<b>CIS<sup>a</sup></b> .....	-1.0	-0.9	-1.4	-1.4	-0.6	-8.0	-5.3	-7.6	-7.7	-3.4
Armenia .....	-0.8	-2.8	-4.4	-4.1	-2.4	-14.7	-15.8	-10.2	-10.8	-3.9
Azerbaijan .....	-0.5	2.0	0.2	0.2	0.3	-5.8	-19.7	-14.5	-11.5	-11.4
Belarus .....	-6.2	-1.0	0.1	-0.6	0.5	-10.9	-1.2	0.2	-0.1	-
Georgia .....	21.8	0.2	4.5	..	..	-9.4	-28.1	-23.2	..	..
Kazakhstan .....	-0.5	-0.5	-0.7	-0.9	-2.7	-9.4	-3.9	-11.8	-13.6	-3.7
Kyrgyzstan .....	-0.2	0.6	2.3	1.5	0.2	-15.0	-10.8	-6.1	-6.3	-1.0
Republic of Moldova .....	-0.5	-0.8	-0.8	-1.9	-1.7	-14.2	-1.7	-2.4	-1.3	-2.3
Russian Federation .....	-3.0	-0.7	-2.0	-2.0	-0.6	-8.1	-4.7	-8.0	-8.5	-4.1
Tajikistan .....	-0.1	-6.6	3.3	3.5	-0.2	-12.1	-1.1	-13.3	-14.7	-2.6
Turkmenistan .....	0.5	-0.4	0.5	..	..	-0.1	3.7	9.4	..	..
Ukraine .....	3.0	-2.1	-2.7	-1.6	-1.4	-7.7	-7.3	-8.5	-8.3	-4.2
Uzbekistan .....	0.9	1.3	1.4	0.9	1.6	2.4	1.3	0.2	2.4	0.6
<b>Total above<sup>a</sup></b> .....	-0.9	-0.5	-0.8	-0.8	-0.4	-5.8	-3.8	-5.4	..	..
<i>Memorandum items:</i>										
<b>CETE-5</b> .....	1.4	1.2	1.4	0.7	0.8	0.8	-0.7	-0.2	-0.7	-
<b>SETE-7<sup>a</sup></b> .....	-3.1	-0.2	0.2	1.2	-1.3	-4.4	-	-2.6	..	..

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

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

<sup>a</sup> Three quarters regional aggregates of total employment exclude Bulgaria, Georgia and Turkmenistan; those of employment in industry also exclude Albania and Croatia.

<sup>b</sup> First half of the year.

<sup>c</sup> End of year data based on labour force balances up to 1997; from 1997, annual average figures based on labour force survey data. Consequently, the regional aggregates which include Romania are not fully comparable before and after 1997.

although the rate of growth decelerated considerably between the first and the third quarters. The increase in total employment was mainly due to services but new jobs were also being created in industry, albeit at a significantly slower rate than in 1997. In contrast, despite the relatively strong economic upturn, employment fell again by more than 1 per cent in Lithuania.<sup>408</sup> The

decline was most pronounced in agriculture and in industry, while in services it fell only slightly.

The available quarterly data suggest that in the *CIS countries*, the fall in the level of employment slowed down in the first three quarters of 1998 reflecting the modest economic recovery in most of them. The rate of decline, however, accelerated in Kazakhstan and employment began to fall again in Tajikistan. It

<sup>408</sup> In the first three quarters of 1998, industrial output grew by nearly 10 per cent, the highest rate of increase in the Baltic states. However, output growth was relatively concentrated on capital intensive activities; thus, the Mazeikiiai oil refinery, which accounted for almost 25 per cent of all industrial production, increased its output significantly, lifting overall

production. Light industry and the food industry laid off workers due to decreasing production of goods destined for Russia, one of Lithuania's biggest trading partners.

increased by more than 1 per cent in Uzbekistan, and slightly in Azerbaijan and Belarus. The continuing weakness of employment despite the recent economic upturn in some of the CIS countries suggests a considerable degree of excess employment which is mainly seen in the form of widespread unpaid administrative leave and part-time employment.

## (b) Unemployment

### Levels and rates of registered unemployment

In most of the east European countries unemployment had been falling since the end of 1993 and early 1994, but, as a result of the general economic slowdown and the Russian crisis, it started to increase again in the second half of 1998 and particularly in the fourth quarter. In December, six countries (Croatia, the Czech Republic, Latvia, Russia, Slovakia and Yugoslavia) reported their highest unemployment rates since the transition started. The total number of unemployed in the transition economies as a whole, was 17.6 million people at the end of December 1998 (some 6.6 million in eastern Europe and 10.7 million in the CIS countries), the highest level since records began in the early 1990s. The most pronounced increase (14 per cent) was in the Baltic states; in eastern Europe and the CIS countries unemployment grew by some 6 and 10 per cent, respectively, in the 12 months to December 1998.

In *eastern Europe*, the already high rate of unemployment increased further and in December 1998 averaged 12.6 per cent (compared with 11.9 per cent a year earlier), with most countries falling within a range of some 9 per cent (Hungary) to almost 19 per cent (Croatia) (table 3.5.2). In the 12 months to December 1998, unemployment declined only in Bulgaria and Hungary, while in Poland and Slovenia it was broadly unchanged.

In Bulgaria, the unemployment rate declined steadily during 1998, from a peak of 14.3 per cent in February to 10.7 per cent in September. The fall reflects a smaller number of layoffs in the state sector as the closure of loss-making enterprises was delayed<sup>409</sup> and an increasing number of job offers from small and medium businesses in the private sector.<sup>410</sup> However, in October, this positive development was broken: apart from a seasonal fall in the number of jobs in tourism, etc., there was an acceleration in the pace of job cuts in state industrial plants and by December 1998, the unemployment rate had risen to 12.2 per cent. If the structural reforms agreed with the IMF are

carried out,<sup>411</sup> the average unemployment rate in 1999 could reach nearly 14 per cent.

In Hungary, where there was strong economic growth, the unemployment rate declined steadily during 1998 to stand at 9.1 per cent in December (1.3 percentage points less than a year earlier). The Hungarian authorities expect this positive trend to continue in 1999 and the unemployment rate to be around 8 per cent by June.<sup>412</sup>

In Poland, as in Hungary, unemployment has been declining for several years,<sup>413</sup> and in August the rate was at its lowest (9.5 per cent) since 1991. However, in contrast to Hungary, the rate of improvement slowed notably during 1998: the unemployment rate was actually flat from May to September, when it began to rise again in the wake of the Russian crisis, reaching 10.4 per cent by the end of the year. Given the fall in industrial output at the end of 1998,<sup>414</sup> which is expected to continue, the unemployment rate is expected to increase further in 1999.<sup>415</sup> Some Polish experts believe that the present unemployment rate of around 10 per cent may continue for quite a long time,<sup>416</sup> given the scale of surplus labour in agriculture, the planned restructuring of the coal and steel industries, and increases in the labour force for demographic reasons.<sup>417</sup>

Unemployment has remained persistently high in Slovenia.<sup>418</sup> Although as a relatively sheltered transition economy, Slovenia was not much affected by the Russian crisis, and was able to maintain a relatively robust rate of economic growth, the unemployment rate in December 1998 was still 14.6 per cent, only marginally less than a year earlier.

<sup>411</sup> According to a statement by Prime Minister Kostov, there are about 900 loss-making enterprises in the country and if 400 of these are closed by 1 July 1999, as planned, some 100,000-150,000 people will be left jobless. All workers who lose their jobs as a result of the structural reform will get 2 million leva (some \$1,200) of compensation from the government. Bulgarian Press Digest as reported in *Reuters News Service*, 4 December 1998.

<sup>412</sup> *BBC Monitoring Service: Central Europe and Balkans*, 14 January 1999. Nevertheless, unemployment rose in early 1999 and in February stood at 10.5 per cent, little different from a year earlier.

<sup>413</sup> The highest unemployment rate in Hungary (13.9 per cent) was reported in February 1993 and in Poland (16.9 per cent) in February 1994; these have been declining since then in both countries, with temporary fluctuations.

<sup>414</sup> In December, industrial output was 2.2 per cent lower than in December 1997.

<sup>415</sup> *Gazeta Bankowa*, 19 February 1999; see also SG Warsaw, *Poland 1999 Economic Outlook* (Warsaw), 29 December 1998, p. 4. The slowdown in the Polish economy had already pushed the unemployment rate to an 18-month high in January, to 11.4 per cent.

<sup>416</sup> *Gazeta Bankowa*, 5-11 December 1998; *Prawo I Gospodarka*, No. 245, 5-7 December 1998.

<sup>417</sup> Poland's working-age population is forecast to increase by nearly 2 million between 1996 and 2005, against a rise of 813,000 in the preceding decade. *Ibid.*

<sup>418</sup> Since 1994 the registered unemployment rate in Slovenia has been broadly unchanged, varying with some fluctuations around 14.5 per cent (chart 3.5.1). One of the factors behind this persistently high rate is the high proportion of long-term unemployed (chart 3.5.4).

<sup>409</sup> Closing down unviable loss-making enterprises by end-1998 was a key reform target under the \$850 million, three-year funding programme agreed with the IMF. However, the unpopular target has been extended by six months to 30 June 1999.

<sup>410</sup> In January-September 1998, the number employed in the private sector was 480,000 higher than a year earlier, while state sector employees were down by 280,000. Bulgarian National Bank, *Monthly Bulletin*, No. 9, 1998, p. 19.

TABLE 3.5.2

Registered unemployment in the transition economies, 1997-1998  
(Per cent of labour force)

	1997		1998			
	Dec.	Jun.	Sept.	Oct.	Nov.	Dec.
<b>Eastern Europe</b>	11.9	11.6	11.7	11.9	12.2	12.6
Albania	14.9	16.5	16.9	17.1	17.4	17.6
Bosnia and Herzegovina <sup>a</sup>	39.0	..	40.5	38.0	38.3	..
Bulgaria	13.7	11.4	10.7	11.1	11.8	12.2
Croatia	17.6	16.8	17.5	18.0	18.2	18.6
Czech Republic	5.2	5.6	6.8	6.8	7.0	7.5
Hungary	10.4	9.1	8.9	8.8	8.8	9.1
Poland	10.3	9.6	9.6	9.7	9.9	10.4
Romania	8.8	8.8	8.7	9.0	9.5	10.3
Slovakia	12.5	13.5	13.8	13.9	14.5	15.6
Slovenia	14.8	14.1	14.3	14.6	14.5	14.6
The former Yugoslav						
Republic of Macedonia <sup>b</sup>	42.5	44*	..	..	..	..
Yugoslavia <sup>b</sup>	25.6	26.9	27.2	27.3	27.2	27.2
<b>Baltic states</b>	6.3	5.9	6.1	6.5	7.0	7.3
Estonia <sup>c</sup>	4.6	4.3	4.5	4.8	4.8	5.1
Latvia	6.7	7.2	7.6	8.2	8.8	9.2
Lithuania	6.7	5.5	5.6	6.0	6.5	6.9
<b>CIS</b>	7.6	7.7	8.0	8.3	8.4	8.5
Armenia	11.0	8.8	8.7	8.7	8.8	8.9
Azerbaijan	1.3	1.4	1.4	1.4	1.4	1.4
Belarus	2.8	2.3	2.3	2.3	2.3	2.3
Georgia	8.0	3.5	4.3	4.3	4.7	4.2
Kazakhstan	3.9	4.0	4.0	3.8	3.8	3.7
Kyrgyzstan	3.1	3.7	3.6	3.4	3.3	3.1
Republic of Moldova	1.7	2.0	2.0	2.0	2.0	1.9
Russian Federation <sup>d</sup>	11.2	11.3	11.9	12.3	12.3	12.4
Tajikistan	2.8	3.3	3.5	3.5	3.4	2.9
Ukraine	2.8	3.4	3.7	3.9	4.1	4.3
Uzbekistan	0.3	0.4	0.4	0.4	0.4	0.4
<b>Total above</b>	8.8	8.9	9.1	9.3	9.5	9.6
<b>Memorandum items:</b>						
<b>CETE-5</b>	9.8	9.3	9.5	9.6	9.8	10.2
<b>SETE-7</b>	14.3	14.2	14.2	14.5	14.8	15.4
<b>Russian Federation<sup>e</sup></b>	2.8	2.5	2.4	2.5	2.6	2.7

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

<sup>a</sup> Figures cover only the Moslem-Croat Federation; data for Republika Srpska are not available.

<sup>b</sup> The data for employment cover only the social sector in agriculture; unemployment rates are therefore biased upwards.

<sup>c</sup> Job seekers.

<sup>d</sup> Based on monthly Russian Goskomstat estimates according to the ILO definition, i.e. including all persons not having employment but actively seeking work.

<sup>e</sup> Registered unemployment.

Elsewhere in the region, unemployment increased sharply reflecting the aggravation of an already weakening general economic situation by the Russian crisis and by intensified restructuring in several economies. One of the largest increases in unemployment was in Albania, despite the strong recovery of output reported for 1998 and the small declines in employment (less than 1 per cent in 1997 and some 0.5 per cent in the first three quarters of 1998). In December 1998, the unemployment rate was 17.6 per cent (2.7 percentage points higher than a year

earlier), back to where it was in early 1995. The reasons for the continued high unemployment rate may include the relative concentration of increased output in the more capital-intensive sectors and the difficulties of small enterprises in obtaining loans from banks. In addition, the influx of refugees has helped to increase the unemployment figures.<sup>419</sup>

The rapid increase in unemployment in the Czech Republic, which started in mid-1997, continued through 1998<sup>420</sup> and in December reached a record 7.5 per cent. Nevertheless, the rate is still relatively low in comparison with neighbouring transition economies. Since the main reasons for rising unemployment (deepening economic recession and intensified restructuring in industry) are likely to continue to prevail in 1999, unemployment is expected to continue to rise and by the end of the year could exceed 10 per cent.<sup>421</sup> The new Czech government has set the reduction of unemployment as one of its main priorities.<sup>422</sup>

Unemployment has also increased considerably in Romania to stand at 10.3 per cent in December 1998 (more than 1 million people), the highest rate since 1996.<sup>423</sup> The rise was triggered by layoffs, especially in the mining sector, coupled with a worsening economic climate. One of the principal objectives of the Romanian government for 1999 remains the closure of at least 30 loss-making companies and the privatization of major state owned enterprises as part of the restructuring programme agreed with the IMF. According to the government's estimates, this will increase the number of unemployed by about 70,000.<sup>424</sup>

<sup>419</sup> Some 20,000 refugees from Kosovo in the northern prefectures in the shanty towns around Tirana have added to the jobless rate and to the demand for benefit payments. Economist Intelligence Unit, *Country Report, Albania*, 4th quarter 1998 and 1st quarter 1999 (London).

<sup>420</sup> For several years, unemployment in the Czech Republic has remained at very low levels, *inter alia*, because of slow micro-level restructuring. Since June 1997, unemployment started to rise rapidly as a result of the government's austerity measures aimed at transforming the economy and the efforts of businesses to cut their workforce in order to increase productivity and improve competitiveness. For a more detailed discussion of the phenomenon of low unemployment in the Czech Republic see UN/ECE, *Economic Survey of Europe in 1996-1997*, p. 114.

<sup>421</sup> In January and February 1999, the rate of unemployment increased further to 8.1 per cent and 8.3 per cent, respectively.

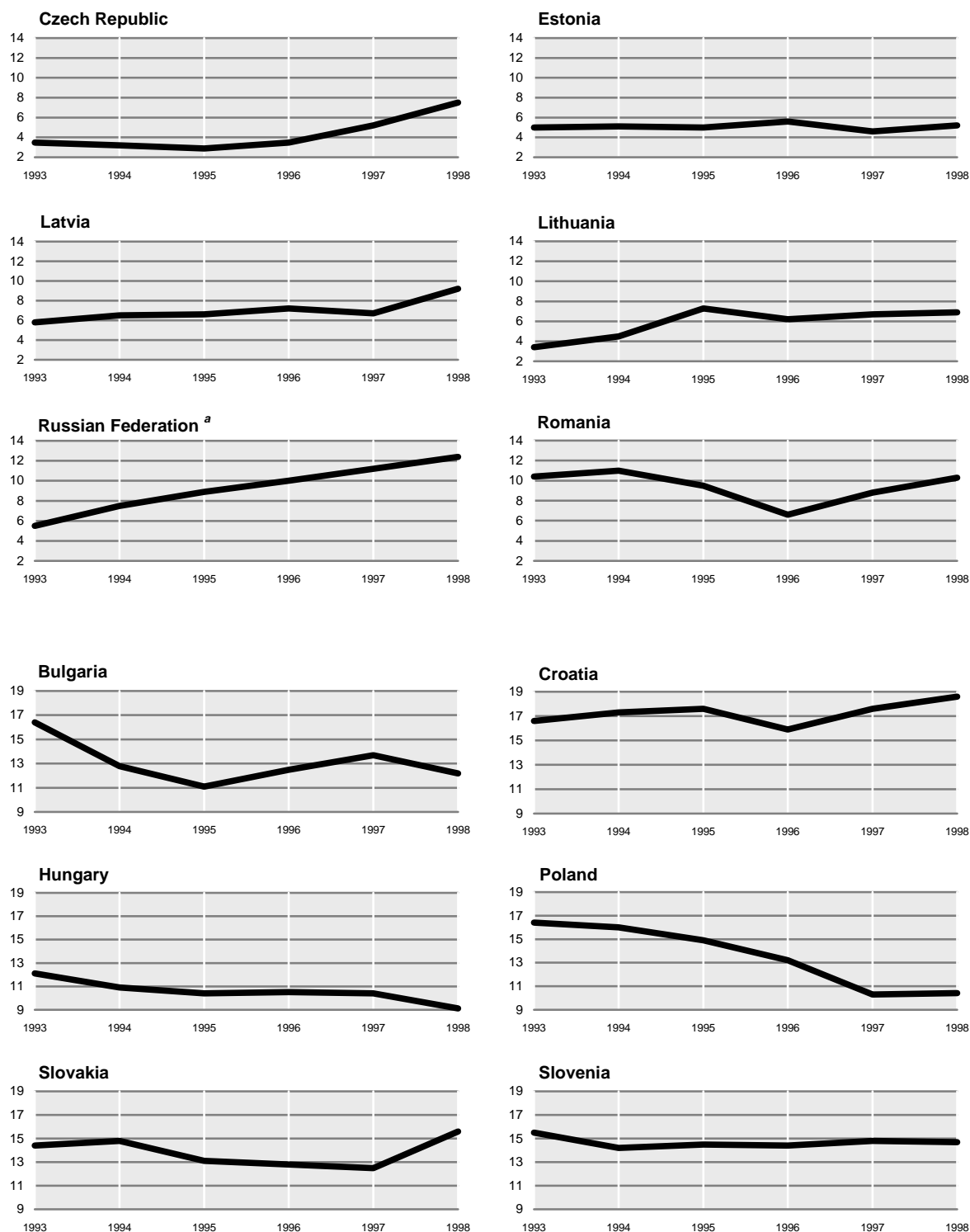
<sup>422</sup> The Ministry of Labour and Social Affairs is preparing an ambitious project called "The National Struggle against Unemployment" which plans to initiate economic growth and create new jobs. The document is to be drafted by the end of March and submitted to the government in April. *Lidove Noviny* as reported in *Reuters News Service*, 12 January 1999.

<sup>423</sup> Despite a sharp rise, the figure was still far lower than expected, in part because restructuring efforts and the liquidation of unviable entities were delayed to avoid social tension. Moreover, on 22 January, the government had to re-open two coal mines to halt massive protests by around 10,000 coal miners.

<sup>424</sup> *Romania Economic Newsletter*, Vol. 8, No. 3, October-December 1998. In February 1999 the unemployment rate reached a record 11.8 per cent.

CHART 3.5.1

Registered unemployment rates in selected transition economies, 1993-1998  
(Per cent of labour force, end of period)



Source: National statistics and direct communications to UN/ECE secretariat.

<sup>a</sup> Based on Russian Federation Goskomstat estimates according to the ILO definition.

In Slovakia unemployment soared in November and December, reaching a record 15.6 per cent (3.1 percentage points higher than in December 1997).<sup>425</sup> The increase was mainly caused by the general deterioration in the economy and a wave of redundancies in industry.<sup>426</sup> The programme of the new Slovak government, approved by the parliament in early December 1998, intends to pursue reform, accelerate privatization and undertake long-delayed industrial restructuring. The faster rate of restructuring of the economy, as proposed in the government's package of economic measures, is expected to raise the average unemployment rate in 1999 to 15 per cent (13.8 per cent in 1998) which implies that by the end of 1999 it could reach 17 per cent.<sup>427</sup>

Unemployment has continued to rise in Croatia and Yugoslavia, and in both cases the December unemployment rate was the highest since the transition started. The rate of over 27 per cent in Yugoslavia was one of the highest among all the transition economies, exceeded only by Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia.<sup>428</sup>

In the *Baltic states*, robust economic growth had led to a fall in unemployment during the spring and summer,<sup>429</sup> but in September when the effects of the Russian crisis began to be felt, unemployment started to grow again. In Estonia and Lithuania, where the influence of the Russian crisis was less pronounced than in Latvia, registered unemployment rates increased to some 5 and 7 per cent. In Latvia, which of all the Baltic states is the most dependent on the transit business and where many enterprises started to lay off workers because of falling exports to Russia, the unemployment rate had climbed to 9.2 per cent by the end of 1998, the highest figure since records began. According to the national labour exchange, the unemployment rate is unlikely to return to the pre-Russian crisis level (around 7.5 per cent) in the near future.<sup>430</sup> In Lithuania the rate is expected to rise to 7.5 per cent by the end of 1999.

<sup>425</sup> The highest unemployment rate of some 15 per cent was recorded in the first quarter of 1994.

<sup>426</sup> Industrial output fell in the fourth quarter of 1998 by 0.1 per cent, year-on-year basis, after a 8.6 per cent increase in the third quarter. The decline of employment in industry accelerated during 1998 and in the third quarter employment was nearly 5 per cent lower than a year earlier.

<sup>427</sup> *BBC Monitoring Service: Central Europe and Balkans*, 14 January 1999. In February 1999, the unemployment rate reached a record 16.5 per cent.

<sup>428</sup> In The former Yugoslav Republic of Macedonia, the most recent official data on unemployment refer to December 1997, when the statistics office stopped publishing unemployment figures. Some semi-official estimates indicate that by the end of August 1998, the rate of registered unemployment stood at 44 per cent. However, a large number of registered unemployed work in the black economy or are engaged in agriculture so that the true unemployment rate may be around 30 per cent. Economist Intelligence Unit, *Country Report. Macedonia*, 4th quarter (London), 1998. A labour force survey conducted in April 1998 put the unemployment rate at 34.5 per cent.

<sup>429</sup> In the first half of 1998, GDP increased in these countries between some 6 and 7 per cent, and industrial output by some 9-11 per cent.

<sup>430</sup> *Baltic Business Daily*, 28 December 1998; *Reuters News Service*, 8 January 1999. In January 1999, the Latvian unemployment rate reached 9.4 per cent, and increased again to a record 9.7 per cent in February.

In the *CIS countries*, official unemployment rates were still very low in December 1998, varying between 0.4 per cent (Uzbekistan) and 4.3 per cent (Ukraine), the main exception being Armenia (nearly 9 per cent). These low rates of registered unemployment, despite the steep decline in output, reflect on the one hand the excess employment still prevailing in many, particularly large enterprises, and on the other, the omission from the *registered* unemployment statistics of a large part of the jobless who are willing to work but, for various reasons, do not register (see box 3.5.1 and the subsection below). According to some estimates, at the end of September 1998, the "true" number of unemployed (including, in addition to the registered unemployed, those who were searching independently for a job) in the region was four times higher than the registered number.<sup>431</sup> On this basis unemployment rates would vary between less than 5 per cent in Azerbaijan and Uzbekistan, 5 and 8 per cent in Tajikistan, Kyrgyzstan, the Republic of Moldova, Georgia and Belarus, 9 and 13 per cent in Ukraine, Russia and Kazakhstan. Some of these rates are probably still too low given the state of other macroeconomic indicators.

#### **Registered and labour force survey unemployment**

In addition to registered unemployment statistics an increasing number of transition economies are starting to produce data on the basis of labour force surveys (LFSs) conducted in accordance with ILO definitions. However, since a full-scale LFS is a labour- and cost-intensive process, and in addition requires a well prepared staff, this source of information is still relatively limited.<sup>432</sup> It is generally considered that the ILO measure is more accurate and valuable for analysis as it is calculated on the basis of unified international standards and can be used for comparisons of unemployment between countries. At the same time, there is a widespread opinion that the registered measure usually underestimates the incidence of open unemployment in transition economies. However, a comparison of unemployment rates based on registered statistics with those derived from LFSs clearly indicates that in practice the relationship between the two measures is not so evident and the pattern varies from country to country.

<sup>431</sup> CIS Statistical Committee, *Statistical Bulletin*, No. 18 (Moscow), September 1998, p. 44.

<sup>432</sup> Thirteen transition economies now implement LFS on the basis of ILO definitions. However, only six of them (the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia) conduct a regular quarterly LFS. Bulgaria conducts one three times a year – in March, June and October. Croatia does one annually. In Latvia and Lithuania LFSs are conducted twice a year in May and November, while Estonia does one a year in June. Among the CIS countries only Russia and Ukraine conduct an annual LFS; in 1999 both countries are to start preparing them on a quarterly basis.



## BOX 3.5.1

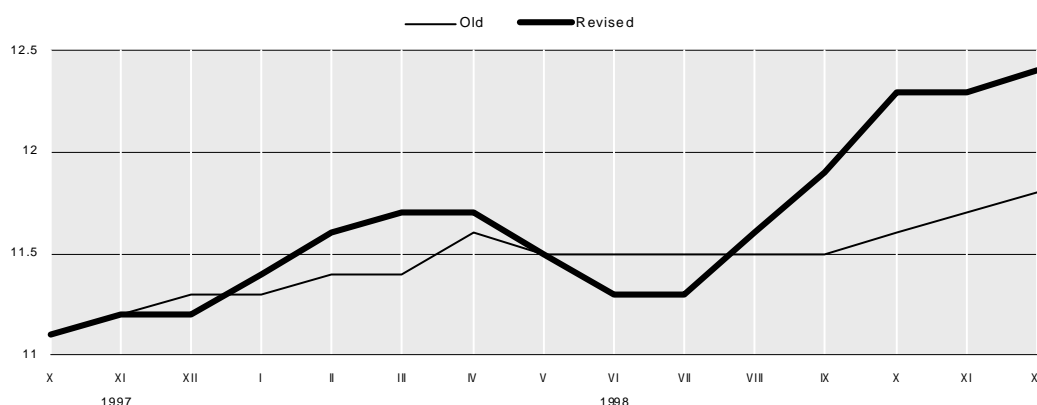
## Goskomstat revision of Russian unemployment

Further revisions to the series for Russian monthly unemployment – known as “unemployment according to ILO methodology” – were issued by the Russian State Statistical Committee (Goskomstat) in January 1999.<sup>1</sup> The need for a revision to the series arose from the initial results of Goskomstat’s October 1998 labour force survey. (The previous survey had been conducted in October 1997.) The table below shows the new and old Goskomstat series for the entire period covered by the revision, November 1997 to December 1998. The magnitude of the change is shown by the revision for October 1998, from 11.6 per cent of the labour force to 12.3 per cent. The movement of the two series was rather similar until May but, as the chart clearly illustrates, they then diverge strikingly, particularly after the August crisis.

Russian unemployment: old and revised data for 1997-1998  
(Per cent of labour force)

	January	February	March	April	May	June	July	August	September	October	November	December
<b>1997</b>												
Old data .....										11.1	11.2	11.3
Revised data .....										11.1	11.2	11.2
<b>1998</b>												
Old data .....	11.3	11.4	11.4	11.6	11.5	11.5	11.5	11.5	11.5	11.6	11.7	11.8
Revised data .....	11.4	11.6	11.7	11.7	11.5	11.3	11.3	11.6	11.9	12.3	12.3	12.4

Russian unemployment, 1997-1998  
(Per cent of labour force)



Source: Russian Federation Goskomstat and direct communications to UN/ECE secretariat.

Although the revision raises the unemployment rate the rise in unemployment was unexpectedly small given the financial turmoil in August 1998 and the subsequent sharp economic downturn.<sup>2</sup> The unemployment rate stood at 12.4 per cent in December 1998, only 1.2 percentage points higher than a year earlier, and 1.1 percentage points over the pre-crisis month of July 1998 (the old series suggested increases of only 0.5 and 0.3 percentage points, respectively). One reason for this mild reaction is the traditional and continuing reluctance of managers and local authorities to encourage large-scale redundancies, a reluctance which leads to increased hidden unemployment, widespread unpaid administrative leave and part-time employment, and a high level of wage arrears. However, another reason is the marked decline in real wages as a result of the post-August inflation and the absence of any significant degree of wage indexation.<sup>3</sup> Under these conditions it is easier for management to pay low wages (or in many cases not to pay them at all) than to undertake the politically and socially unpopular move of releasing workers. The indexation of public sector salaries, planned for 1 April 1999, may change this situation.

When commenting on the Russian monthly “ILO” unemployment data it should be borne in mind that they are always estimates of what the situation would have been if a survey had been conducted at the relevant time. In 1999, Goskomstat plans to start conducting quarterly labour force surveys. The first was already conducted at the end of February and the results, which are expected in May, should better reflect the real situation on the Russian labour market.

<sup>1</sup> Direct communication to UN/ECE secretariat. For a more detailed discussion of the content and some of the peculiarities of the Russian monthly “ILO” series see UN/ECE, *Economic Survey of Europe, 1998 No. 3*, pp. 68-69. That discussion refers to the revisions published by Goskomstat in June 1998.

<sup>2</sup> Industrial output declined by nearly 15 per cent in September and by some 11, 9 and 7 per cent in October, November and December respectively; GDP fell by 4.6 per cent in 1998.

<sup>3</sup> In the 12 months to December 1998, real wages declined by some 40 per cent in rouble terms and by more than 60 per cent in dollar terms.

In the second quarter of 1998, in the majority of east European countries for which both sets of data are available, the rates of unemployment based on registration tended to give similar results to those based on LFS data (chart 3.5.2). Surprisingly, in Croatia, Romania and Slovenia registered unemployment rates were substantially higher than those obtained from the labour force surveys. In contrast, in all the Baltic states, Ukraine and particularly in Russia the registration data are much lower than the survey-based unemployment rates. The comparison in individual countries becomes more evident when the relationship between the two measures is expressed in relative terms (chart 3.5.3). In Croatia, Romania and Slovenia registered unemployment rates exceeded those of the LFSs by some 60 to 90 per cent, while in the other countries of eastern Europe they tend to be rather close to the LFS figures (particularly in Bulgaria, the Czech Republic and Poland). In all the Baltic states, a very similar pattern prevails: the registered unemployment rates are less than half the rates derived from the LFSs. In Ukraine the proportion is about 36 per cent; in Russia, the registered measure is virtually useless as it is only just above 20 per cent of the rate estimated on the basis of the ILO definition. These large differences between the two measures in the Baltic states, Ukraine and Russia on the one hand (the registered unemployment rates are considerably lower) and Croatia, Romania and Slovenia on the other (where they are substantially higher) can probably only be explained by the specific characteristics of the statistics prevailing in the individual countries.<sup>433</sup>

As was already mentioned, LFS unemployment rates, being calculated on the basis of unified international standards, can provide a good basis for intercountry comparisons. The picture changes radically when, instead of registered unemployment, LFS data are used for analysis. LFS unemployment rates in the countries under review varied in the second quarter of 1998, between some 6 and 8 per cent of the labour force in Romania, the Czech Republic, Slovenia and Hungary; some 10 and 12 per cent in Estonia, Poland, Croatia, Bulgaria, Ukraine, Russia and Slovakia; and they exceeded 14 per cent in Latvia and Lithuania whereas, according to the registration data, the Baltic states, Ukraine and Russia belong to the group of countries with a low unemployment rate.

### *Structure of unemployment*

In the third quarter of 1998, *the share of women in total unemployment* remained very high in the Czech Republic and Poland, exceeding 55 per cent, whereas it was lower in Hungary (less than 40 per cent) (chart

3.5.4). In all other countries the female share fell within the range of 44 to 47 per cent. The proportion of women among the unemployed has tended to fall in all the countries under review.<sup>434</sup>

A worrying trend is the very high proportion of *youth unemployment* in the total. The available data suggest that young persons under 25 years old, given their share in the total labour force, are disproportionately represented among the unemployed. In the third quarter of 1998, young people accounted for more than 40 per cent of total unemployment in Romania, and one third or more in the Czech Republic, Slovakia and Slovenia, and for around one fourth in the other countries in chart 3.5.4. Moreover, youth unemployment is continuing to increase in most countries and has become one of the most pressing social problems in all the transition economies.

In spite of a relatively short history of open unemployment, most of the transition economies are facing the increasingly serious problem of *long-term unemployment*. In the third quarter of 1998, the share of the long-term unemployed in total unemployment varied between some 31 and 37 per cent in the Czech Republic and Poland, but it was more than 40 per cent everywhere else, and close to 60 per cent in Bulgaria and Slovenia (chart 3.5.4). A striking feature of the development of long-term unemployment is that between the third quarters of 1996 and 1998, there had been a notable decline in its share of the total in all the east European countries except Slovenia, where it increased from 52 to nearly 57 per cent. In contrast, in the Baltic states and Russia the share of long-term unemployed increased considerably in a very short period, in Latvia and Lithuania reaching a very high 55 per cent, a level exceeded only by Bulgaria and Slovenia.

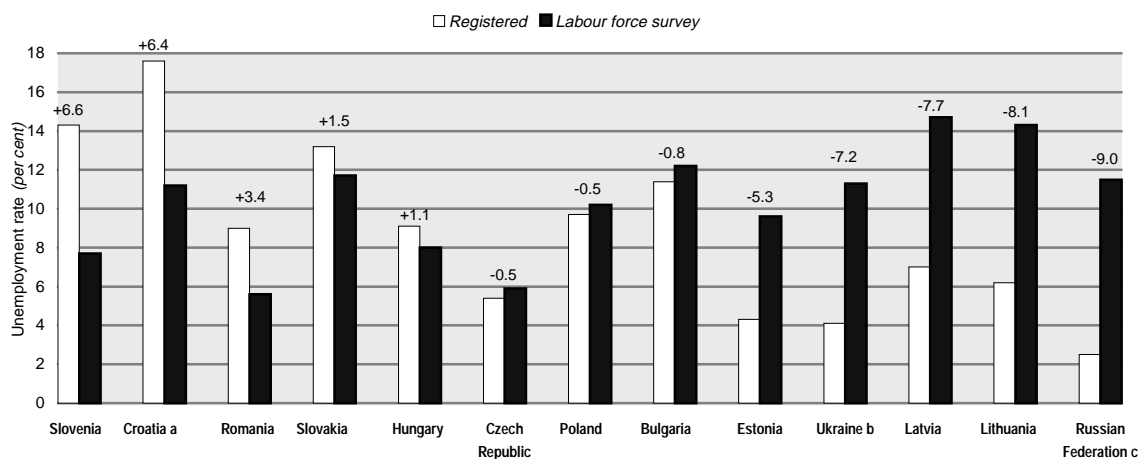
Long-term unemployment is not only very painful for individuals and a potential source of social instability, but it also creates serious obstacles for the market-clearing mechanism. The experience of west European countries since the 1980s demonstrates that reducing unemployment during a recovery is much more difficult when there is a high incidence of long-term unemployment. It seems that it is also true for the transition economies. The case of Slovenia is illustrative: although a relatively strong recovery in output was already in its sixth year and employment began to increase, a very high and persistent unemployment rate (above 14.5 per cent) prevailed through 1997-1998.

<sup>433</sup> For a more detailed discussion see UN/ECE, *Economic Survey of Europe in 1995-1996*, p. 89.

<sup>434</sup> In the same period of 1996, it was only in Hungary and Slovenia that the female share was less than 50 per cent. See UN/ECE, *Economic Survey of Europe in 1996-1997*, p. 118. For a more detailed discussion of women's position in labour markets in the transition economies see the next subsection.

CHART 3.5.2

Registered and labour force survey unemployment rates in selected transition economies, 1998-QII  
(Per cent of labour force)



Source: National statistics and direct communications to UN/ECE secretariat.

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

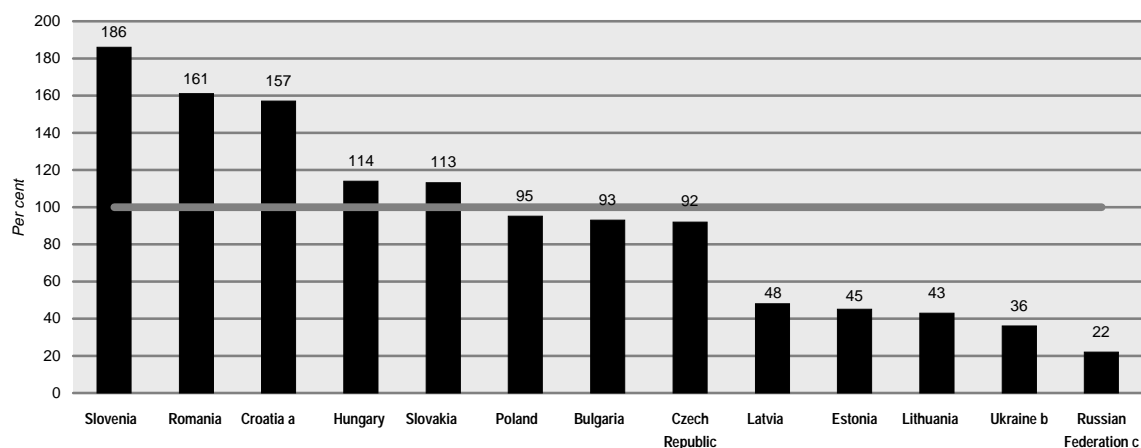
a Average for the first half of the year.

b November 1998.

c Based on Russian Federation Goskomstat estimates according to the ILO definition.

CHART 3.5.3

Relationship between registered and survey-based unemployment rates in selected transition economies, 1998-QII  
(Labour force survey unemployment rate = 100)



Source: National statistics and direct communications to UN/ECE secretariat.

Note: Countries are ranked by the relative deviation between the two measures.

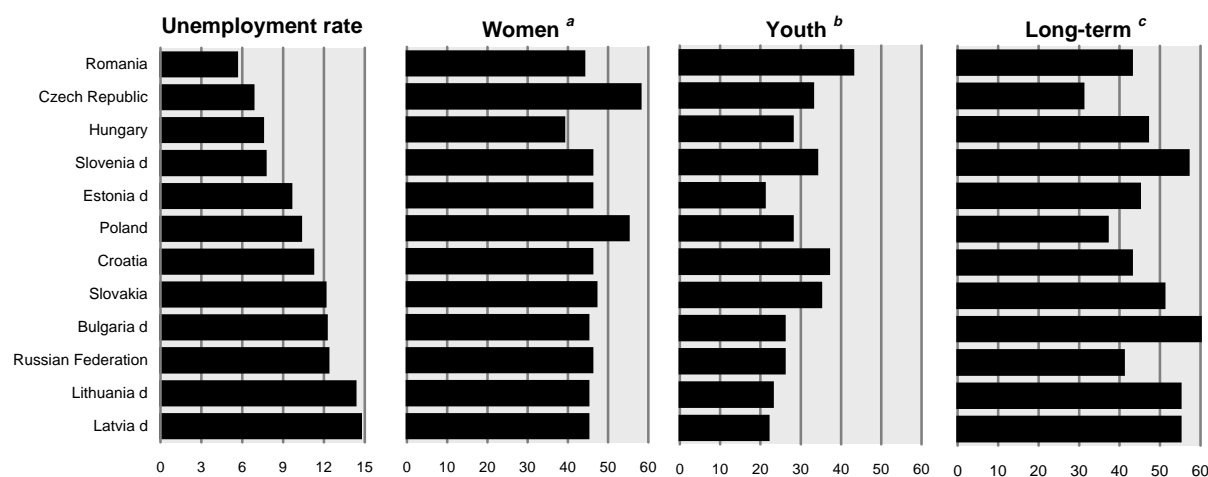
a Average for the first half of the year.

b November 1998.

c Based on Russian Federation Goskomstat estimates according to the ILO definition.

CHART 3.5.4

Unemployment rate, share of women, youth and long-term unemployed in total unemployment in selected transition economies, 1998-QIII  
(Percentages)



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

Note: Data refer to labour force survey results.

<sup>a</sup> Share of women in total unemployment.

<sup>b</sup> Share of persons less than 25 years old in total unemployment.

<sup>c</sup> Share of persons who have been unemployed for more than 12 months in total unemployment.

<sup>d</sup> Second quarter.

## (ii) Effects of transition on the labour force and employment from a gender perspective, 1985-1997

### (a) Introduction

One of the major transformation shocks in the former centrally planned economies at the start of their reform process was the severe decline in employment and the emergence of open unemployment, a phenomenon which was generally unknown in the communist era. Unemployment benefits, which were initially rather generous, have been cut gradually in real terms (in the CIS falling well below the minimum subsistence levels) and entitlement has been subject to tighter conditions. Large numbers of the unemployed have thus stopped registering and some have also stopped looking for work (the discouraged worker effect). Both men and women were affected by the closure of plants, restructuring and the overall fiscal squeeze. However, women were disproportionately affected by the transition from a centrally planned to a market economy; not only did a large number of them lose their jobs and their wages, just as men did, but those who kept their jobs lost their social benefits and services which, in addition to the loss of a large part of their money wages in real terms, rendered their employment uneconomical. Therefore they left their jobs and withdrew from the labour force altogether, changing their role in society, from second bread winner to that of full-time mother or to take care of ailing parents.

Policies towards women's employment in the centrally planned economies was more progressive than in the west in the sense that it facilitated the combination of women's productive and reproductive roles, the "double burden". By the 1980s, women accounted for nearly half of the labour force in these economies and also, in the absence of open unemployment, of employment. Measures such as free childcare facilities, extended maternity and sick child leave, etc., were part of the labour codes and were provided by the enterprises which, in turn, were supported by generous subsidies from the government. With the squeeze on government budgets and the removal of subsidies, these social welfare measures in favour of the female labour force were dramatically reduced de facto, but to a large extent remained on the statute books in most of the transition economies. Women therefore not only lost most of their privileges, in fact, as workers, but they were also considered overpriced in terms of the remaining welfare codes even if these were usually ignored.<sup>435</sup>

The various labour market indicators discussed below demonstrate that in fact women are disproportionately affected in general by the transition from a centrally planned to a market economy. The main findings of the analysis show that the transition process has involved large job losses both for men and women.

<sup>435</sup> V. Einhorn, "Gender issues in transition: the east and central European experience", *The European Journal of Development Research*, Vol. 6(4), December 1994.

However female employment fell more than male employment due to the large cuts in public sector service jobs which were (and still are) predominantly held by women. Furthermore, as mentioned above, there were women who could have kept their jobs but preferred to give them up because they were no longer paid an economic wage. This last reason for declining female employment led to a smaller female labour force but not to a much larger pool of female unemployed. Consequently, the unemployment rate of women was not significantly higher than men in general, and in some economies it was even lower. Nevertheless, structural change in these economies has tended to favour growth in a number of service sector branches where again women's occupations are rising. Furthermore, if the pattern in the western economies is a guide to the future, then the new social infrastructure, which has already started to be constructed in many of these economies, will create new job opportunities for women, for example, through the monetization of the "care economy".

The data used in this note for the period 1992-1997 are mostly taken from the national labour force surveys conducted in seven east European, three Baltic countries and Russia, according to the ILO's methodology.

### (b) Labour force

#### Growth, 1985-1997

The female labour force shrank in all eight countries, for which there are data, between 1985 and 1997 (table 3.5.3). It declined even in those countries where the male labour force remained fairly stable (Poland, Estonia, Latvia) or even increased (Czech Republic, Lithuania, Russia). In Hungary, the female labour force in 1997 was more than a third smaller than in 1985; however, the male labour force also fell strongly, by more than one fifth. In Estonia and Latvia female labour force fell by nearly one fourth between 1985 and 1997. In Estonia, much of this decline can be explained by demographic changes,<sup>436</sup> but in Latvia it was mainly due to a fall in activity rates.

#### Activity rates and labour force population ratios

Female activity rates<sup>437</sup> were lower than in 1985 in all the countries for which there are data (table 3.5.4). The large fall in some countries is partly due to the early retirement schemes promoted at the onset of the reforms (for example, in the Czech Republic). These schemes also affected the male rates, but the fiscal squeeze and

<sup>436</sup> In Estonia, between 1985 and 1997, the female population of working age declined by 16 per cent against 7 per cent for males.

<sup>437</sup> Activity rates show the share of the working-age population participating in the labour force (i.e. employed plus unemployed). These activity rates are lower than those reported by the countries as the upper age limit differs among countries, over time, and in some also between males and females. In order to have more comparable rates, the working age population is taken here as 15 years of age and over for both sexes throughout the period 1985-1997.

TABLE 3.5.3

Growth rates of labour force and employment in selected transition economies, by sex, 1985-1997  
(Cumulative, percentages)

	Labour force		Employment	
	Male	Female	Male	Female
Czech Republic .....	2.9	-5.5	-1.2	-11.8
Hungary .....	-22.5	-35.1	-29.8	-40.1
Poland .....	0.4	-1.6	-8.3	-13.4
Slovenia .....	-9.2	-9.7	-15.6	-16.2
Estonia .....	0.5	-23.5	-10.8	-30.9
Latvia .....	-0.9	-22.5	-16.4	-33.3
Lithuania .....	7.8	-11.2	-7.4	-23.7
Russian Federation .....	5.6	-11.1	-6.4	-20.6

Source: UN/ECE secretariat estimates, based on national labour force surveys, statistical yearbooks and direct communications from national statistical offices.

eventual subsidy cuts hurt women more as these included the de facto elimination of social entitlements and services, cuts which remained in place even after growth resumed. The female activity rates fell significantly (by about one fifth) in Hungary, Slovenia and Latvia. However, in Hungary and Slovenia male rates also fell by as much, while in Latvia they remained stable. In Estonia and Lithuania male activity rates were even higher in 1997 than in 1985 while the female rates, which were nearly as high as male rates in 1985, fell by 10 percentage points in both countries during 1985-1997. Nevertheless, the Baltic countries had the highest female activity rates of all the 11 transition economies in 1997. Female activity rates in 1997 were also high in Romania, largely because of the high share of agriculture in the economy where women farmers, although decreasing, remain in a slight majority (see below). The lowest female rate in 1985 was in Poland (some 55 per cent), but the smallest decline was also in Poland, probably because of the relatively earlier recovery in economic growth which started in 1992 and accelerated thereafter. However, the female activity rate of 50 per cent in 1997 in Poland was again relatively low compared with most of the other transition economies; the exceptions were Hungary and Bulgaria where the rates fell to just below 43 per cent and 47 per cent, respectively.

As activity rates can vary among countries because of differences in the definition of working age, it is sometimes more appropriate to use labour force population ratios which can be defined as crude activity rates. These crude rates also show that female labour force participation declined everywhere and faster than male rates.

#### Share of women in the labour force

In 1985, women were a majority of the labour force in the Baltic countries and Russia (table 3.5.5). In the four east European countries, for which there are data, the female share was relatively smaller but still very high by western standards, varying between 46 and 48 per cent.

TABLE 3.5.4

Gender specific labour market indicators in selected transition economies, 1985 and 1997  
(Percentages)

	Activity rates <sup>a</sup>		Unemployment rates		Labour force-population ratio		Employment-population ratio	
	1985	1997	1985	1997	1985	1997	1985	1997
Bulgaria								
Male .....	..	56.8	-	14.7	..	46.8	..	40.0
Female .....	..	46.9	-	15.3	..	39.4	..	33.4
Czech Republic								
Male .....	75.1	71.3	-	4.0	56.5	58.2	56.5	55.9
Female .....	59.3	52.1	-	6.7	46.0	43.5	46.0	40.6
Hungary								
Male .....	73.9	60.4	-	9.5	57.1	46.4	57.1	42.0
Female .....	61.3	42.8	-	7.8	48.9	32.7	48.9	30.2
Poland								
Male .....	69.5	65.5	-	8.7	50.9	49.3	50.9	45.0
Female .....	54.9	50.0	-	12.0	41.5	39.2	41.5	34.5
Romania.....								
Male .....	..	72.3	-	5.7	..	57.7	..	54.4
Female .....	..	57.5	-	6.4	..	46.8	..	43.9
Slovakia								
Male .....	..	66.2	-	10.8	..	51.6	..	46.0
Female .....	..	51.0	-	12.5	..	40.8	..	35.7
Slovenia								
Male .....	82.3	65.7	-	7.0	62.5	53.5	62.5	49.8
Female .....	65.2	53.0	-	7.2	51.3	44.0	51.3	40.9
Estonia								
Male .....	68.4	71.5	-	11.2	51.4	54.1	51.4	48.1
Female .....	67.7	57.7	-	9.6	53.9	43.4	53.9	39.2
Latvia								
Male .....	69.4	69.8	-	14.1	53.2	54.5	53.2	46.0
Female .....	68.4	54.3	-	14.0	55.2	44.5	55.2	38.2
Lithuania								
Male .....	70.1	72.4	-	14.1	52.6	54.8	52.6	47.1
Female .....	65.1	55.6	-	14.0	51.2	44.0	51.2	37.8
Russian Federation								
Male .....	72.6	70.9	-	11.4	55.0	55.3	55.0	50.0
Female .....	63.5	53.6	-	10.7	50.0	43.7	50.0	39.8

Source: UN/ECE secretariat estimates, based on national labour force surveys, statistical yearbooks and direct communications from national statistical offices.

Note: Working age population used to calculate activity rates is: 15 and over except for Hungary and Estonia: 15-74.

<sup>a</sup> Labour force ÷ working age population.

However, as female activity rates fell faster than male rates during 1985-1997, even when the male rates remained stable or increased, the female share of the labour force declined rapidly, particularly in the Baltics and Russia although they still remained high in 1997, between 47-49 per cent. The lowest proportions of females in the labour force in 1997 were in Hungary (43.5 per cent, down from some 48 per cent in 1985) and the Czech Republic (some 44 per cent).

### (c) Employment

#### Growth, 1985-1997

One of the major consequences of the reforms and the accompanying structural adjustments was the general decline in employment during the 1990s, even in those economies where the recovery in output occurred relatively quickly. Both male and female employment

fell, but, the decline in female employment was considerably sharper because of the fiscal squeeze and loss of jobs in the public sector.

In Hungary, female employment fell by 40 per cent, while for males by 30 per cent, the largest rates of decline in all eight countries. Female employment fell more than 30 per cent in both Estonia and Latvia, considerably more than the fall in male employment. Even the smallest cut in female employment, in the Czech Republic (less than 12 per cent), was nearly 10 times larger than that for male employment. Only in Slovenia did male and female employment shrink at the same rate between 1985 and 1987.

Female employment not only fell more than male employment, but also more than the decline in the female labour force, a fact which is reflected in soaring female (open) unemployment, much of it remaining unemployed for more than one year.

TABLE 3.5.5

Share of women in labour market indicators in selected transition economies, 1985 and 1997  
(Percentages)

	Labour force		Employment		Unemploy- ment	Long-term unemploy- ment <sup>a</sup>
	1985	1997	1985	1997	1997	1997
Bulgaria .....	..	46.8	..	46.7	47.8	47.6
Czech Republic .....	46.2	44.1	46.2	43.4	57.0	53.9
Hungary .....	47.9	43.5	47.9	44.0	38.6	35.8
Poland .....	46.2	45.7	46.2	44.7	53.8	59.7
Romania .....	..	45.8	..	45.7	48.4	52.4
Slovakia .....	..	45.4	..	45.0	49.0	50.6
Slovenia .....	46.5	46.4	46.5	46.3	47.0	43.2
Estonia .....	54.7	47.9	54.7	48.4	44.1	..
Latvia .....	54.8	48.6	54.8	49.1	46.0	48.8
Lithuania .....	52.2	47.3	52.2	47.4	47.1	..
Russian Federation...	51.5	47.3	51.5	47.4	45.8	48.9

*Source:* UN/ECE secretariat estimates, based on national labour force surveys, statistical yearbooks and direct communications from national statistical offices.

<sup>a</sup> Unemployed for more than one year.

### Employment-population ratio

The employment-population ratio is a better basis for comparison among countries of the changes in the employment opportunities as it is neither affected by different definitions of working age population (as in the case of conventional activity rates) nor by differences in the coverage of the unemployed (as in the case of the labour force). It also measures (inversely) the dependency rate (sex-specific in this case) in an economy. The only bias which may arise is from the shadow (grey) economy which is unfortunate because this is important in these countries and its size probably varies greatly not only between countries but also by gender. However, this is a bias which is embodied, directly or indirectly, in all the labour market indicators.

The employment-population ratio fell in all eight countries for both men and women between 1985 and 1997, although, the female ratio fell much more. In the Czech Republic the male ratio fell less than 1 percentage point while the female ratio fell more than 5 percentage points. Nevertheless, the largest fall was again in Hungary, from 49 per cent in 1985 to 30 per cent in 1997, the lowest rate in the region; in other words, in 1985, one out of two Hungarian women (regardless of age) was employed; in 1997 this ratio was less than one out of three. The employment-population ratio in 1997 was also very low in Bulgaria, Slovakia and Poland but the latter country had the lowest ratio among the eight countries already in 1985 (41.5 per cent). In Estonia and Latvia, the ratio fell considerably, from some 55 per cent in 1985 in both – higher than for men – to less than 40 per cent in 1997 – nearly 10 percentage points lower than men. In 1997 the ratio remained above 40 per cent in the Czech Republic, Romania and Slovenia.

### Share of women in employment

Not only did the proportion of women in the labour force fall everywhere between 1985 and 1997, but so did their share in employment (except in Slovenia where it remained stable). It nevertheless remained high in the Baltics and Russia (between 47.5-49 per cent), where women were in a majority in 1985. In the Czech Republic, Hungary and Poland it fell below 45 per cent. However these rates are still high by western standards.

The massive decline in employment, both for men and women, during the transition process has been accompanied by considerable changes in the industrial distribution of employment. The share of goods producing sectors (i.e. agriculture, industry and construction) in total employment has declined while the share of services has increased in general. This structural change in employment affected both men and women but was more pronounced for women. Chart 3.5.5 shows the rate of change in employment in a given industry<sup>438</sup> relative to the rate of change in total employment,<sup>439</sup> where employment, both in industry and total economy, is gender specific. Both male and female agricultural employment declined faster than total employment in the majority of countries, but for women, the relative fall was generally much greater than for men. There was a similar development in industry except in Poland, where there was an increased share of women workers in certain labour intensive branches such as textiles, and utilities.

In contrast, employment growth in the service sector in all 10 economies was greater than in the rest of the economy, both for men and women, although relatively better for men, in general. The sectors where the shares of total female employment generally fell were transport and communications, but they did significantly better in financial, real estate and business services, as well as public administration. However in many countries the shares of total male employment in these branches increased even more than those for women (the main exceptions being the Czech Republic, Poland and Slovenia).

These structural changes in male and female employment rates are, of course, reflected in the gender composition of employment in each sector (table 3.5.6). While the female share in agriculture, industry and construction generally has fallen during the transition (except in agriculture in Slovenia, Estonia and Latvia and industry in Poland), it increased in many service sectors where females were already in a large majority in the early 1990s.

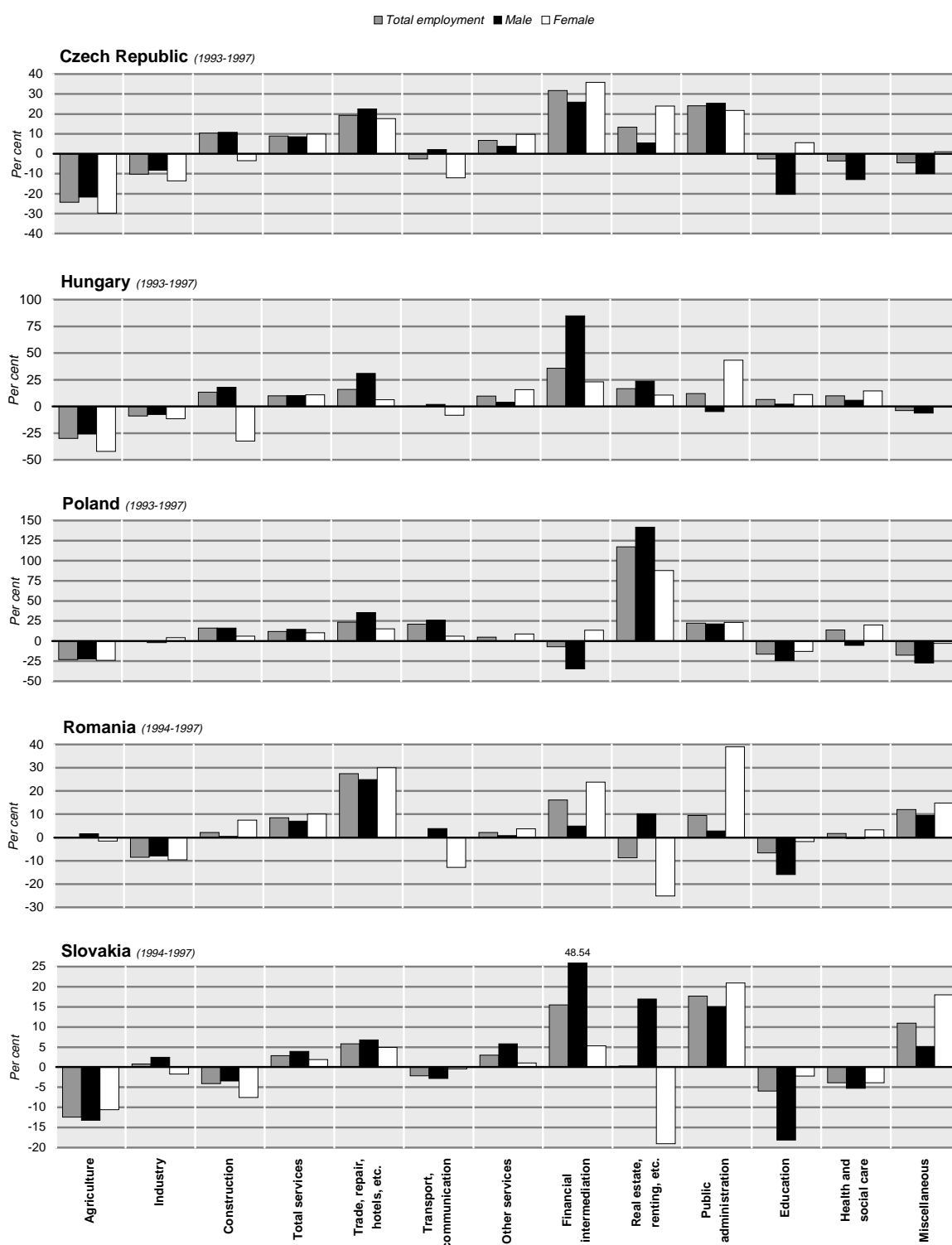
However, in the service sector as a whole the female share of total employment has fallen, albeit by much less than in the goods producing sectors. Furthermore, the women's share in the majority of services was still larger than that of men in 1997, varying between some 53 per cent in Hungary and 63 per cent in Lithuania.

<sup>438</sup> NACE classification as given in the national labour force surveys.

<sup>439</sup> Here the size of the sector in the initial period is an important factor while interpreting the relative growth rates. Furthermore, the initial period differs among countries which is dictated by data availability. This does not affect cross sectoral analysis but should be borne in mind when the comparison is done across countries.

CHART 3.5.5

Relative total and gender specific employment growth index <sup>a</sup> by sectors in selected transition countries, 1992-1997  
(Percentages)

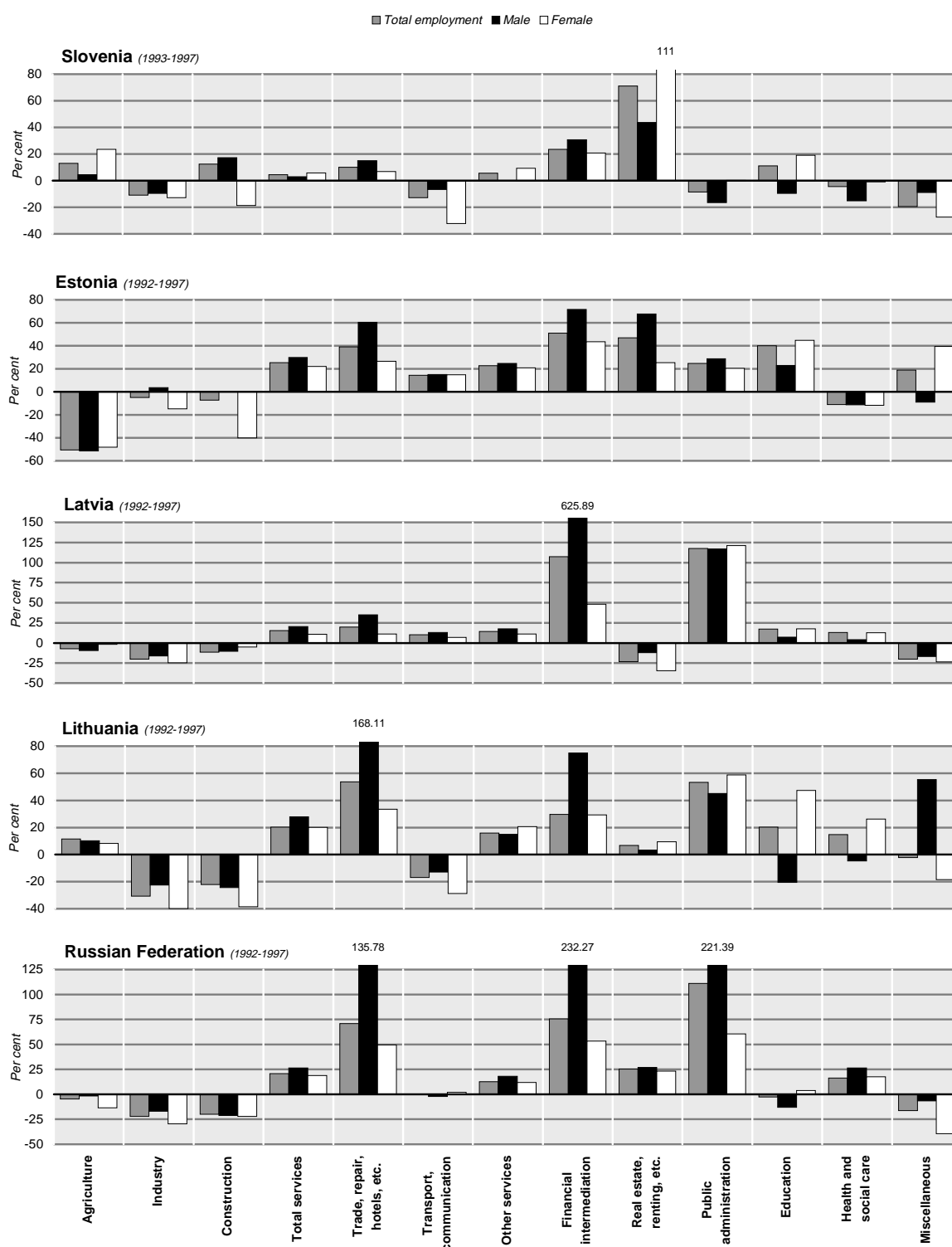


(For source and notes see end of chart.)



CHART 3.5.5 (concluded)

Relative total and gender specific employment growth index <sup>a</sup> by sectors in selected transition countries, 1992-1997  
(Percentages)



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

<sup>a</sup> The zero-line is the cumulative per cent change in total employment (i.e. total, total male, total female). Each sector's relative employment change is calculated as the following:  $[(I_j \div I_t) - 1] \times 100$ ; where I is the employment index in 1997 with 1992=100, j is the sector and t, the total (i.e. total, total male, total female).

TABLE 3.5.6

Share of women in total employment by industry in selected transition economies, 1992-1997  
(Per cent)

	Czech Republic		Hungary		Poland		Romania		Slovakia	
	1993	1997	1992	1996	1993	1997	1994	1997	1994	1997
<b>Total</b> .....	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<b>Female</b> .....	44.1	43.4	45.7	44.0	45.2	44.7	46.2	45.7	44.3	45.0
Agriculture .....	35.7	32.7	31.2	24.8	45.6	44.5	52.1	50.8	31.1	31.3
Industry .....	39.5	37.5	41.3	38.6	33.9	34.8	40.6	39.6	39.0	38.2
Mining and quarrying .....	16.0	16.9	13.7	12.1	13.1	8.6	14.8	15.5	17.2	15.8
Manufacturing .....	42.1	39.8	43.9	40.8	37.0	39.3	44.3	43.3	42.0	41.5
Electricity, gas, etc. ....	26.7	23.6	29.1	25.9	20.8	22.3	23.3	23.8	19.8	18.7
Construction .....	10.3	8.9	15.0	8.6	10.4	9.4	13.5	14.1	10.1	8.6
Total services .....	54.8	54.4	54.2	52.6	56.4	55.0	48.6	48.7	56.5	57.3
Trade, repair, hotels, etc. ....	56.9	55.2	58.2	51.3	57.9	53.5	55.6	56.1	57.9	58.9
Trade and repair .....	57.0	55.1	58.2	51.4	56.9	52.2	53.9	54.5	56.2	57.7
Hotels and restaurants .....	56.7	55.8	57.9	50.7	70.4	67.7	63.5	64.7	64.7	64.0
Transport, communication .....	35.0	31.1	29.8	26.3	28.6	24.9	26.2	22.6	30.4	30.6
Other services .....	59.4	60.1	59.0	59.9	61.2	62.7	52.4	52.6	62.6	63.1
Financial intermediation .....	66.8	67.8	76.0	66.3	58.2	70.3	61.9	65.3	77.0	72.5
Real estate, renting, etc. ....	43.7	47.1	51.2	46.8	45.5	38.9	53.4	43.3	46.2	41.8
Public administration .....	38.8	37.5	34.7	42.7	42.0	42.0	16.7	21.0	44.0	46.9
Education .....	72.1	76.9	75.8	76.1	73.8	76.1	69.0	71.8	75.1	79.5
Health and social care .....	79.3	81.1	75.1	75.3	79.5	82.8	76.9	77.1	80.6	79.9
Miscellaneous .....	51.6	53.8	49.0	48.8	40.1	46.7	47.6	48.3	44.7	48.3
Private sector .....	..	..	..	..	43.6	41.7	54.4	50.7	24.0	26.6
	Slovenia		Estonia		Latvia		Lithuania		Russian Federation	
	1993	1997	1992	1996	1992	1997	1992	1997	1992	1997
<b>Total</b> .....	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<b>Female</b> .....	46.7	46.3	47.2	48.4	47.8	49.1	52.9	49.2	49.2	47.4
Agriculture .....	44.4	48.1	36.6	37.5	34.2	37.3	41.2	37.2	36.0	31.5
Industry .....	40.7	39.4	45.7	40.9	46.4	45.1	51.7	41.8	45.1	39.3
Mining and quarrying .....	..	14.3	20.5	12.7	38.5	26.1	35.0	30.3	..	..
Manufacturing .....	42.2	41.0	48.8	43.6	47.2	47.6	53.2	45.0	..	..
Electricity, gas, etc. ....	25.0	15.4	31.8	29.6	31.6	23.5	30.2	20.0	..	..
Construction .....	15.2	10.9	16.5	12.9	12.4	13.7	15.0	11.0	25.0	23.5
Total services .....	55.8	56.0	59.2	57.5	59.0	58.2	67.3	62.5	61.9	58.7
Trade, repair, hotels, etc. ....	58.1	55.9	63.4	59.9	66.6	63.4	82.1	66.3	73.0	61.5
Trade and repair .....	56.3	52.3	61.2	57.3	65.2	61.9	81.7	65.8	..	..
Hotels and restaurants .....	64.3	65.8	72.7	73.9	70.8	74.6	85.5	71.6	..	..
Transport, communication .....	25.5	19.6	27.9	33.4	33.5	33.5	39.3	31.3	32.5	31.9
Other services .....	62.6	64.3	67.3	63.7	62.5	62.4	68.5	66.4	66.8	64.0
Financial intermediation .....	68.8	66.7	76.3	68.2	90.1	66.2	86.1	79.8	85.8	72.2
Real estate, renting, etc. ....	40.9	50.0	48.6	43.8	49.3	43.3	49.1	46.8	48.0	45.5
Public administration .....	48.6	52.8	48.1	40.1	39.8	41.5	37.1	35.8	68.3	50.0
Education .....	73.9	78.5	74.0	79.0	77.8	80.1	67.2	76.6	71.9	74.0
Health and social care .....	78.9	81.1	86.5	82.1	81.7	83.6	82.4	84.2	83.0	80.9
Miscellaneous .....	56.1	50.0	61.0	60.4	42.5	41.7	76.1	59.0	34.7	24.3
Private sector .....	..	..	..	..	..	..	..	..	..	..

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

#### (d) Unemployment

##### Share of women in unemployment

Even though the women's share of total employment fell everywhere between 1985 and 1997 (except in Slovenia), their share in unemployment in 1997 was generally smaller than that of men. This largely reflects their departure from the labour market, encouraged by the loss of benefits which supported their

employment,<sup>440</sup> as discussed above. For example, in Hungary the female share in total unemployed was less than 40 per cent, the lowest share of all the 11 transition economies. Between 1985 and 1997 female employment fell by more than 1 million while the number of women

<sup>440</sup> Hidden unemployment, i.e. unemployed but not registered, is not an issue here due to the use of the comprehensive definition (ILO) of the unemployed in the national labour force surveys.

unemployed in 1997 was only 135,000, equivalent to 12.5 per cent of the jobs lost by women between 1985 and 1997. This suggests that more than 900 thousand women left the labour market, the equivalent of more than one third of the labour force in 1985. In fact in most of these economies there is a much larger withdrawal of women from the labour force once they become unemployed than is the case for men.<sup>441</sup> Furthermore, not only do more women than men leave the labour force once they become unemployed but those who do remain and keep on searching jobs, remain unemployed for longer than men. In the Czech Republic, Romania, Slovakia and, particularly, Poland, women constitute the majority of the long-term unemployed while in Latvia (and probably in the other two Baltic states) and Russia their share in the long-term unemployed is larger than their share in total employment.

#### *Rates of unemployment*

Given their large-scale exodus from the labour market, female unemployment rates are higher than for men only in the Czech Republic, Poland, Slovakia and, to a much lesser extent, in Bulgaria and Romania. In the other countries their rates are similar to those for men or even lower.

#### *(e) Conclusion*

The above analysis has tried to set out the effects of economic reforms on the shares of women in the labour force, employment and unemployment.

In general, more women than men have lost their jobs as a result of the restructuring process but their share of unemployment is less simply because they tend to leave the labour force altogether. For those who stay in the labour force, employment is less remunerative because of the withdrawal or reduction of many social benefits and if they become unemployed they tend to remain so for much longer than men.

Although it is often difficult to say how far these changes reflect the preferences of women or whether they reflect unequal treatment, the loss of benefits and social services which previously had made it easier for women – especially those with children – to hold a job suggests that many of the adjustments that have been made under the preserves of transition have fallen most heavily on women. Apart from the injustice of policies which effectively undermines the principal of equal opportunity, the emergence of differential incentives for men and women to remain in the labour force is not a desirable attribute of a well-functioning labour market.

### **3.6 International trade**

#### **(i) Introduction**

In the first nine months of 1998, the value of exports from the ECE transition economies declined slightly. Strong but increasingly more competitive western import demand helped to raise east European and Baltic countries exports by nearly 10 per cent. However, their export performance weakened considerably towards the end of the year as a result of Russia's economic crisis. In contrast, Russian exports fell sharply due to falling commodity prices and, to a lesser extent, the currency devaluation and subsequent disruption to the banking system. Exports of the remaining CIS countries also suffered, as they are, in many cases, primary commodity exporters to the non-CIS area. The devastating events in Russia, which accounts for about half of regional trade flows, together with a series of currency devaluations in the CIS area have led to a sharp fall in intra-CIS trade.

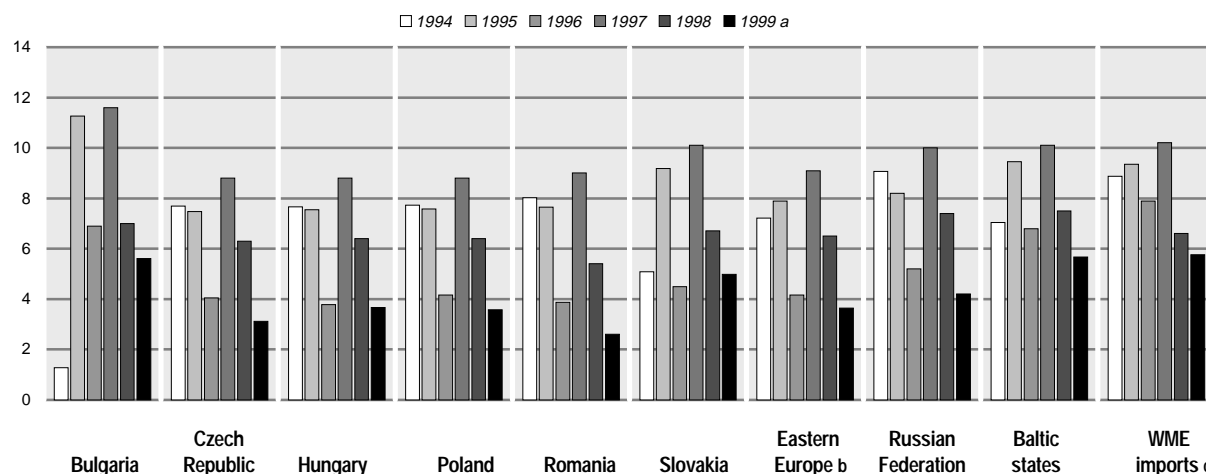
Imports into the east European and Baltic countries increased in the first three quarters of 1998, partly a result of favourable terms of trade and the increased demand for imported intermediate inputs. In the fourth quarter, however, with aggregate demand in the area cooling down, still lower global commodity prices, and unfavourable credit conditions in some of these countries, the growth in the value of imports slowed down. In the CIS countries, the fall in the value of imports in the first nine months of 1998 reflected the financial crisis in Russia and balance of payment difficulties in a number of them. Overall, the value of imports into the ECE transition economies increased by 4 per cent.

The deterioration in the global economic environment since mid-1997 has led to increased competitive pressures not only on external but also on the domestic markets of the ECE transition economies. As a result, there was an increasing number of calls in 1998, across all the transition economies from Poland to Hungary to the Baltic states to central Asia, for increased domestic protection against imports. Moreover, these calls for protection came from a range of sectors including agriculture, food, textiles, footwear, steel and coal. While protectionist sentiments against imports are strong and prevalent, there have as yet been no major policy reversals in the area of trade policy. In eastern Europe and the Baltic states, most attempts to increase import duties, impose quotas or file trade complaints to the WTO, were handled within the existing framework of bilateral or multilateral trade agreements or were quickly abandoned. Similar pressures to protect domestic industries were evident in the CIS region as well. While CIS protectionist measures have been largely limited to foodstuffs, so far, the effects of the Russian financial crisis and the consequent exchange rate realignments in the area may eventually lead to more serious implications for trade policy.

<sup>441</sup> "It is difficult to say to what extent these withdrawals correspond to discouragement (declared or implied); to what extent they reflected the personal preference of Hungarian women for full-time family care; and to what extent more women in Hungary could afford to give up paid employment than in neighbouring countries." L. Paukert, "Economic transition and women's employment in four central European countries, 1989-1994", *ILO Labour Market Papers*, No. 7 (Geneva), 1995.

CHART 3.6.1

Specific western demand for selected transition economies' exports, 1994-1999  
(Annual percentage change in volume terms)



*Source:* UN/ECE secretariat calculations: aggregation of the import volume growth rates of individual western countries weighted by their share in the exports of each eastern country. The western import data refer to goods and services on a national accounts basis. Data for 1998 are preliminary.

*a* Forecast.

*b* Six countries shown.

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

## (ii) Trade of eastern Europe and the Baltic states

### (a) Exports, imports and trade balances in 1998

The expansion of the foreign trade of the *east European* countries continued for a second consecutive year in 1998, but it weakened substantially in the second half of the year under the impact of developments in the important Russian market. Growth was relatively strong on the export side in the last quarter of 1997 and in the first months of 1998, still supported by the strength of western import demand (chart 3.6.1) and by increased vertical integration with EU and United States multinational companies. East European imports slowed somewhat towards the end of 1997, but picked up again in 1998, largely reflecting increased demand for imported inputs, in some cases in spite of attempts by policy makers to curtail domestic demand.

According to preliminary data, *overall export and import growth* in 1998 was about 8-9 per cent in current dollars, after an increase of some 6 per cent in 1997; the aggregate *trade deficit* of eastern Europe was around \$40.5 billion, \$1.4 billion higher than in 1997 (tables 3.1.2 and 3.6.1).

For the first time since 1994, export growth in the *Baltic* countries lagged behind that of eastern Europe; there was a sharp slowdown because of falling demand in the CIS markets and increased competitive pressures in the west. Preliminary full-year data for 1998 suggest that the *Baltic* countries' *exports and imports* grew just above 3 and 7 per cent, respectively, against average annual

rates of some 25 and 30 per cent in the previous three years. With imports continuing to outpace exports, their aggregate *trade deficit* increased by another \$0.7 billion in 1998, to \$5 billion (see table 3.6.1 for preliminary full-year figures, and tables 3.6.2 and 3.6.3 for January-September 1998 figures by major partner groups).<sup>442</sup>

As international commodity prices declined considerably, trade growth in *volume* generally outpaced the increases in value in 1998. Preliminary ECE estimates for the region as a whole (eastern Europe and the *Baltic* countries together) arrive at volume growth in the range of 9 to 12 per cent. On this measure, the increases in exports were generally smaller than in 1997; among the countries officially reporting trade volume or unit value indicators, export volume growth accelerated slightly only in the *Czech Republic* (table 3.6.4).

The loss of momentum in export growth, which was apparent already in May-June 1998, intensified significantly in the second half of the year as exports to Russia and to the rest of the CIS collapsed (in August-October 1998) while at the same time competitive pressures on the main western markets tended to increase. The growth of east European exports was 7.5 per cent in July-December 1998 (year-on-year) as compared with 10.5 per cent in the first half of the year, while exports from the *Baltic* countries actually fell by 5 per cent (in

<sup>442</sup> Most of the preliminary full-year data for 1998 available at the time of writing this *Survey* cover only total exports and imports, without their geographical and commodity breakdown; hence the discussion below is based on the more complete data for January-September/October.

TABLE 3.6.1

Trade performance and external balances in the east European and Baltic countries, 1998<sup>a</sup>

(Value in million dollars, growth rates in per cent)

	Exports		Imports		Trade	
	growth rates		growth rates		balances	
	Oct.- Dec.	Jan.- Dec.	Oct.- Dec.	Jan.- Dec.	Oct.- Dec.	Jan.- Dec.
<b>Eastern Europe</b> .....	7.2	9.4	6.9	8.5	-11 532	-40 548
Albania .....	19.9	34.5	-23.4	25.8	-153	-590
Bosnia and Herzegovina <sup>b</sup> ..	..	56.9	..	-32.5	..	-879
Bulgaria <sup>b</sup> .....	..	-12.5	..	-1.0	..	-540
Croatia .....	15.7	8.9	-21.7	-7.9	-946	-3 842
Czech Republic .....	12.3	15.7	8.7	4.6	-1 033	-2 464
Hungary .....	15.8	20.5	19.3	21.0	-722	-2 690
Poland <sup>c</sup> .....	-10.3	2.2	6.4	12.2	-6 210	-21 174
Romania .....	3.7	-1.6	-1.5	-4.9	-1 094	-2 436
Slovakia .....	14.8	10.7	21.3	11.0	-735	-2 292
Slovenia .....	10.1	8.1	13.8	7.9	-306	-1 049
The former Yugoslav						
Republic of Macedonia <sup>b</sup> ..	..	11.0	..	9.0	..	-602
Yugoslavia .....	43.0	20.3	-20.0	1.0	-333	-1 990
<b>Baltic states</b> .....	-9.6	3.3	-9.4	7.3	-1 274	-5 005
Estonia .....	1.2	9.7	-13.0	7.1	-281	-1 545
Latvia .....	-3.8	8.4	5.0	17.1	-418	-1 377
Lithuania .....	-20.7	-3.8	-13.6	2.7	-575	-2 084
<b>Total above</b> .....	5.9	9.0	5.4	7.8	-12 807	-45 553

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

<sup>a</sup> Preliminary data.

<sup>b</sup> Annual rates and trade balances based on reported January-October growth rates.

<sup>c</sup> Annual rates and trade balances based on reported January-November growth rates. October-November 1998 over same period in 1997 instead of October-December data.

current dollar values) after increasing by 13 per cent in January-June (for quarterly year-on-year changes see chart 3.6.2).<sup>443</sup>

Among individual countries, only in Croatia, Slovakia and Slovenia was there a continued expansion of export value in the second half of the year.<sup>444</sup> Slovenia's exports, concentrating increasingly in a few manufacturing sectors, were gradually gathering momentum throughout the year, helped by sustained import demand in some of its

<sup>443</sup> For comparisons of individual country performance, see table 3.6.1 above and tables 2.3.6, 3.2.1-3.2.3 in the previous issue of this *Survey*. Note that the Statistical Office of the Czech Republic, after discovering some methodological biases, has recently revised the export and import values series back to 1994; the final complete series after revision are to be published in the second half of 1999. In tables 3.1.2. and 3.6.1, export and import growth rates and the merchandise trade deficit to GDP ratios are based on the preliminary revised figures kindly made available by the Czech Statistical Office to the UN/ECE secretariat in March 1999. For the revised values of Czech trade flows see appendix tables B.10-B.12 of this *Survey*. There was also a recent downward revision of 1998 quarterly data for Lithuania.

<sup>444</sup> The apparent strong export gains in the last two quarters of 1998 in Slovakia's trade, however, raise some doubts as to the reliability of the data. There are many deficiencies in the recently revised (according to a new methodology) monthly and quarterly figures for the base year 1997. Note, for instance, the very different year-on-year growth rates of monthly exports and imports in 1998 shown in the last two issues of Slovakia Statistical Office, *Economic Bulletin*, both claiming to be based on the definitive data for 1997.

major western markets – Italy and lately also France (the latter reflecting the increasing activity of a Renault subsidiary in Slovenia). The further liberalization of trade within CEFTA and its low exposure to the Russian and other CIS markets were also favourable factors for Slovenia. The 9 per cent rise in the value of Croatian exports in 1998 was entirely generated in the second half of the year (up 18 per cent, year-on-year, after zero growth in January-June), and reflected a more than doubling of the dollar value of exports in the machinery and transport equipment sector, whereas exports of all other commodity categories fell or stagnated during 1998.<sup>445</sup> Slovakia's export growth was also generated exclusively in the transport equipment sector, which posted a 45 per cent rise in export sales in 1998, due mainly to capacity expansion in the Bratislava plant of Volkswagen,<sup>446</sup> while exports from all other economic sectors declined in dollar value.

Although export growth moderated somewhat in the south-east European transition economies, increases remained above 20 per cent in Albania and Bosnia and Herzegovina and Yugoslavia and was in two digits in The former Yugoslav Republic of Macedonia. The continuing economic recession in Bulgaria and crisis in Romania, in addition to the unfavourable external environment, strongly affected their export performance: Bulgaria's exports shrank by nearly 13 per cent in January-September 1998, compared with the same period of 1997, while Romania's declined by 2 per cent in 1998 according to preliminary data for the full year.<sup>447</sup>

East European import growth tended to strengthen slightly in the first three quarters of 1998, but later in the year, with domestic demand cooling down throughout the region (section 3.3 above) and world commodity prices sinking even deeper in October-December,<sup>448</sup> there was a sharp loss of momentum: the value of imports in January-September was some 9 per cent higher than a year earlier but in October-December the rate was below 7 per cent (table 3.6.1). Nevertheless, there was still rapid import growth (19 per cent) in Hungary for the second consecutive year and in Poland, it remained in two digits, although it decelerated somewhat in the last quarter.

<sup>445</sup> The main factor behind this development of exports were discontinuities in export deliveries from Croatia's shipbuilding sector: in 1997 the sector's exports were rather sluggish, but in the second half of 1998 it delivered several oil tankers. At least two oil tankers, with a carrying capacity of over 47,000 tons, were launched and delivered in September and October 1998 to the Liberian Shipping Company and a Moscow-based shipping company. *Reuters Business Briefing*, 8 and 17 October 1998.

<sup>446</sup> In 1998, Volkswagen of Germany employed an extra 1,500 workers in its Bratislava plant and raised its production of VW Golf and Bora family cars to 125,000 units from 40,000 in 1997. VW also assembles gearboxes in Bratislava, output of which increased from 280,000 in 1997 to 328,000 units in 1998, while at the same time the gearbox components output was raised from 6 million to 8 million units. The bulk of the output is distributed outside Slovakia via the VW distribution network. *Financial Times*, 21 January 1999.

<sup>447</sup> For more details on recent developments in the Romanian economy, see sect. 3.2(iii) above.

<sup>448</sup> In the last quarter of 1998 world commodity prices contracted by 27 per cent on average on a year-on-year basis, and by 6 per cent against the previous quarter. For details see chap. 2.1(i) above.

TABLE 3.6.2

**Foreign trade of the ECE transition economies by direction, 1996-1998**  
(Value in billion dollars, growth rates in per cent)<sup>a</sup>

Country or country group <sup>b</sup>	Exports				Imports			
	Value 1997	Growth rates			Value 1997	Growth rates		
		1996	1997	1998 <sup>c</sup>		1996	1997	1998 <sup>c</sup>
<b>Eastern Europe, to and from:</b>								
World .....	102.5	2.1	5.8	9.9	136.2	13.1	5.8	9.3
ECE transition economies .....	27.5	6.1	6.7	1.0	29.7	9.4	0.1	-2.6
CIS .....	9.3	8.3	17.4	-8.9	14.0	12.2	-2.6	-14.1
Baltic states .....	0.9	37.6	26.8	30.5	0.2	22.0	0.8	11.9
Eastern Europe <sup>d</sup> .....	17.3	4.2	0.8	4.6	15.5	6.8	2.7	7.8
Developed market economies .....	67.7	-	7.6	15.7	93.4	13.1	7.4	13.1
European Union .....	62.1	-0.1	7.3	16.0	80.9	13.0	6.5	13.8
Developing economies .....	7.3	5.7	-10.5	-10.4	13.1	23.1	7.9	9.5
<b>Baltic states, to and from:</b>								
World .....	8.5	17.6	23.0	8.3	12.8	26.6	26.7	14.1
ECE transition economies .....	4.3	24.3	19.0	-2.6	4.6	14.7	17.6	4.6
CIS .....	3.1	21.8	19.3	-10.0	3.0	4.5	12.4	-8.6
Baltic states .....	1.1	43.4	25.1	16.3	0.8	38.1	25.7	29.2
Developed market economies .....	3.9	9.0	26.5	20.1	7.6	32.0	31.1	21.4
European Union .....	3.5	9.9	24.5	17.8	6.7	30.8	29.7	20.3
Developing economies .....	0.3	55.4	44.9	9.5	0.6	88.8	53.4	-2.0
<b>Russian Federation, to and from:</b>								
World .....	85.0	8.8	-0.1	-14.5	52.9	-1.4	14.9	-2.5
Intra-CIS .....	16.6	9.4	4.3	-12.8	14.1	7.0	-3.2	-8.8
Non-CIS economies .....	68.4	8.7	-1.2	-14.9	38.8	-4.9	23.3	-0.2
ECE transition economies .....	13.3	17.9	6.0	-19.8	5.3	-22.7	34.4	-7.6
Baltic states .....	3.1	16.4	17.4	-26.7	1.0	-38.8	61.9	-17.6
Eastern Europe .....	10.2	18.3	3.0	-17.8	4.3	-18.6	29.2	-5.1
Developed market economies .....	40.1	4.1	-0.2	-12.3	26.5	-7.2	24.0	-0.1
European Union .....	28.0	4.0	2.4	-16.4	19.5	-11.6	23.2	-2.2
Developing economies .....	15.0	14.1	-9.0	-17.3	7.0	24.2	13.5	4.8
<b>Other CIS economies, to and from:<sup>e</sup></b>								
World .....	32.1	10.5	4.1	-11.4	36.6	16.8	4.0	-8.3
Intra-CIS .....	16.1	13.6	-7.1	-14.1	21.2	12.0	-1.3	-13.9
Russian Federation .....	11.7	9.3	-2.8	..	15.8	12.8	-0.2	..
Non-CIS economies .....	16.0	6.7	18.5	-8.9	15.4	25.1	12.3	-1.5
ECE transition economies .....	2.8	7.2	-8.2	..	3.3	12.9	14.5	..
Baltic states .....	0.6	-0.5	-27.6	..	0.8	17.4	28.7	..
Eastern Europe .....	2.2	10.4	-1.0	..	2.5	11.7	10.7	..
Developed market economies .....	6.3	5.5	18.6	..	9.1	30.3	16.6	..
European Union .....	4.6	31.0	21.9	..	6.7	21.9	22.9	..
Developing economies .....	6.9	7.6	34.2	..	2.9	25.3	-1.3	..
<b>ECE transition economies, to and from:</b>								
World .....	231.7	7.2	4.0	-2.0	246.6	12.5	8.6	3.9

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

**Note:** There were changes in the methodology of foreign trade reporting in several economies in transition in 1996-1998. Starting 1998, Slovakia reports foreign trade flows according to the new methodology (including imports for inward processing and exports after processing). The Czech Republic has recently revised its export and import figures back to 1994. However, these revisions are not reflected in the eastern Europe aggregate above because revised data by destination are not yet available. For details on prior-1998 changes see UN/ECE, *Economic Bulletin for Europe*, Vol. 48 (1996) and Vol. 49 (1997).

<sup>a</sup> Growth rates are calculated on dollar values.

<sup>b</sup> "Eastern Europe" refers to Albania, Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. For lack of adequate data, the trade of Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia is not covered. The partner country grouping has been revised recently (subsequent changes back to 1980 were made also in appendix table B.13) following the changes in the national statistical sources. Thus, the earlier reported "Transition economies" group is now replaced by "ECE transition economies", which covers the east European countries, including the successor states of the former SFR of Yugoslavia, the Baltic states and the CIS. "Developed market economies" excludes Turkey and includes Australia, New Zealand and South Africa.

<sup>c</sup> January-September over same period of 1997. For Slovakia data are derived from export and import data reported according to the new methodology.

<sup>d</sup> Including Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia.

<sup>e</sup> Aggregate values and growth rates do not include Uzbekistan.

TABLE 3.6.3  
Trade balances of the ECE transition economies, 1993-1998  
(Billion dollars)

	1993	1994	1995	1996	1997	January-September	
						1997	1998
<b>Eastern Europe<sup>a</sup></b>							
World .....	-13.6	-12.5	-19.7	-31.9	-33.7	-23.8	-25.6
ECE transition economies .....	-3.8	-2.1	-3.2	-3.9	-2.2	-1.9	-1.2
Developed market economies .....	-10.5	-10.2	-15.1	-24.1	-25.7	-17.9	-18.9
European Union .....	-5.6	-6.1	-10.6	-18.0	-18.8	-13.0	-13.8
Developing economies .....	0.7	-0.2	-1.4	-3.9	-5.7	-4.0	-5.5
<b>Baltic states<sup>b</sup></b>							
World .....	-0.3	-0.9	-2.2	-3.2	-4.3	-2.9	-3.7
ECE transition economies .....	0.1	-	-0.5	-0.3	-0.3	-0.2	-0.4
Developed market economies .....	-0.3	-0.8	-1.6	-2.7	-3.7	-2.5	-3.1
European Union .....	-0.1	-0.4	-1.4	-2.4	-3.2	-2.1	-2.6
Developing economies .....	-0.1	-0.1	-0.1	-0.2	-0.3	-0.3	-0.2
<b>Russian Federation<sup>c</sup></b>							
World .....	17.5	24.6	31.5	39.1	32.1	23.6	15.7
Intra-CIS .....	..	3.8	0.9	1.3	2.5	1.6	1.0
Non-CIS economies .....	17.5	20.9	30.6	37.7	29.6	22.0	14.7
ECE transition economies .....	5.3	4.3	5.5	8.6	8.0	6.1	4.4
Eastern Europe <sup>d</sup> .....	4.6	3.3	4.3	6.6	5.9	4.5	3.4
Developed market economies .....	10.2	12.8	15.6	18.8	13.6	10.2	6.8
European Union .....	8.4	6.9	8.4	11.5	8.5	6.7	3.7
Developing economies .....	2.0	3.8	9.4	10.3	8.0	5.7	3.5
<b>Other CIS economies<sup>e</sup></b>							
World .....	..	-1.3	-2.1	-4.3	-4.4	-3.7	-4.2
Intra-CIS .....	..	-2.6	-4.0	-4.2	-5.1	-3.8	-3.3
Non-CIS economies .....	1.7	1.3	1.8	-0.1	0.7	0.1	-0.9
ECE transition economies .....	..	0.4	0.1	0.1	-0.5	..	..
Eastern Europe .....	..	0.2	-0.2	-0.1	-0.3	..	..
Developed market economies .....	..	-0.6	-0.7	-2.5	-2.8	..	..
European Union .....	..	-0.3	-0.6	-1.7	-2.2	..	..
Developing economies .....	..	1.5	2.4	2.2	4.0	..	..

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

Note: There were changes in the methodology of foreign trade reporting in several economies in transition in 1996-1998. Starting in 1998, Slovakia reports foreign trade flows according to the new methodology (including imports for inward processing and exports after processing). The Czech Republic has recently revised its export and import figures back to 1994. However, these revisions are not reflected in the eastern Europe aggregate above because revised data by destination are not yet available. For details on prior-1998 changes see UN/ECE, *Economic Bulletin for Europe*, Vol. 48 (1996) and Vol. 49 (1997).

<sup>a</sup> Trade balances as from 1996 are derived from export and import data reported by Hungary according to the new methodology and those for January-June 1998 are derived from export and import data reported by Slovakia according to the new methodology.

<sup>b</sup> Trade balances as from 1995 are derived from export and import data reported by Lithuania according to the new methodology.

<sup>c</sup> For the Russian Federation: Goskomstat data for 1993; State Customs Committee data for 1994-1998. The two series are not fully comparable.

<sup>d</sup> Excludes the former SFR of Yugoslavia in 1993.

<sup>e</sup> Trade balances for 1996, 1997 and first half of 1998 do not include Uzbekistan.

There was a strong pick-up of imports, partly boosted by favourable changes in the terms of trade and the increased demand of exporting sectors for imported inputs, in the Czech Republic, Slovakia and Slovenia, following declines in 1997. Everywhere else in eastern Europe, imports stagnated or declined in 1998 – most strongly in Croatia, where they fell by 8 per cent in dollar value after rapid growth in the three preceding years. The latter slump resulted from depressed domestic demand, due mainly to the very tight fiscal stance adopted earlier in the year, coupled with measures introduced in April by the Croatian national bank to discourage domestic banks from borrowing abroad.

In the Baltic countries changes in imports were in line with those for exports: a steady deceleration in value growth from early on in 1998, turned into an 9 per cent fall (year-on-year) in the last quarter of 1998 (table 3.6.1). The growth of imports slowed most steeply in Estonia, from an average annual rate of nearly 40 per cent in 1995-1997 to just above 7 per cent in 1998. There was also a dramatic deceleration in growth in Lithuania as well, although in Latvia it remained in two digits. Falling world commodity prices certainly played a role in slowing growth in the value of imports, but the cooling of domestic demand, due mainly to the collapse of export earnings from the Russian and other CIS markets, as well

TABLE 3.6.4  
Changes in the volume of foreign trade in selected transition economies, 1995-1998  
(Per cent)

	Exports						Imports					
	1995	1996	1997	1998 <sup>a</sup>			1995	1996	1997	1998 <sup>a</sup>		
				Jan.-Mar.	Jan.-Jun.	Jan.-Oct.				Jan.-Mar.	Jan.-Jun.	Jan.-Oct.
Czech Republic .....	5.7	2.7	14.2	29.1	20.4	16.0	23.7	10.7	7.6	11.2	7.7	7.6
Hungary .....	8.4	4.6	29.9	32.8	29.5	24.0	-3.9	5.5	26.4	28.1	27.4	26.6
Transition economies .....	20.2	-0.2	25.2	23.4	20.2	8.3	-4.1	2.8	5.3	6.0	9.9	11.5
European Union .....	5.1	5.7	33.6	36.2	29.9	25.6	-2.7	4.0	29.7	29.3	27.8	26.6
Poland .....	16.7	9.7	13.7	18.1	10.0	3.8	20.5	28.0	22.0	20.1	16.7	16.2
Transition economies .....	46.5	29.0	35.8	31.2	19.2	0.8	25.1	19.3	13.5	14.2	13.8	15.9
European Union .....	17.1	5.7	11.9	19.3	11.8	8.1	19.6	27.3	25.2	20.5	18.3	17.4
Slovenia <sup>b</sup> .....	7.5	3.1	11.3	15.9	10.0	9.0	15.5	-	9.6	18.1	10.1	9.3
Estonia .....	8.1	6.7	51.1	27.0	23.0	14.7	..	..	..	..	..	..
Latvia <sup>c</sup> .....	7.1	8.8	20.1	33.1	24.5	16.7	..	..	..	..	..	..
Russian Federation <sup>c</sup> .....	..	0.1	1.8	0.1	0.4	1.4	..	-1.9	21.1	24.1	17.5	4.8
Non-CIS .....	6.4	3.6	1.8	-2.6	-1.4	0.4	-3.2	-0.1	31.7	32.4	24.3	9.9
CIS .....	..	-15.6	1.9	10.6	7.7	5.3	..	-6.2	-1.8	2.9	0.1	-8.8

Source: UN/ECE secretariat calculations, based on national foreign trade statistics.

<sup>a</sup> Over same period of 1997.

<sup>b</sup> Volume indices for Slovenia as reported by IMAD, *Slovenian Economic Mirror*, Vol. III, 1997; Vol. IV, 1998 and *Spring Report*, 1998. January-July instead of January-June in 1998.

<sup>c</sup> Volume indices for January-September instead of January-October 1998.

as unfavourable developments in the conditions for import credit in the Baltic countries, were also important.

Lower import growth in the last months of 1998 allowed a few countries to contain their trade deficits (Croatia, Estonia and Romania), but, in general, they increased, and, in some countries, quite considerably. In January-September 1998 the aggregate trade deficit of eastern Europe and the Baltic states, on the basis of the customs data, widened by some \$2.7 billion, to \$29.4 billion (table 3.6.3), but for the year as a whole it may well have risen to over \$42 billion.<sup>449</sup> The sharpest absolute deterioration again was in Poland, where the trade deficit rose from almost \$17 billion in 1997 to over \$21 billion in 1998. Deficits widened notably in Bulgaria and Hungary, by some \$0.6 billion in each, while in Latvia, Lithuania, Slovakia and Slovenia the increases were less pronounced (\$0.1 billion-\$0.3 billion). The considerable narrowing of the trade deficit (by nearly \$2 billion) in the Czech Republic resulted mainly from increased export earnings, particularly in the early months of the year. In relation to GDP, trade deficits remained very high in Croatia, Estonia, Latvia and Lithuania, near or above 20 per cent. The ratio was also high in Poland, at 12.5 per cent in January-September 1998 (table 3.1.2). Balance of payments data, however show much smaller deficits on the merchandise trade

account for some countries, reflecting differences and lags in the coverage of trade flows between the two data sets (section 3.7 below).

### (b) Effect of Russia's market collapse

The crisis that unfolded in Russia in late summer 1998 and its repercussions on other CIS countries had a strong immediate effect on export performance and, less directly, on import growth throughout the east European and Baltic region. Although the region's reliance on the Russian and other CIS markets had already been considerably reduced by mid-1998 – CIS partners including Russia accounted for some 10 per cent of the region's total exports and imports in January-June 1998, as against 20-22 per cent in 1991 – for some important east European and Baltic export products, such as foods, beverages, and other consumer goods and, in some cases, machinery and equipment, these countries still remained major export markets.<sup>450</sup>

Trade with Russia and many other CIS member-countries had plummeted in August-October 1998 as the result of hard currency shortages and the collapse of the payments system in Russia. The attempts of exporters in the east European and Baltic countries to resort to barter deals or to arrange state-to-state export sales have not so far been very successful. For several countries their export earnings from Russia during these three months declined by 50-70 per cent, as compared with the same

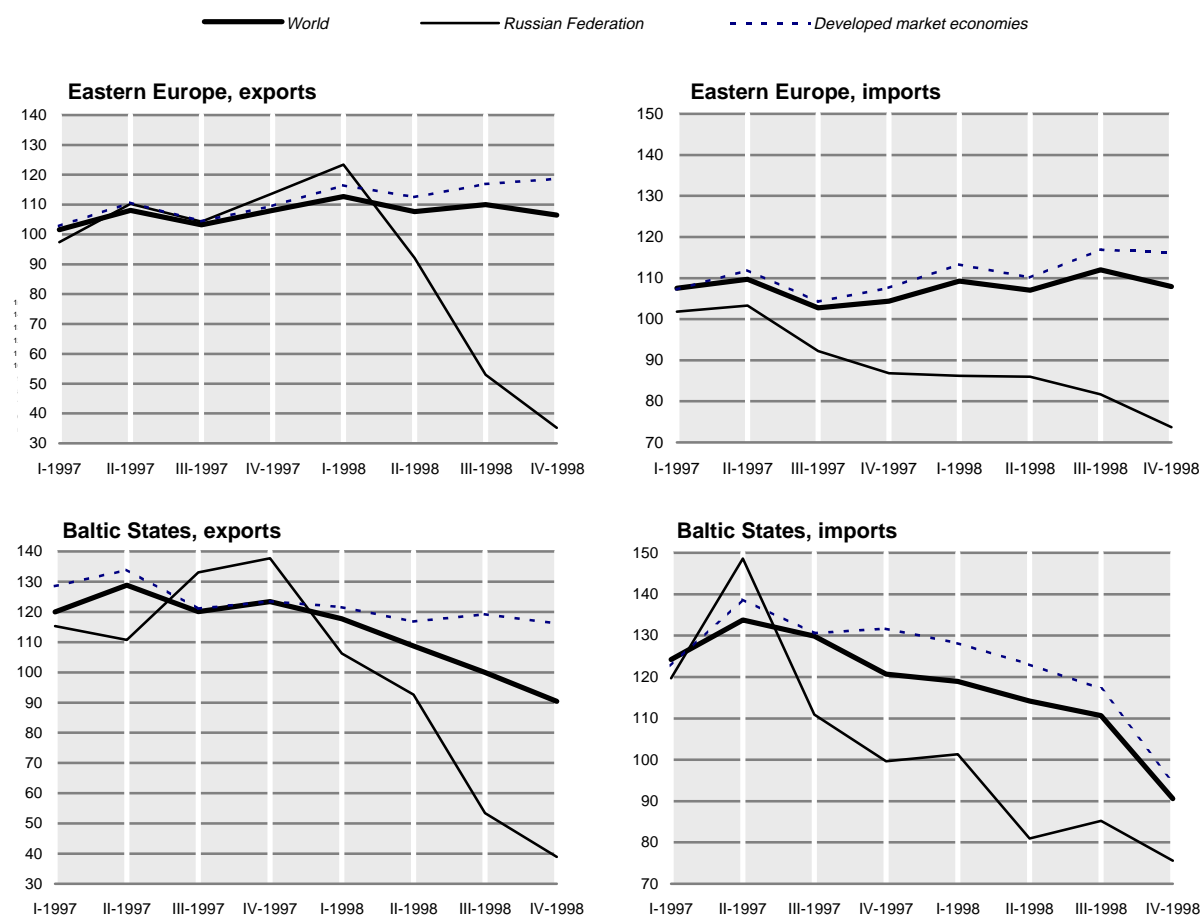
<sup>449</sup> In tables 3.6.2 and 3.6.3 the aggregate figures for eastern Europe do not include data for Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Yugoslavia (see notes to the tables). If estimates for these countries are taken into account (as is done in table 3.6.1), the full-year 1998 trade deficit of the region might be nearly \$45.5 billion.

<sup>450</sup> For further details see UN/ECE, "Outlook for trade in the wake of Russian and global financial turmoil", *Economic Survey of Europe*, 1998 No. 3, pp. 85-88.



CHART 3.6.2

Quarterly changes in east European and Baltic exports and imports, 1997-1998  
(Index over same quarter of the preceding year)



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

period in 1997; in addition there were losses of 25-45 per cent in trade with Ukraine and probably of a similar order of magnitude in trade with other CIS countries (table 3.6.5). Based on the three different scenarios, presented in table 3.6.5, the secretariat estimates that the losses by the end of October 1998 ranged from some \$90 million to \$220 million in the Czech Republic, Estonia and Latvia, from \$230 to \$420 million in Hungary and Lithuania, and from \$550 million to \$1.3 billion in Poland.

The data in table 3.6.5 indicate that none of these countries except Hungary managed to offset these losses with exports to other markets, including intraregional ones. The cumulative effect of these losses on total export performance was largest in Poland and the three Baltic countries, where in the second half of the year previously strong growth was cut short and exports declined (chart 3.6.2).

In relative terms, the share of the Russian market in east European exports declined by some 1-3 percentage points in January-October 1998, while for the Baltic countries the reduction was 5-6 percentage points, to 13-

14 per cent of exports from Estonia and Latvia and under 19 per cent for Lithuania. The share of the CIS in total east European and Baltic exports may have declined by some 1.5-2 percentage points in 1998. The share of their exports going to western market economies more than offset this decline; exports to developing country markets also fell, while growth in intraregional trade was relatively sluggish.

As mentioned above, individual commodity categories were differently affected by the collapse of trade with Russia and other CIS countries. In the third quarter of 1998, there was a 12-18 per cent fall in the dollar value of total exports of foods and beverages (SITC 0, 1) in Poland and the three Baltic states, and there was also a decline in their exports of chemical products (SITC 5) and some manufactured goods (SITC 6). Exports of these commodities were also noticeably depressed in the Czech Republic, Croatia, Hungary and Slovakia in the last two quarters of 1998. Sales of machinery and equipment (SITC 7) only appear to have been hit in the three Baltic countries (down by 2-5 per

TABLE 3.6.5

Effect of Russia's August 1998 market collapse on export performance in selected east European and Baltic countries  
(Growth rates in per cent, value in million dollars)

	Growth rates <sup>a</sup>		Value of hypothetical loss in January-October 1998 <sup>b</sup>		
	Jan.-Oct. 1998	Aug.-Oct. 1998	Scenario A	Scenario B	Scenario C
<b>Czech Republic</b>					
Total exports .....	16.2	14.0	171.2	85.4	206.7
of which:					
Russian Federation .....	-9.3	-51.3	167.5	80.2	205.7
Ukraine .....	14.9	-6.0	3.7	5.2	1.0
Rest of the world .....	17.1	17.1	-	-	-
<b>Estonia</b>					
Total exports .....	11.4	0.7	169.3	225.6	152.4
of which:					
Russian Federation .....	-19.4	-47.2	169.7	185.3	109.1
Ukraine .....	19.0	-24.8	-0.4	40.4	43.4
Rest of the world .....	18.6	16.7	-	-	-
<b>Hungary</b>					
Total exports .....	21.4	20.5	418.7	251.0	364.6
of which:					
Russian Federation .....	-22.9	-71.3	362.0	225.7	305.7
Ukraine .....	-4.5	-46.4	56.7	25.3	58.9
Rest of the world .....	24.1	26.5	-	-	-
<b>Latvia</b>					
Total exports .....	10.6	-5.7	171.8	118.7	120.6
of which:					
Russian Federation .....	-30.0	-71.4	149.4	106.8	113.9
Ukraine .....	-17.8	-39.5	22.4	11.9	6.7
Rest of the world .....	23.2	15.3	-	-	-
<b>Lithuania</b>					
Total exports .....	-	-13.5	233.9	405.9	308.6
of which:					
Russian Federation .....	-21.7	-59.7	218.5	298.8	213.3
Ukraine .....	2.0	-43.5	15.4	107.1	95.4
Rest of the world .....	7.5	7.2	-	-	-
<b>Poland</b>					
Total exports .....	3.6	-8.5	546.1	1 313.1	1 157.1
of which:					
Russian Federation .....	-18.2	-69.7	415.3	856.2	939.5
Ukraine .....	-7.0	-38.4	130.7	456.8	217.5
Rest of the world .....	6.2	-0.4	-	-	-

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

<sup>a</sup> As compared with the same period of 1997.

<sup>b</sup> Difference between actual export value in January-October 1998 and the hypothetical export value for the same period, as derived from the following three scenarios. Scenario A: the actual export growth rate to the rest of the world is applied across the board (constant shares). Scenario B: hypothetical values of exports to Russia and Ukraine are based on the average annual rate of their growth in 1995-1997, while for the rest of the world actual export value of January-October 1998 is used. Scenario C: hypothetical values of exports to Russia and Ukraine are based on the January-March 1998 growth rates while for the rest of the world actual export value of January-October 1998 is used.

cent in the third quarter of 1998) (chart 3.6.3). In eastern Europe, in contrast to the Baltic countries, this sector is widely engaged in vertically integrated production processes organized by EU and United States multinational companies, a development which improves the stability of export orders and, in 1998, was behind the relatively strong export performance of several countries of the region.

### (c) Trade prospects in 1999

As already noted, the weakening of export growth became more pronounced after Russia's default in August, but the data in chart 3.6.2 show that exports had begun to falter several months earlier, particularly from the Baltic states. The virtual disappearance of the Russian export market in the last months of 1998, and the difficulties encountered by the east European and Baltic exporters in their attempts to revive trade on the basis of barter deals or export credits from state agencies or commercial entities, suggest that the prospects for a full export recovery in the short- or even medium-run are rather poor.<sup>451</sup> In addition, the steep devaluation of the Russian rouble, and its impact on the currencies of other CIS countries, have sharply raised the rouble cost of imports from eastern Europe and the Baltic countries (even when subsidized by the exporting countries), which in turn has prompted widespread import substitution by domestically produced goods (or goods received on a non-commercial basis from the EU and the United States) in an environment of depressed consumer demand.

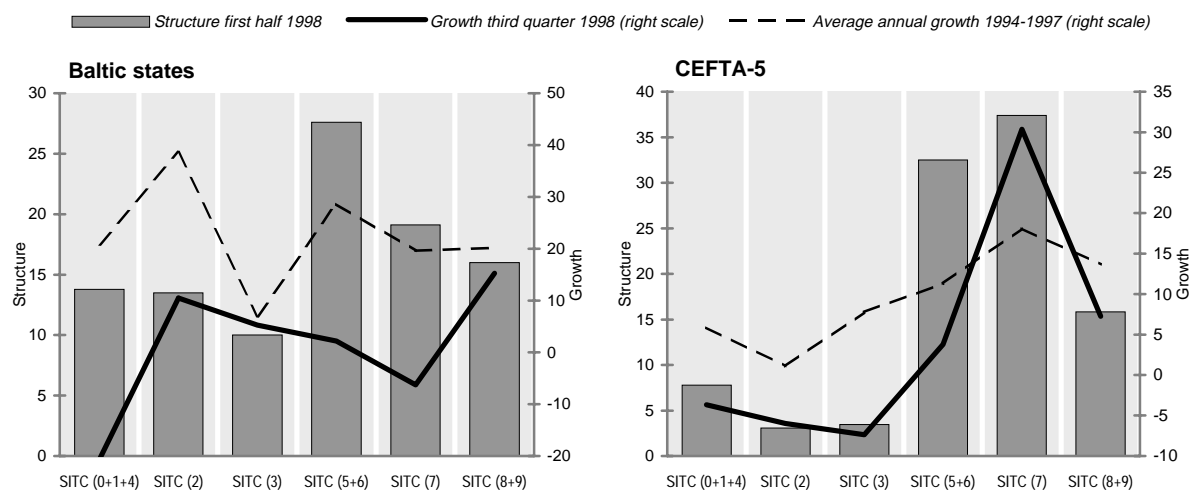
The recent signs of a noticeable weakening of demand in western Europe also weigh on the prospects for east European and Baltic exports, including those areas where they had acquired some competitive advantage in recent years thanks to their integration into the production networks of multinational companies (transport equipment, machinery and especially engineering; see chart 3.6.3). The forecasts of estimated western import demand for east European and Baltic exports point to a strong deceleration in 1999 (chart 3.6.1). The negative effect of this development on transition economies' exports may be still stronger, bearing in mind the current high income and price elasticities of western imports from these countries. According to ECE estimates, the income elasticity coefficient for total west European imports in 1990-1996 was 2.42, with a price elasticity of -0.526; but for west European imports from Poland and Hungary the income (price) elasticity coefficients ranged from 5.68 (-2.34) to 7.36 (-1.98), respectively.<sup>452</sup>

<sup>451</sup> At the time of writing this *Survey* there had been announcements of only two barter deals concluded with Russia, by Bulgaria and Hungary. For details see *BBC Monitoring Service: Central Europe and Balkans*, 31 December 1998. On 20 January 1999, the Hungarian Economics Minister told journalists, after a meeting in Moscow with the Russian Deputy Prime Minister and Foreign Trade Minister, that the Russian partners did not show any particular interest in the offer of a Hungarian credit of \$200-\$250 million annually (with a one-year grace period, repayment over three years and interest at 4-6 percentage points above LIBOR), as both the United States and the EU had offered credits with very preferential terms. *Reuters*, 22 January 1999.

<sup>452</sup> Of course these very high elasticity coefficients reflect the major changes in trade regimes since transition started and cannot be expected to last in this order in a longer run. One also has to be cautious interpreting these short-run elasticities as they are prone to several shortcomings as compared with the long-run results (see for instance, P. Hooper, K. Johnson and J. Marquez, "Trade elasticities for G-7 countries", Board of Governors of the Federal Reserve System, *International Finance Discussion Papers*, No. 609, April 1998). Income and price elasticities above were estimated from the conventional trade equation:  $M(t)=a+b*GDP(t)+c*(Pm(t)/P(t))+u(t)$ , where  $M(t)$  denotes imports of west European countries (EU+EFTA) in volume terms. For imports in volume terms from transition economies, data on quarterly western imports in current dollar values were deflated by German import unit values for east European goods.

CHART 3.6.3

Changes in east European and Baltic exports by commodity, 1993-1998  
(Structure and growth rates, per cent)



**Source:** UN/ECE secretariat calculations, based on United Nations COMTRADE Database; national statistics and direct communications from national statistical offices.

**Note:** Commodity groups are Sections of the United Nations Standard International Trade Classification (SITC Rev. 3): (0+1+4) – Food, beverages, agricultural products; (2) – Raw materials except fuel; (3) – Mineral fuels; (5+6) – Chemical products and intermediates; (7) – Machinery and transport equipment; (8+9) – Other manufactured goods. Growth rates (year-on-year basis) are calculated on dollar values of exports. CEFTA-5 includes the Czech Republic, Hungary, Poland, Slovakia and Slovenia.

Moreover, the increasing competitive pressure on these markets, in particular from Asian exporters, narrows the possibility of redirecting exports from CIS markets to the west, since they tend to consist mainly of low value-added products. Nor are the east European markets themselves ready to absorb these goods. The duality of the commodity structure of east European and Baltic exports, where the higher value added goods are traded with western countries and lower value exports with the east, is now a problem because the possibility of substituting western for eastern markets is constrained by the competitiveness of the cheaper Asian producers. The competitiveness of east European and, in particular, Baltic exports is also burdened by the real appreciation of domestic currencies in many countries of the region. In recent years, east European and Baltic export growth has tended to react in general to shifts in the valuation of the domestic currency, with a one-quarter lag (with the exception of the strong pick-up in Czech exports in the third quarter of 1997 after the devaluation of the koruna in May). The effect of changes in the exchange rate policies implemented at the beginning of 1999 in some of these countries (see above section 3.2(ii)) are therefore likely to be seen in the second or third quarter.

#### (d) Rising protectionist sentiments

Competitive pressures and the necessity of finding alternative export markets to the CIS have prompted protectionist pressures throughout the region. The strongest and in many cases successful appeals have come from the agricultural and food sectors. Demands to

strengthen protection of domestic producers have also been common in other traditional sectors (textiles and clothing, footwear, steel and coal, etc.).<sup>453</sup>

Starting in October 1998, a number of countries have not only intensified the surveillance of imports but have also increased export subsidies and/or raised customs (including preferential) tariffs on meat and other agricultural products.<sup>454</sup> In January 1999, the Czech Republic amended its agricultural law to allow the use of special tariffs and quotas and minimum intervention prices. At about the same time the Polish government, in

<sup>453</sup> Poland, for instance, instead of lifting duties on textiles and leather products imported from Turkey in January 1999, as expected, decided to maintain tariff protection until 2001 or 2002. Higher tariffs (16.6 per cent) have also been levied, for three years, on shoes imported from China. *BBC Monitoring Service: Central Europe and Balkans*, 31 October 1998; *Rzeczpospolita*, 7 January 1999.

<sup>454</sup> In Poland, export subsidies were raised and, as from 22 October 1998, duties on pork imports were increased by 20 percentage points to 80 per cent, with preferential rates of 45 per cent on imports from CEFTA and 50 per cent on imports from Lithuania. *Prawo i Gospodarka*, 22 October 1998; *Rzeczpospolita*, 20 October 1998. Also in October, Croatia increased its import duty on wheat from 400 to 520 kuna per tonne, while the Latvian parliament approved an increase of the basic import duty on margarine to 20 per cent (from 1 per cent). *MTI-Econews*, 2 October 1998; *Baltic Business Daily*, 16 October 1998. In November, the import tariffs on pork were also raised in Croatia. In the same month, Lithuania introduced new, higher customs tariffs on various commodities imported from countries with which it does not have free trade agreements, and in February 1999 it raised import duties for agricultural products from the EU. *BBC Monitoring Service: Central Europe and Balkans*, 12 November 1998; *ITAR-TASS World Service*, 1 November 1998; *ELTA*, 1 March 1999.

addition to the measures taken in October 1998 and in response to farmers' protests which had led to roads being blocked for several days in January, increased minimum intervention prices for pork and moved to amend the 1999 budget to provide extra funds to subsidize those purchases.<sup>455</sup> These measures, more often than not, have resulted from increased tension between the EU and east European countries after the EU, in an attempt to protect its own farmers with higher support prices for pork, boosted export subsidies by 30 per cent in mid-October 1998. The EU arrangement for agricultural exports to Russia under very favourable terms, together with a similar arrangement by the United States government, also played a role here, as east European and Baltic exporters saw little chance of regaining their export markets in Russia in the near future.<sup>456</sup>

Trade frictions among CEFTA and Baltic Free Trade Agreement (BAFTA) countries were also on the rise during the last months of 1998 and in some cases have resulted in complaints being lodged at the WTO. The Czech Republic, for instance, has filed a complaint to the WTO about Hungary's imposition in December of a quota on imports of Czech steel.<sup>457</sup> Hungary, in its turn, claimed that the quota was imposed in response to restrictions introduced earlier on its wheat exports to the Czech Republic.<sup>458</sup> A dispute among members of the Baltic Free Trade Agreement on quotas for pork (approved by Latvia's parliament in late 1998 for introduction in January 1999) was resolved before the quotas took effect when Latvia revoked the bill under the threat of countermeasures by Estonia and Lithuania. At the same time another dispute arose as the Lithuanian government increased reference border prices for imported foodstuffs and some other agricultural products.<sup>459</sup>

Against a background of excess capacity and falling prices for many traded products, a new wave of anti-dumping complaints against east European and Baltic producers were filed in the second half of 1998 and in the first few months of 1999. Provisional duties on steel and iron products, fertilizers, hardboard and some other

products were imposed by the EU and the United States, as well as by Australia and India.<sup>460</sup> In a few cases, price commitments made by Czech, Hungarian, Latvian and Polish producers were accepted and the provisional duties were removed or lowered.<sup>461</sup> In their turn, east European and Baltic countries also tried to protect their own local steel and chemical markets by resorting to quotas, surcharges or the postponement of scheduled reductions of tariffs.<sup>462</sup> These measures most strongly affected Russian and other CIS producers, but they have also had an impact on intraregional trade as in the case of the above-mentioned Czech-Hungarian dispute.

Nevertheless, there have been no major trade policy reversals in the east European and Baltic region, as most of the measures undertaken had been provided for in the existing bilateral or multilateral agreements, and those which were disputed were quickly abandoned. Moreover, the general tendency remains for a further liberalization of tariffs in 1999. Tariffs on the region's trade with the EU, as well as within CEFTA and BAFTA, are expected to be reduced according to existing schedules. Romania is expected to catch up with its obligations as a CEFTA member. Bulgaria, too, after joining CEFTA on 1 January 1999 and abolishing tariffs on most industrial goods, should soon begin to reduce its tariff barriers to trade in agricultural products within this area. The three Baltic countries have now signed bilateral free trade agreements with all the CEFTA founding countries including Slovenia, and a number of these agreements (for instance with Hungary) are expected to take effect in 1999. Croatia is also attempting to enter CEFTA by signing bilateral free trade agreements with the existing members; however, so far there have only been outline discussions with Bulgaria and the Czech Republic, while the recent confirmation by Hungary to start free trade agreement negotiations with Croatia has prompted a rather negative reaction on the part of the EU.<sup>463</sup>

Estonia and Lithuania have intensified WTO accession negotiations after Latvia became a member on 10 February 1999, the two hoping to join WTO before the end of 1999. Croatia, too, intensified its WTO

<sup>455</sup> *Prawo i Gospodarka*, 2 February 1999.

<sup>456</sup> *Reuters News Service*, 5 December 1998; *Rzeczpospolita*, 23 February 1999.

<sup>457</sup> Hungary introduced a quota of 45,000 tons a year for seven groups of metallurgic products from the Czech Republic for four years in response to the Czech restrictions on Hungarian wheat. *Financial Times*, 27 January 1999.

<sup>458</sup> The restrictions imposed on Hungarian wheat exports are to be removed in the Czech Republic from 1 April 1999 and in Slovakia from 1 May 1999. Hungary also held talks with Slovenia in order to remove its market protection measures against Hungarian wheat. An agreement on the same issue was reached with Poland early in January 1999. *BBC Monitoring Service: Central Europe and Balkans*, 31 December 1998; *MTI-Econews*, 26 January 1999.

<sup>459</sup> The Lithuanian imposition of reference border prices for imported foodstuffs and other agricultural products is to remain in force until 1 January 2000 or until Lithuania is accepted into WTO. *ELTA*, 2 February 1999.

<sup>460</sup> For instance, in January 1999, definitive anti-dumping duties were imposed on EU imports of hardboard originating in Bulgaria, Estonia, Latvia, Lithuania, Poland and Russia, while in February the EU imposed provisional anti-dumping duties on imports of steel ropes and cables from seven countries including Hungary and Poland. Several anti-dumping complaints against such imports were filed by steelmakers with the United States International Trade Commission. *Reuters News Service*, 29 January 1999 and 3, 12 and 17 February 1999.

<sup>461</sup> *Agence Europe* (Brussels), 15 December 1998; *Timber Trades Journal*, 13 February 1999.

<sup>462</sup> In December 1998, Hungary, for instance, imposed an import duty surcharge on nitrogen-based fertilizers from Russia and Ukraine, while Poland decided to reduce import tariffs on EU steel products from 4 to 3 per cent instead of eliminating them altogether. *BBC Monitoring Service: Central Europe and Balkans*, 31 December 1998; *Rzeczpospolita*, 16 December 1998.

<sup>463</sup> *Financial Times*, 3 February 1999.

accession negotiations in January 1999 when it emerged that if it did not join before November 1999, it might have to wait for three years because of the planned reorganization of the WTO.

### (iii) Trade of the CIS countries

In the first nine months of 1998, the dollar value of total merchandise *exports* from CIS countries declined by 14 per cent (table 3.6.6). Only in Armenia and Belarus, was there an increase in total exports; in all the others, including Russia, exports fell, from 10 per cent in Kazakhstan to 36 per cent in Azerbaijan. As most CIS countries are dependent on exports of natural resources, the poor export performance was, to a large extent, the result of falling commodity prices. On the *import* side, the dollar value of total CIS merchandise imports decreased by 5 per cent. Only in Azerbaijan and Kyrgyzstan were there significant year-on-year increases, a result of rising imports of machinery and equipment by the oil sector in Azerbaijan and the gold mining sector in Kyrgyzstan. The imports of other CIS countries were either stagnant (Armenia, Georgia, Kazakhstan, the Republic of Moldova and Tajikistan) or declining (Turkmenistan, Ukraine and Uzbekistan). In Turkmenistan and Uzbekistan, where international trade is still state-controlled, the falls in imports reflected current account difficulties exacerbated by low merchandise exports.<sup>464</sup> In Ukraine, the fall in imports was the result of balance of payments concerns and the country's continued weak trade performance with its principal trading partner, Russia. The CIS region's aggregate *trade surplus* decreased by over 40 per cent, mainly due to the decline in the Russian surplus, but there was also a worsening in the trade deficits of most other CIS countries. Russia and Kazakhstan were the only CIS members with a merchandise trade surplus. The financial crisis in Russia was already contributing to the region's overall trade decline in the first nine months of 1998, but its effects are likely to be much more visible in the data for the fourth quarter.

The *volume* of Russia's exports was slightly higher while the volume of imports increased by 5 per cent in the January-September period (table 3.6.4). The third-quarter export volumes were up by 3 per cent (year-on-year), chiefly the result of exporters attempting to counteract falling commodity prices. The third quarter's import volumes fell by 16 per cent, a dramatic reversal of the 24 and 12 per cent (year-on-year) increases in the first and second quarters, respectively. Estimates of trade volumes for other CIS countries are not available.

Russia and the other CIS countries are not expected to show any significant improvement in their international trade performance in the immediate future. Their short-term export performance is largely determined by commodity prices and these are unlikely to recover in

1999, thus continuing to have a negative effect on foreign exchange receipts. The price of *crude oil*, the key export commodity in Russia, Azerbaijan and Kazakhstan fell by some 35 per cent in 1998 and the slowing global economy is unlikely to absorb the excess oil supply in the near future. In mid-March 1999, oil prices were about 25 per cent higher than in December 1998 following a production cuts agreement among leading exporters. Nevertheless, many remain sceptical that any price turnaround can be long-lasting given the weak demand conditions. Similarly – and partly as a result of the Asian crisis and the continued underperformance of the Japanese economy – the world's *base metal* production needs to be reduced to match the lower global demand. Future improvements in the demand for base metals such as copper, nickel and aluminium are dependent, to a large degree, on the resurgence of interest in large-scale capital investment projects, particularly in Asia. Until then, the export performance of Tajikistan, Kazakhstan and, to a lesser degree Russia, is not expected to improve. With respect to *ferrous metals*, cheap Russian and Ukrainian steel exports are facing numerous anti-dumping actions throughout the world, most recently in North America, and the use of this largely protectionist trade device is not expected to abate.<sup>465</sup> The price of gold, of particular importance to Kyrgyzstan and Uzbekistan, has been relatively steady but low. Cotton prices have fallen by 17 per cent in 1998, negatively affecting the exports of the CIS countries of central Asia and Azerbaijan.

Another unfavourable development affecting Russian exporters is the reintroduction of *export duties*. The duties, applicable only to non-CIS exports, are aimed at increasing federal revenues.<sup>466</sup> The new export tariffs coupled with a mandatory 75 per cent surrender requirement on foreign exchange earnings have clearly reduced incentives to export. They have also diminished the windfall devaluation gains accruing to the hard-pressed Russian oil and metal producers. Russian commodity exporters, however, are unlikely to redirect their exports towards the domestic or CIS market as they are facing extremely weak domestic demand and non-paying customers in the CIS.<sup>467</sup>

<sup>465</sup> In February 1999, rather than face punitive tariffs, Russia agreed to an annual quota and a minimum price for its steel exports to the United States.

<sup>466</sup> The duties will apply to crude oil exports at the level of 2.5 euros per tonne if the price falls between \$9.8 and \$12.3 a barrel. The duty will double if the price is higher and will not be charged if it falls below the limit. Duties of 5 per cent will apply to exports of oil products, natural gas (reportedly rescinded six days after its introduction), coal, copper and nickel. Export duties of 10 per cent (with lower limits denominated in euros) will be levied on scrap metals, selected lumber products and various agricultural products such as soya beans, seeds, animals and leather. All export duties will be in effect for a period of six months.

<sup>467</sup> While the government often resorts to limiting access to export pipelines to oil producers who "fail" to supply domestic refineries, the oil producers are not likely to increase their domestic shipments voluntarily. Similarly, in the natural gas sector, the government generally prohibits cutting off gas deliveries to non-paying customers, but only about 12 per cent of Russian gas consumers pay in cash, and many pay nothing at all. In September 1998, Gazprom was owed about \$13 billion in consumer debt. *Petroleum Economist*, September 1998, p. 8.

<sup>464</sup> Both countries have also tightened their foreign exchange regulations. In Turkmenistan, the government suspended hard currency conversion, while in Uzbekistan the foreign exchange surrender requirement was raised to 50 per cent.

TABLE 3.6.6  
CIS countries' total trade, 1996-1998  
(Value in million dollars, growth rates in per cent)

	Exports			Imports			Trade balances			
	Value 1996	Growth rates		Value 1996	Growth rates		1996	1997	January-September	
		1997	1998 <sup>a</sup>		1997	1998 <sup>a</sup>			1997	1998
Armenia .....	290	-19.9	12.9	856	4.3	0.4	-566	-660	-474	-457
Azerbaijan .....	631	23.8	-35.8	961	-17.3	33.5	-329	-13	-1	-398
Belarus .....	5 652	29.2	4.1	6 939	25.2	5.4	-1 288	-1 388	-1 087	-1 211
Georgia .....	199	20.5	-13.6	687	36.9	-1.6	-488	-701	-517	-528
Kazakhstan .....	5 911	7.7	-10.0	4 241	0.8	2.3	1 670	2 091	1 622	1 085
Kyrgyzstan .....	505	19.5	-12.0	838	-15.3	22.9	-332	-106	-37	-198
Republic of Moldova .....	795	10.0	-16.1	1 072	9.3	-1.9	-277	-297	-256	-336
Tajikistan .....	770	-3.2	-19.8	668	12.3	-2.9	102	-5	-85	-171
Turkmenistan <sup>b</sup> .....	1 693	-55.6	-28.8	1 314	-6.5	-16.1	379	-476	-257	-292
Ukraine .....	14 401	-1.2	-14.1	17 603	-2.7	-16.1	-3 203	-2 896	-2 270	-1 704
Uzbekistan <sup>c</sup> .....	4 211	-0.4	-21.3	4 712	-3.8	-30.2	-501	-340	-362	-2
<b>Total above</b> .....	35 058	3.6	-11.4	39 890	3.1	-8.3	-4 833	-4 790	-3 724	-4 213
Russian Federation .....	85 107	-0.1	-14.5	46 034	14.9	-2.5	39 073	32 110	23 594	15 713
<b>CIS total</b> .....	120 165	1.0	-13.6	85 924	9.4	-5.1	34 241	27 320	19 870	11 500
<i>Memorandum item:</i>										
Russian Federation <sup>d</sup> .....	89 100	-1.9	-14.4	62 300	8.5	-4.6	26 800	19 800	11 200	4 500

*Source:* CIS Statistical Committee; direct communications to UN/ECE secretariat; CIS Statistical Committee, *CIS Statistical Bulletin*, 22 (206), November 1998; for the Russian Federation, State Customs Committee data.

<sup>a</sup> January-September over same period of 1997.

<sup>b</sup> For 1998, Turkmenistan's State Statistics Committee as reported by *Reuters News Service*, 18 November 1998.

<sup>c</sup> CIS Statistical Committee estimates for 1996 and 1997. For 1998, TACIS, *Uzbekistan Economic Trends*, Third Quarter 1998 and UN/ECE secretariat calculations.

<sup>d</sup> Adjusted for non-registered trade; for 1996 and 1997, Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii*, No. 1 (Moscow), 1998. For 1998, *Sotsial'no-ekonomicheskoe polozhenie Rossii* (Moscow), October 1998. Note that the two series may not be directly comparable as the 1998 statistics are revised to be compatible with balance of payments data.

Nevertheless, the new export duties and surrender requirement create an incentive for Russian exporters to find ways to lower their non-CIS export receipts in order to minimize their tax burden.<sup>468</sup>

Russia's *imports* will remain depressed reflecting the country's current banking crisis and stalled foreign investment, as well as falling GDP and currency devaluation. While the rouble's real depreciation was spectacular – the currency lost about half of its value against the dollar between August and December 1998 – the future course of the real exchange rate (and consequently of imports) will depend on the scale of money emission. The currency devaluation will continue to affect imports of foodstuffs and consumer products as well as those sectors of manufacturing that depend on foreign intermediate inputs. Moreover, the country's fiscal requirements will continue to influence the country's import policies, just as they have already affected export policies. The early 1999 postponement of the deadline for the reduction of import duties from 30 to

20 per cent on some goods is perhaps a harbinger of the future direction of import policies.

In other CIS countries, the Russian financial crisis, aside from its immediate effects in reducing the demand for CIS goods and services, has triggered a series of *currency devaluations*. While these realignments are still underway, the initial currency movements have caused some "traditional" trade flows, especially of foodstuffs and consumer goods, to be redirected, bringing about local shortages in exporting countries and a backlash of producers against cheap imports in importing countries. Kazakhstan, for example, imposed 200 per cent tariffs on selected products from Kyrgyzstan and Uzbekistan in February 1999, following an earlier ban on imports of Russian food products. The appearance of these regional "trade shocks" have resulted in calls for trade measures to protect domestic enterprises, accusations of trade blockades, and even prospects of a trade war among the CIS countries of central Asia.<sup>469</sup>

Finally, low commodity prices, which have hit Russia's and other CIS countries' natural resource exports, have lowered the cost of *food imports*. New

<sup>468</sup> The State Customs Committee has already claimed that Russian exporters are evading the 75 per cent surrender requirement and export duties by signing rouble contracts with agents from other CIS countries to re-export their products outside the CIS. *ITAR-TASS News Agency* (Moscow) as reported by *BBC Monitoring Summary of World Broadcasts*, 12 February 1999.

<sup>469</sup> "Central Asia tariff war beckons", *Financial Times*, 12 February 1999 and "Kyrgyz President accuses neighbors of trade blockade", *Russia Today*, 11 February 1999 (internet website).

breeding technologies, cheap animal feed, abundant supplies of cattle and hogs and favourable livestock cycles have all contributed to low beef, pork and poultry prices. Prices of other agricultural commodities have also fallen. Because agricultural and food products represent a considerable share of imports in many CIS countries, low prices will ease, to a limited extent, the merchandise trade deficits and economic hardship.<sup>470</sup>

(a) *Russian Federation: trade with non-CIS countries*

*Trade performance*

In the first three quarters of 1998, the value of Russia's exports to non-CIS markets fell by 15 per cent (tables 3.6.2 and 3.6.7). This occurred despite a 4 per cent increase in the volume of Russian exports in the third quarter, which reversed a small decrease in the first six months of 1998. Clearly, the lower export value was a result of falling export prices. In the third quarter, average non-CIS export prices were almost 20 per cent lower than a year earlier, exacerbating the already significant price decreases of 12 and 17 per cent in the first and second quarters, respectively.<sup>471</sup> In *October and November*, Russia's export prices came under additional pressures, leading, in turn, to an export value of about 25 per cent below that in the same months of 1997 (table 3.6.8).<sup>472</sup>

On the *import* side, the dollar value of non-CIS imports in the first nine months were no higher than in the same period of 1997. While the volume of imports grew rapidly in the first half of 1998, in the third quarter it fell 13 per cent, almost matching the 16 per cent decline in import prices. In *October and November*, non-CIS imports continued at their very low post-August crisis levels – at about 50 per cent below the corresponding months of 1997 – as imports continued to be heavily affected by devaluation and the banking crisis.<sup>473</sup> In the first three quarters, the merchandise *trade surplus* with non-CIS countries stood at \$15 billion. While this represented a relative improvement

over the first half of 1998,<sup>474</sup> the surplus is still one third lower than in the same period of 1997.

*Directions of trade*

The value of Russia's exports to all country groups declined across the board in the first nine months of 1998 (table 3.6.2) and was closely associated with lower commodity prices. The value of imports from each country group, except developing economies, also fell, ranging from 18 per cent in the Baltic states to 2 per cent in the European Union. The dramatic fall in purchases from the Baltic states is, of course, related to the financial crisis in Russia and the resulting reduced import demand for food and agricultural products. These products represented a high (about 50 per cent) and, in Estonia and Latvia, growing share of Baltic states' exports to Russia. Russia continued to run merchandise *trade surpluses* with all partner country groups. (Trade data by direction for other CIS countries were not available at the time of writing this *Survey*.)

*Commodity structure*

Russian exports of crude oil, oil products, natural gas, ferrous and base metals, which represent about 70 per cent of its total exports to non-CIS countries, fell in the first three quarters of 1998 (table 3.6.9). In dollar terms, mineral products and metals, the key export sectors, declined by 28 and 10 per cent, respectively. Dramatically lower export prices of crude oil, oil products and natural gas and a mixed export performance in volume terms were the major factors behind the declines.<sup>475</sup> Similarly, base metal – nickel and copper – exporters had to cope with price declines of over 20 per cent in the first three quarters of 1998 compared with the corresponding period of 1997. In contrast, aluminium prices were steady and export shipments increased slightly, partly due to tolling arrangements.<sup>476</sup> Russian exporters of ferrous metals have continued to be affected by weak global demand, lower prices and market access difficulties. While price declines were not as severe as for base metals – ranging between 3 and 15 per cent depending on the product – anti-dumping actions against Russian exports in 36 countries have continued to hinder exports of steel and other products.

<sup>470</sup> For example, in Armenia, Georgia and Russia this share is about 30 per cent; it is about 20 per cent in Azerbaijan and Uzbekistan; and in the remaining CIS countries it ranges between 5 and 11 per cent of the total imports.

<sup>471</sup> Of non-CIS export prices of Russia's key exportables, crude oil, natural gas and oil products were down by 34, 17 and 33 per cent, respectively, in the first nine months of 1998 compared with the same period of 1997. CIS Statistical Committee, *CIS Statistical Bulletin*, 24(208) (Moscow), December 1998, p. 45.

<sup>472</sup> In these two months, the low and declining prices have continued to afflict Russia's export performance: average export prices for crude oil, natural gas and oil products were down (year-on-year) by over 40, 20 and 35 per cent, respectively. Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii* (Moscow), November and December 1998.

<sup>473</sup> In spite of the overall decline in imports of consumer products, machinery and equipment and food relative to 1997, imports of some goods have shown value and volume increases on a month-to-month basis. While the amounts are very small, this may be a tentative sign of a return to more regular banking operations in Russia (table 3.6.8).

<sup>474</sup> In the January-November period, year-on-year, non-CIS exports and imports (including non-registered trade) fell by 17.2 and 13.7 per cent, respectively. The trade surplus (including non-registered trade) stood at \$9.4 billion, \$4 billion less than in the corresponding period of 1997. Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii* (Moscow), December 1998.

<sup>475</sup> In volume terms, in the first three quarters of 1998, exports of crude oil and natural gas grew by 7 and 3 per cent, respectively, but shipments of oil products were down by 24 per cent. Export volumes of copper, nickel, ferrous metals and coal declined, but that of aluminium rose. Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii* (Moscow), October 1998.

<sup>476</sup> Tolling, where imported raw materials are processed in Russia and immediately exported, contributes to high capacity utilization rates in the aluminium industry (by some estimates about 90 per cent of total production is under tolling). In 1998, the government of Russia indicated that customs and tax concessions for tolling operations, costing about \$300 million in foregone revenues, may be withdrawn. However, at the end of 1998, it decided to retain aluminium tolling for another year.

TABLE 3.6.7

**CIS countries' trade with CIS and non-CIS, 1996-1998**  
(Value in million dollars, growth rates in per cent)

	Exports			Imports			Trade balances				
	Value 1996	Growth rates		Value 1996	Growth rates		1996	1997	January-September		
		1997	1998 <sup>a</sup>		1997	1998 <sup>a</sup>			1997	1998	
<b>Armenia</b>											
CIS .....	134	-29.1	19.6	288	3.9	-34.5	-154	-204	-157	-72	
Non-CIS .....	157	-12.1	8.9	568	4.4	18.4	-411	-455	-318	-385	
<b>Azerbaijan</b>											
CIS .....	290	30.4	-30.4	340	3.3	16.6	-50	27	6	-112	
Non-CIS .....	341	18.1	-40.1	621	-28.6	46.3	-280	-40	-7	-286	
<b>Belarus</b>											
CIS .....	3 764	42.9	8.7	4 570	27.3	1.5	-807	-438	-495	-244	
Non-CIS .....	1 888	1.8	-7.4	2 369	21.2	13.2	-481	-950	-592	-967	
<b>Georgia</b>											
CIS .....	129	7.0	-11.3	270	25.8	-24.2	-142	-203	-142	-96	
Non-CIS .....	70	45.2	-16.4	416	44.2	10.2	-346	-498	-374	-432	
<b>Kazakhstan</b>											
CIS .....	3 179	-10.3	-17.9	2 946	-21.7	-7.2	233	545	455	196	
Non-CIS .....	2 732	28.7	-3.4	1 296	51.9	13.6	1 437	1 547	1 168	888	
<b>Kyrgyzstan</b>											
CIS .....	393	-18.8	-25.8	487	-10.5	1.1	-94	-117	-58	-123	
Non-CIS .....	112	154.0	4.7	351	-22.0	59.4	-239	11	21	-75	
<b>Republic of Moldova</b>											
CIS .....	543	12.0	-16.8	653	-7.4	-22.3	-109	4	-	24	
Non-CIS .....	252	5.6	-14.0	420	35.2	20.5	-168	-301	-256	-360	
<b>Tajikistan</b>											
CIS .....	331	-17.5	-25.3	383	26.1	-0.4	-52	-209	-185	-235	
Non-CIS .....	439	7.7	-16.2	286	-6.1	-7.4	154	205	100	65	
<b>Turkmenistan<sup>b</sup></b>											
CIS .....	1 142	-60.5	-28.3	389	78.9	-16.5	753	-245	-54	-92	
Non-CIS .....	551	-45.5	-29.7	924	-42.5	-15.7	-374	-231	-203	-201	
<b>Ukraine</b>											
CIS .....	7 405	-24.6	-23.7	11 176	-11.6	-23.2	-3 771	-4 294	-3 272	-2 532	
Non-CIS .....	6 996	23.6	-8.0	6 428	12.8	-6.2	568	1 398	1 002	827	
<b>Uzbekistan<sup>c</sup></b>											
CIS .....	890	14.6	-35.9	1 517	-15.6	-27.0	-627	-260	77	-29	
Non-CIS .....	3 321	-4.4	-13.6	3 195	1.9	-31.5	126	-80	-439	27	
<b>Total above</b>											
CIS .....	18 200	-6.1	-14.1	23 018	-2.3	-13.9	-4 818	-5 394	-3 826	-3 314	
Non-CIS .....	16 858	14.0	-8.9	16 872	10.4	-1.5	-15	604	102	-899	
<b>Russian Federation</b>											
CIS .....	15 895	4.3	-12.9	14 549	-3.2	-8.8	1 346	2 503	1 626	1 007	
Non-CIS .....	69 212	-1.2	-14.9	31 485	23.3	-0.2	37 727	29 607	21 968	14 706	
<b>CIS total</b>											
CIS <sup>d</sup> .....	34 095	-1.2	-13.5	37 567	-2.6	-12.0	-3 472	-2 891	-2 200	-2 307	
Non-CIS .....	86 070	1.8	-13.6	48 357	18.8	-0.6	37 713	30 211	22 070	13 807	
<b>Memorandum item:</b>											
<b>Russian Federation<sup>e</sup></b>											
CIS .....	17 200	4.1	-12.4	18 300	-4.4	-11.8	-1 100	400	200	100	
Non-CIS .....	71 900	-3.3	-14.9	44 000	13.9	-2.3	27 900	19 400	11 000	4 400	

**Source:** CIS Statistical Committee; direct communications to UN/ECE secretariat; CIS Statistical Committee, *CIS Statistical Bulletin*, 22 (206), November 1998; for the Russian Federation, State Customs Committee data.

<sup>a</sup> January-September over same period of 1997.

<sup>b</sup> For 1998, Turkmenistan's State Statistics Committee as reported by *Reuters News Service*, 18 November 1998.

<sup>c</sup> CIS Statistical Committee estimates for 1996 and 1997. For 1998, TACIS, *Uzbekistan Economic Trends*, Third Quarter 1998 and UN/ECE secretariat calculations.

<sup>d</sup> Note that the values of total intra-CIS exports and imports are not identical as they should be in this closed trading circle. The reported aggregate intra-CIS imbalances reflect the same statistical discrepancy.

<sup>e</sup> Adjusted for non-registered trade; for 1996 and 1997, Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii*, No. 1 (Moscow), 1998. For 1998, *Sotsial'no-ekonomicheskoe polozhenie Rossii* (Moscow), October 1998. Note that the two series may not be directly comparable as the 1998 statistics are revised to be compatible with balance of payments data.



TABLE 3.6.8

**Russian Federation's merchandise trade, July-November 1998**  
(Billion dollars and per cent)

	July		August		September		October		November	
	Value	Change	Value	Change	Value	Change	Value	Change	Value	Change
<b>Non-CIS</b>										
Exports .....	4.7	-20	4.9	-17	4.8	-12	4.9	-24	4.6	-28
Imports .....	4.4	-7	3.9	-18	2.5	-50	2.2	-60	2.2	-53
Machinery and equipment (million dollars) .....	1184.0	-20	1 255.7	1	132.3	-29	746.5	-42	684.5	-48
Furniture (million dollars) .....	23.4	-41	19.5	-48	15.6	-68	13.7	-76	15.0	-68
Clothing (million dollars) .....	17.0	-11	18.9	-25	9.4	-70	10.9	-70	15.6	-45
Pharmaceuticals (million dollars) .....	101.8	-35	92.7	-10	33.5	-74	31.6	-84	42.6	-70
Meat (thousand tonnes) .....	77.8	-	41.2	-38	19.3	-64	8.2	-87	20.2	-61
Poultry (thousand tonnes) .....	103.7	-9	57.7	-54	20.4	-78	22.2	-80	31.8	-68
Citrus fruit (thousand tonnes) .....	22.7	32	11.1	-17	9.2	-67	12.9	-65	29.7	-41
Trade balance .....	0.3	..	1.0	..	2.3	..	2.7	..	2.4	..
<b>CIS</b>										
Exports .....	1.3	6	1.0	-30	0.8	-47	1.1	-35	1.3	-24
Imports .....	1.2	-21	1.3	-18	0.7	-55	0.8	-55	0.8	-43
Trade balance .....	0.1	..	-0.3	..	0.1	..	0.3	..	0.5	..

*Source:* Russian Federation Goskomstat, *Sotsial'no-ekonomicheskoe polozhenie Rossii* (Moscow), various issues.

*Note:* Non-registered trade is only included in total exports and imports. Change is percentage change over same month of 1997.

Low demand for steel, caused by the diminished Asian demand and the threat of anti-dumping measures in many Asian countries, has forced the Russian steel exporters to redirect their shipments to other markets.<sup>477</sup> A subsequent influx of steel imports from Russia and other CIS countries to North America has prompted domestic steel producers there to initiate anti-dumping proceedings. In contrast to the third quarter performance of Russian non-CIS exports, which was generally in line with the first half of 1998, third quarter *imports* were drastically lower. The August devaluation, debt default and, most importantly, paralysis in the banking sector caused large import declines in August and September (food, consumer products, textiles). Imports of machinery and equipment and chemicals also fell reflecting the immediate currency and banking crisis and the continuing poor industrial performance.

#### *Determinants of trade performance*

Russia's overall export performance is closely related to fluctuations in world commodity prices. As prices of virtually all commodities continued to fall in 1998, Russia's export performance suffered correspondingly. While Russian producers have attempted, in some sectors, to boost export volumes to make up for the falling prices, it appears, in general, that the limits of production capacity have been reached for many natural resources. Moreover, transport bottlenecks are likely to prevent any significant increase in exports in the near future.<sup>478</sup> In addition to falling commodity prices, the August devaluation of the

Russian rouble has also had a significant impact on trade. The central bank also implemented administrative controls to prevent capital flight and to slow down the rate of nominal depreciation.<sup>479</sup> All of these measures have had a direct impact on Russian trade, imports in particular. While the immediate dramatic fall in *imports* was caused mainly by the banking crisis that accompanied the devaluation, the currency devaluation raised the rouble prices of imported goods, drastically curtailing the demand for many imports. The combined effect of the payments crisis, paralyzing the activities of many importers, and the subsequent fall in the rouble have caused a sharp drop in import demand and the collapse of imports since August (table 3.6.8).

#### *(b) Other CIS countries: trade with non-CIS countries*

##### *Trade performance*

In the first three quarters of 1998, the value of *exports* from CIS countries other than Russia to the rest of the world declined by 9 per cent (table 3.6.7). Only in Armenia and Kyrgyzstan were there increases while declines in the remaining countries ranged between 3 per cent in Kazakhstan to 40 per cent in Azerbaijan. Aggregate *imports* from the non-CIS area were down 2 per cent, largely as a result of declines in Ukraine, Uzbekistan and, to a lesser extent, Turkmenistan and Tajikistan. All other CIS countries registered double-digit import increases, although in most cases there was a considerable deceleration in the second half of 1998. The

<sup>477</sup> In 1998, the United States share of Russian steel exports was about 50 per cent, up from 30 per cent in 1996.

<sup>478</sup> Preliminary data indicate that crude oil production fell by 0.6 per cent, but natural gas was up by 3.5 per cent in 1998.

<sup>479</sup> The partial re-regulation of the foreign exchange market includes a mandatory 75 per cent surrender of export receipts and a dual exchange rate regime.

TABLE 3.6.9

Non-CIS trade of the Russian Federation by selected commodities, 1994-1998  
(Shares and growth rates in per cent)

	Exports					Imports				
	Share			Growth rates		Share			Growth rates	
	1994	1997 <sup>a</sup>	1998 <sup>a</sup>	1997	1998 <sup>b</sup>	1994	1997 <sup>a</sup>	1998 <sup>a</sup>	1997	1998 <sup>b</sup>
Agricultural products (I-III) .....	1.2	0.6	1.1	-5.4	43.7	13.4	14.2	13.7	30.6	-4.9
Food, beverages and tobacco (IV) .....	0.6	0.4	0.2	-30.7	-64.3	17.0	12.8	14.5	28.7	11.2
Mineral products (V) .....	41.5	49.1	43.2	-1.0	-28.0	2.9	2.8	2.4	21.4	-13.6
Chemical or allied products (VI) .....	7.3	6.8	7.7	-3.3	-8.3	8.8	12.5	12.3	24.0	-3.2
Textiles and textile articles (XI) .....	1.8	0.9	1.0	-3.0	-4.5	5.3	2.5	2.3	8.9	-9.5
Precious metals and stones (XIV) .....	12.7	2.8	3.2	-16.4	-6.8	0.1	0.3	-	-75.3	-85.0
Base metals and articles (XV) .....	20.8	24.1	26.5	5.1	-10.3	3.9	4.4	4.3	7.4	-3.3
Machinery and equipment (XVI) .....	2.9	3.1	3.6	12.8	-5.8	27.6	24.7	23.1	19.8	-8.0
Vehicles, transport equipment (XVII) .....	3.3	4.4	4.8	-5.6	-9.7	4.7	9.4	10.8	95.4	13.6
Precision and optical equipment (XVIII) .....	0.2	0.3	0.6	12.7	54.7	5.4	3.9	4.3	1.1	9.2
Arms and ammunition (XIX) .....	0.9	0.5	0.3	-56.7	-45.8	-	-	-	50.0	10.4
<b>Total above</b> .....	93.4	93.2	92.3	-1.4	-18.9	89.2	87.6	88.0	24.7	-1.2
<b>Total</b> .....	100.0	100.0	100.0	-1.2	-14.9	100.0	100.0	100.0	23.2	-0.2

*Source:* Russian Federation State Customs Committee, *Tamozhennaya statistika vneshnei torgovli Rossiiskoi Federatsii* (Moscow), various issues. Commodity groups are Sections of the Harmonized Commodity Description and Coding System (HS).

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

<sup>b</sup> January-September over same period of 1997.

aggregate merchandise trade deficit was \$900 million with only Kazakhstan, Tajikistan, Ukraine and Uzbekistan running trade surpluses.

#### Determinants of trade performance

The decline in the value of exports to non-CIS countries was closely related to the drop in prices for the major export commodities. The declines in value occurred in spite of, in many cases, increased volumes. For example, in Kazakhstan crude oil exports were up by 31 per cent in volume but remained flat in value. Similarly, copper and zinc exports were over 10 per cent higher in volume but revenues were almost 20 per cent lower. Shrinking demand for ferrous metals also affected Kazakh and Ukrainian exports. Non-CIS exports of iron ores and ferrous metals fell by 60 and 14 per cent in volume, respectively. In other commodity exporting countries, lower prices, fluctuating volumes and production difficulties played variable roles in determining performance. In Azerbaijan, exports of oil products decreased by 22 per cent in volume. The decline was related to drastically lower shipments to Iran, traditionally a major purchaser of Azerbaijani oil products, which apparently has found alternative and cheaper sources of supply. Despite lower oil prices, Turkmenistan has continued to increase crude oil extraction and refining in an attempt to offset the revenue lost because of the country's inability to export natural gas (natural gas exports to Ukraine resumed in early 1999). Tajikistan's aluminium exports, representing over half of the country's exports to non-CIS countries, increased marginally but revenues were down by 8 per cent. Despite the improved cotton harvest, exports of cotton fibre, contributing about 40 per cent of total non-CIS exports, decreased by a third in value.

On the import side, CIS countries buy non-CIS products such as foodstuffs, machinery and equipment and, in some cases, raw materials. A slowdown in imports of food suggests reduced consumption levels following the Russian crisis and subsequent currency devaluations in many CIS countries (e.g. Georgia and the Republic of Moldova). The persistent pressures on many regional currencies are expected to have a significant impact on non-CIS trade flows in 1999. In recent years, substantial imports of machinery and equipment have been associated with the industrialization and modernization of CIS economies. While foreign investment continues to play an important role in Azerbaijan, Kazakhstan and Kyrgyzstan, the unfavourable conditions and outlook in the oil sector are affecting imports of machinery and equipment in Kazakhstan. In contrast, in the third quarter, the rate of increase of Azerbaijan's imports rose on account of continued vigorous activity in the country's oil industry, but it slowed down in Kyrgyzstan due to the completion of the import-intensive Kumtor gold mine. In Turkmenistan, Ukraine and Uzbekistan, balance of payments problems will continue to limit their ability to import from non-CIS countries.

#### (c) Intra-CIS trade

##### Trade performance

In the first nine months of 1998, the value of intra-CIS trade decreased, with the decline rapidly accelerating in the third quarter. Russian and other CIS countries' exports (imports) fell by 14 per cent (table 3.6.7). The only two countries that increased their exports to other CIS countries were Armenia and Belarus, but the rates of increase were less than half those in the first half of 1998.

In the remaining CIS countries exports fell between 11 per cent in Georgia to 36 per cent in Uzbekistan. In almost all cases, lower import demand in Russia and falling commodity prices were the main causes behind the fall in trade. On the *import* side, only Azerbaijan increased significantly its CIS purchases (up by 16 per cent) while in all the other countries nine month imports were either flat (Belarus, Kyrgyzstan and Tajikistan) or fell considerably. The aggregate intra-CIS merchandise *trade deficit* of countries other than Russia decreased slightly, at the expense of a smaller Russian surplus.

The *volume* of Russia's exports to CIS countries in the first nine months of 1998 increased by 5 per cent, but it was not enough to offset a 15 per cent decline in average export prices. In the first three quarters of 1998, export prices of Russia's natural gas, crude oil, oil products and coal shipments to the CIS were, respectively, 20, 15, 12 and 26 per cent lower than in the corresponding period of 1997.<sup>480</sup> As over half of Russia's exports to the CIS area are mineral products such as natural gas and crude oil, the change in the export prices of these commodities was a major determinant of Russia's export revenues. The volume of Russia's imports from CIS countries was down by 9 per cent in the first nine months of 1998, a stagnant performance in the first half being followed by a sharp fall in the third quarter. In that quarter, the volume of Russia's CIS imports fell by 24 per cent and average import prices by 11 per cent.

### *Determinants of trade performance*

The devaluation of the Russian rouble in August 1998 was the most important event affecting intra-CIS trade. Economic shocks that originate in Russia are transmitted throughout the CIS area because the country is a principal trading partner of many CIS countries. That is why the trade effects of the financial crisis in Russia have been particularly evident. The devaluation and subsequent banking crisis led to a temporary breakdown of banking operations, which effectively stopped imports into Russia. In September, for example, intra-CIS exports fell 46 per cent (year-on-year). The impact varied by country and ranged from a two-thirds decline in exports from the Republic of Moldova and Armenia, to 55 per cent in Ukraine and 40-46 per cent in Azerbaijan, Belarus, and Kazakhstan.<sup>481</sup>

The spillover effects from the Russian crisis have also exposed weak macroeconomic fundamentals in many CIS countries. So far, the weaknesses have been reflected in the announcements of fiscal austerity measures and downward pressures on the exchange rates. While it is difficult to pinpoint the exact causes of exchange rate movements in the CIS (that is to separate

contagion effects from domestic causes), the relative changes in the value of CIS currencies have led to marked changes in the intra-CIS patterns of competitiveness and trade provoking the imposition of prohibitive tariffs and trade bans in central Asia. Similar pressures to protect domestic industries in the wake of the Russian devaluation and subsequent exchange rate realignments were present in other CIS countries as well. The Belarussian government has approved a list of foodstuffs and other products that can only be exported with special government permission. It has also introduced quotas for the amount of "vital" goods that can be taken out of the country by individuals. The Ukrainian government is considering increasing import taxes on meat and dairy products and excluding them from the list of commodities covered by CIS free trade agreements. Similarly, in Azerbaijan, the government is contemplating increased excise taxation on imports of alcohol and foodstuffs from CIS countries "to defend national producers".<sup>482</sup>

More importantly, the Russian crisis has had direct negative effects on its traditional CIS trade partners and intra-CIS trade flows.<sup>483</sup> The notable exceptions, in the first nine months of 1998, were Armenia and Belarus. Armenia was relatively unaffected because less than 20 per cent of the country's total export goes to Russia.<sup>484</sup> In Belarus, trade data for January-September show continued growth in CIS exports (up 9 per cent), on the strength of almost doubled shipments of ferrous metals and a 7 per cent increase in machinery exports. In other CIS countries, however, the negative effects of the Russian devaluation were more evident. In the Republic of Moldova, where agricultural products represent about 70 per cent of total CIS exports, exports of meat, vegetable oil and raw sugar were down between 65 and 84 per cent. Exports of wine – the Republic of Moldova's most important agricultural export – also declined. Shrinking demand for the Republic of Moldova's foodstuffs on the important Russian and Ukrainian markets were the major factors. Kyrgyzstan's CIS exports, also consisting largely of agricultural products and alcohol, fell 70 per cent in volume largely because of the Russian crisis.<sup>485</sup> While Kazakhstan's key CIS export products – crude oil and coal – increased by 50 and 4 per cent in volume terms, exports of most other

<sup>480</sup> CIS Statistical Committee, *CIS Statistical Bulletin*, 24(208) (Moscow), December 1998, p. 45.

<sup>481</sup> CIS Statistical Committee, *CIS Statistical Bulletin*, 22(206) (Moscow), November 1998, p. 45.

<sup>482</sup> *ITAR-TASS News Agency* (Moscow) as reported by *BBC Monitoring Summary of World Broadcasts*, 24 November 1998. *Infobank* (Ukraine) as reported by *Reuters News Service*, 5 November 1998. *Azer-Press* as reported by *Reuters News Service*, 2 December 1998.

<sup>483</sup> It should be noted that for many CIS countries the data do not yet show the full effects of the Russian crisis since for the most part they are still only available for the first three quarters of 1998. Preliminary full-year data indicate that CIS exports from Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan and the Republic of Moldova declined by 39, 5, 30, 28 and 26 per cent, respectively.

<sup>484</sup> *Sotsial'no-ekonomicheskoe Polozhenie Respubliki Armeniya*, January-October 1998, pp. 19-20.

<sup>485</sup> *Sotsial'no-ekonomicheskoe Polozhenie Kyrgyzskoy Respubliki*, January-December 1998, p. 171.

commodities declined.<sup>486</sup> Ukraine's CIS exports also continued to fall. The country's trade with Russia, while worsened by the rouble's devaluation, has not recovered despite the elimination of double taxation on mutual exports in early 1998. Falling commodity prices also played a role in intra-CIS trade. Russian export volumes of crude oil and oil products were higher by 10 and 6 per cent, but natural gas shipments declined by 3 per cent. As the prices of these commodities fell between 12 and 20 per cent, countries with significant energy imports, such as Armenia, Belarus, the Republic of Moldova and Ukraine, benefited significantly.<sup>487</sup>

#### (d) CIS countries and accession to the World Trade Organization (WTO)

Since the breakup of the Soviet Union it has been recognized that the full integration of CIS countries in the global trade and payments system requires membership in the World Trade Organization. By joining the WTO, CIS countries hope to obtain support for their transition process and at the same time demonstrate their adoption of market-based principles. Despite the overall progress in transition (including unilateral trade liberalization and movement towards more economically "justified" state involvement in international trade), of the 12 CIS countries, only Kyrgyzstan is a WTO member (it became the 133rd WTO member in late 1998). Nine others (except Tajikistan and Turkmenistan) have applied for membership and are at different stages in the accession process (table 3.6.10). They all have observer status at the WTO.

The WTO accession process begins when the applicant country submits a request for accession, upon which the General Council of the WTO establishes a Working Party to consider the request. As a first step, the applicant is required to provide a Memorandum describing all aspects of its trade and economic policies that may have a bearing on WTO Agreements. The Memorandum and other related information (e.g. clarifying questions and answers) provide a basis for a detailed examination of the applicant's trade regime. In due course, WTO members engage in bilateral negotiations with the applicant concerning trade concessions and commitments. Once these negotiations are completed, the Working Party prepares a Protocol of Accession that spells out the precise terms and conditions of entry into the WTO.<sup>488</sup>

<sup>486</sup> Exports of oil products, agricultural products, ferrous metals and machinery decreased between 41 and 51 per cent. CIS Statistical Committee, *CIS Statistical Bulletin*, 22(206) (Moscow), November 1998, p. 46.

<sup>487</sup> In comparison with export price declines to the non-CIS area, CIS countries were paying higher prices for Russian crude oil and oil products but lower prices for natural gas. Because, in value terms, CIS countries import from Russia three times as much natural gas as crude oil and oil products combined, it appears that not only did they benefit from declining prices, but also from the price differentials between CIS and non-CIS markets. CIS Statistical Committee, *CIS Statistical Bulletin*, 24(208) (Moscow), December 1998, p. 45.

<sup>488</sup> WTO, "Becoming a Member of the WTO – the Accession Process" (webpage at internet website).

TABLE 3.6.10

#### CIS countries' progress in acceding to the World Trade Organization

	Working Party established	Memorandum circulation	Clarifying questions and answers	Last Working Party meeting
Armenia .....	Dec. 1993	Apr. 1995	Sept 1995	Dec. 1997
Azerbaijan .....	Jul. 1997	–	–	–
Belarus .....	Oct. 1993	Jan. 1996	Jan. 1997	Apr. 1998
Georgia .....	Jul. 1996	Apr. 1997	Sept. 1997	Oct. 1998
Kazakhstan .....	Feb. 1996	Sept. 1996	Jan. 1997	Oct. 1998
Kyrgyzstan .....	Apr. 1996	Aug. 1996	Jan. 1997	Dec. 1998 <sup>a</sup>
Republic of Moldova .....	Dec. 1993	Sept. 1996	May 1997	Mar. 1998
Russian Federation .....	June 1993	Mar. 1994	Jun. 1995	Dec. 1998
Ukraine .....	Dec. 1993	Jul. 1994	Feb. 1995	Jun. 1998
Uzbekistan .....	Dec. 1994	Sept. 1998	–	–

*Source:* The World Trade Organization and C. Michalopoulos, *WTO Accession for Countries in Transition*, World Bank Policy Research Paper, No. 1934 (Washington, D.C.), June 1998.

<sup>a</sup> Date of membership.

In general, the transition economies have an interest in WTO membership because they wish to become fully-fledged members of the international trade community. Membership will help them to compete fairly in the international market place and allow them to counter discrimination and arbitrary behaviour with the help of enforceable, international trade rules. By virtue of being a member, they would also be able to participate in the process of interpretation of current and the development of future rules and negotiations. Conversely, membership allows transition economies to avoid the costs that non-membership imposes: trade discrimination without recourse to international rules, exclusion from the process of creating new rules, relatively restricted access to foreign markets, and a disadvantageous commercial position vis-à-vis other exporters in third markets.

The first immediate direct benefit of joining the WTO is market access on the unconditional most favoured nation terms. While many OECD countries have already granted trade privileges to some CIS countries (and so has the EU as part of the Partnership and Cooperation Agreements), the status of these trade concessions is neither permanent nor unconditional. Therefore, stable and predictable external trade conditions for CIS exports largely depend on WTO membership. CIS entrants could also reap benefits arising from the reduction and/or elimination of customs duties, import quotas, voluntary export restraints and other liberalization outcomes of the latest Uruguay trade round (as well as those negotiated in future WTO trade rounds). The second important direct benefit of membership is the dismantling of trade barriers specifically aimed at some CIS economies. During a recent steel dumping case in the United States for example, Russia sought to negotiate a "suspension" agreement in contrast to Brazil and Japan, which as market economies faced a lower probability of having prohibitive duties imposed. (A suspension agreement seeks to avert the imposition of high duties in return for a

“voluntary” export quota and agreement to maintain a minimum price.)<sup>489</sup> Third, the WTO as an international body collects and disseminates trade-related information, which members often find invaluable.<sup>490</sup> Transition economies could use WTO trade policy reviews to critically assess their own trade policies and scrutinize the trade regimes of their trading partners. Finally, WTO membership puts at new members’ disposal a contractually binding dispute settlement mechanism: small economies – such as the CIS countries – are most likely to benefit from access to an impartial and binding dispute settlement.

In addition to the above-mentioned benefits, the WTO accession process can provide some impetus for further development of the institutional framework in CIS countries. It is important to note that the former republics of the Soviet Union had no borders, no national currencies, no customs infrastructure and no trade policies of their own. The accession process helps CIS countries in institution-building through encouraging improvements in the quality and transparency of government policies; in supporting market-oriented reforms and encouraging governments’ resistance to protectionist or anti-reform pressures; and improving fiscal discipline by hardening budget constraints through the introduction of bankruptcy procedures and the lowering of subsidies.

While the potential benefits of WTO membership are extensive, the immediate costs of meeting the accession requirements, and the (post-accession) adjustments costs arising from opening up the national economy, cannot be ignored.<sup>491</sup> On the one hand, international trade rules assume the existence of an economic system largely based on market transactions and because market-oriented reforms are far from complete in the CIS area, a large part of *pre-accession* costs is incurred in designing, developing and implementing market-supporting institutions.<sup>492</sup> On the other hand, the *post-accession* adjustment costs, which, it is assumed, are likely to be outweighed by the benefits of being part of a large and competitive marketplace,

usually involve politically sensitive short-term costs such as increased bankruptcies and higher unemployment. However, if these adjustment costs are ignored, or if the process of liberalization is too rapid for the rate of adjustment to cope, then there is likely to be increasing resistance to the entire process.

In part because of these potentially high costs, there has been some delay and hesitation on the part of most CIS countries in making commitments to and implementing comprehensive trade liberalization. However, the reasons for delay in CIS countries are many. In some cases, they reflect a weak commitment to market-oriented economic principles, in others, the lack of capacity to negotiate at the bilateral and multilateral level or to put the necessary legislative and administrative infrastructure in place.<sup>493</sup> Other factors, beyond the CIS countries’ control, also affect the pace of accession. The relatively new WTO now has a “jurisdiction” which extends from goods to services to government procurement to intellectual property, in effect, covering many sectors of the national economy. As a result, WTO accessions have become more complex and, as the experience of recent accessions shows, the terms of membership have become more demanding.<sup>494</sup> Nevertheless, at present, it does not appear that CIS countries, on average, will take much longer to join the WTO than four recent new members (Bulgaria, Ecuador, Mongolia and Panama, for which the negotiations lasted about six years each).<sup>495</sup> In fact, the two first accessions from countries of the former Soviet Union – Kyrgyzstan and Latvia – took rather less time to complete (roughly three and five years, respectively).

While Kyrgyzstan’s accession proceeded relatively rapidly, other CIS applicants are advancing at different rates (table 3.6.11). Armenia is the most advanced – its bilateral market access negotiations in the goods and services sectors are near completion and a draft report describing the terms of entry has been discussed. Similarly, the first draft of Georgia’s accession conditions was discussed in October 1998. The Georgian negotiations covering the goods sector have been concluded and rapid progress is reported in all the remaining areas. Georgian officials hope to join the WTO in 1999, subject to the introduction of the required domestic legislation, especially in the areas of patents and trademarks. The Republic of Moldova’s bilateral market

<sup>489</sup> “U.S. set to be lenient on Russian steel imports”, *International Herald Tribune*, 12-13 December 1998.

<sup>490</sup> J. Pietras, “The role of the WTO for economies in transition”, in A. Krueger (ed.), *The WTO as an International Organization* (Chicago, The University of Chicago Press, 1998), p. 356.

<sup>491</sup> These costs, in particular pre-accession costs, should be seen as one-off investments necessary to modernize and advance the CIS national economies. K. Dziewulski, “Korzysci z uczestnictwa Polski w WTO”, *Gospodarka Narodowa*, No. 3, 1996, p. 28.

<sup>492</sup> Despite the onus on the potential entrants, the WTO accession process does take into consideration the legacy of central planning and the fact that the transition process does not entail marginal changes. Accordingly, “the overall guiding principle [of the accession process] is to achieve the right balance in determining the terms of entry, keeping in view the capacities of individual acceding governments and the need to maintain the credibility of the WTO system.” WTO, “Note by the secretariat”, Document WT/GC/W/100, 30 September 1998 (internet website).

<sup>493</sup> The existence of an “institutional infrastructure” is essential to ensure that a new member is able to participate effectively in the WTO framework of rights and obligations and the infrastructure must be transparent to be verifiable for compliance with international trade liberalization commitments.

<sup>494</sup> Z. Drabek and S. Laird, “The new liberalism: trade policy developments in emerging markets”, *World Trade Organization Staff Working Paper*, ERAD-97-007, January 1997, p. 14.

<sup>495</sup> C. Michalopoulos, “WTO accession for countries in transition”, *World Bank Policy Research Paper*, No. 1934 (Washington, D.C.), June 1998.

TABLE 3.6.11

Status of World Trade Organization accession and major outstanding bilateral issues, as of 30 September 1998

	Armenia	Belarus	Georgia	Kazakhstan	Republic of Moldova	Russian Federation	Ukraine	Uzbekistan <sup>a</sup>
Agriculture .....	X	X	X	X	X	X	X	
Customs system .....	X	X	X	X	X	X	X	
Industrial subsidies .....	X	X	X	X	X	X	X	
State trading .....	X	X	X		X		X	
SPS and TBT .....	X	X	X	X	X	X		
Trade-related Aspects of Intellectual Property .....	X	X	X	X	X	X	X	
Barter trade .....		X						
Institutional transparency ...		X	X	X	X		X	
Price controls .....				X				
Import licensing or non-tariff barriers .....				X	X	X	X	
Taxation and national treatment .....					X	X	X	
Trade-related investment measures .....						X		
Services .....				X	X	X	X	
Status of market access negotiations .....	Near completion (in goods and services)	Have begun (in goods)	Actively engaged (in goods and services)	Ongoing (in goods and services)	Actively engaged (in goods and services)	Have begun (in goods)	Ongoing (in goods and services)	Initiated

Source: The World Trade Organization.

Note: SPS: Sanitary and phytosanitary measures; TBT: Technical barriers to trade. Azerbaijan has not submitted a Memorandum on the Foreign Trade Regime yet. Kyrgyzstan is a member since December 1998. Tajikistan and Turkmenistan have not applied for membership. X denotes topics under discussion in the Working Groups.

<sup>a</sup> Submitted a Memorandum on the Foreign Trade Regime in September 1998.

access negotiations, covering both goods and services, are underway but the Working Party has not produced a draft report yet. The country recently introduced a new 5 per cent tax on all imports to protect local producers and to stabilize the domestic situation in the wake of the Russian financial crisis. While these measures run counter to a possible agreement with WTO members, the government argued that international economic conditions were exceptionally damaging. The market access negotiations with Kazakhstan and Ukraine are continuing in the goods and services sectors based on a revised goods offer by Kazakhstan and a revised services offer by Ukraine. Kazakhstan is scheduled to submit draft domestic legislation designed to comply with WTO accession requirements in early 1999. The Ukraine accession process, however, appears to have stalled. At its last Working Party meeting, the country was criticized for raising import duties on hundreds of goods, for introducing restrictive import quotas on agricultural products, for maintaining various non-tariff barriers to trade and for its foreign investment policy.<sup>496</sup> Russia and Belarus have begun bilateral negotiations in the goods sector. Russia has yet to provide a service sector offer and has recently come under pressure to release more up-to-date information concerning its agricultural sector. Continued bilateral negotiations coupled with a very gradual and moderate opening of the Russian economy appear to remain central to the overall Russian policy stance with respect to WTO membership. Finally, the

government of Azerbaijan is actively seeking accession to the WTO, but the process remains at a very early stage. As part of the country's unilateral trade liberalization, the authorities intend to reduce the general import tariff rate from 15 per cent to 10 per cent by the year 2001, but earlier plans to cut the rate to 12 per cent in 1999 have been postponed.<sup>497</sup>

Most of the CIS countries also face difficulties in improving the institutional aspects of their trade regimes. Many of these difficulties reflect the broader problems of reforming systems of public administration and practice that were designed for a relatively closed centrally planned economy, not a market economy operating in an open, international environment. Nevertheless, they impinge on the trading system in many ways that complicate the accession negotiated with WTO. Certification requirements for consumer goods, import licensing procedures, and customs clearance, are just three examples of areas where the rules are frequently obscure and complex and where bureaucratic process is characterized by inordinate delay and unpredictability. Complying with the accession conditions demanded by the existing WTO members, however, is closely connected to the transition process as a whole and especially with its dimension of building the institutional infrastructure for a market economy.

Agriculture, industrial subsidies and state trading also appear to be issues that are characteristically difficult

<sup>496</sup> "WTO scolds Ukraine on protectionist trade policies", *Journal of Commerce*, as quoted by *Reuters New Service*, 12 June 1998.

<sup>497</sup> IMF, "Azerbaijan: enhanced structural adjustment facility, 1999-2001, *Policy Framework Paper*, 8 January 1999 (internet website).

to settle. First, most transition economies have found the negotiations on agriculture very difficult as, in general, they are trying to retain the right to subsidize agricultural exports. Moreover, demands by WTO members to bind domestic agricultural support at low levels appear to be particularly stringent when compared with the agricultural policies of some OECD countries.<sup>498</sup> Second, also in the industrial sector, many countries are resisting the elimination of subsidies to producers which are viewed by WTO members as inherently trade distorting.<sup>499</sup> Third, state trading – defined by the WTO as trading by an enterprise that has special trading privileges and is not necessarily a state owned enterprise – also represents a typical impediment to WTO accession. While the “size” of state involvement is not as important an issue as that of transparency between the state and exporters, in Russia, for example, the state nevertheless controls an estimated 10-20 per cent of the country’s international trade.<sup>500</sup> Reducing the role of monopolies, introducing more transparency between the state and the private sector, and terminating the state trading aspects of intergovernmental (intra-CIS) agreements appears to be key in advancing the applications of Russia and other CIS countries for WTO membership. Finally, progress in privatization in transition economies is also considered very important by the existing WTO members; in fact, privatization has become a proxy for the transformation of economic institutions in general.

The “entry fee” for joining the WTO is a negotiated one; it is tailored to each applicant and it is represented by the entire package of trade liberalization commitments with flexibility in one area likely offsetting more rigorous demands in others.<sup>501</sup> The entry fee is considered by CIS governments to be worth paying not only to enhance the credibility of their policies and to make transition economies more attractive destinations for foreign investment, but also to encourage structural change and to anchor their economies to market-based principles.<sup>502</sup>

<sup>498</sup> M. Lucke, “Accession of the CIS countries to the World Trade Organization”, *German Yearbook of International Law*, Vol. 39, 1996, p. 146.

<sup>499</sup> P. Milthorpe, “Integration of FSU/economies in transition into the World Trade Organization”, *Economics of Transition*, Vol. 5, No. 1 (Oxford), 1997, pp. 220-221.

<sup>500</sup> C. Michalopoulos and V. Drebenstov, “Observations on state trading in the Russian economy”, *Post-Soviet Geography and Economics*, Volume XXXVIII, No. 5, pp. 273-274.

<sup>501</sup> P. Milthorpe, op. cit., p. 223.

<sup>502</sup> This could be accomplished through the reduction in direct state economic intervention, the creation of a viable private sector, economic autonomy for state owned enterprises, the establishment of linkage between domestic and world prices (and a unified and undistorted exchange rate) and exposing domestic producers to external competition. OECD, *Integrating Emerging Market Economies into the International Trading System* (Paris), 1994, pp. 22-23.

### 3.7 Balance of payments and external finance

#### (i) Introduction

The turmoil in international markets was already putting pressure on the current account balances of the transition economies in the first half of 1998 as the continuing Asian crisis weakened economic activity in an increasing number of major foreign markets. The collapse of Russian and CIS import demand intensified these pressures, although falling commodity prices provided some relief for many countries. The “flight to quality” in the financial markets in October 1997 had an immediate and long-lasting impact, affecting all types of capital flows into the transition economies. Moreover, contagion effects occasionally triggered the flight of short-term funds, drove down exchange rates and in some cases led to the loss of official reserves. Despite all this, capital flows into eastern Europe and the Baltic states increased again in 1998. The few countries seriously affected by the financial shocks were vulnerable not only because of their weak external positions, but also because of inconsistent macroeconomic policies and the slow pace of structural reform.

The outlook for increasing current account deficits, large scheduled repayments of debt (in several cases), continuing constraints on access to international finance, and uncertainty about FDI flows raise concerns about the sustainability of several European transition economies’ financial positions. This is particularly true of those countries which are rated subinvestment grade risks. Their plans for external financing typically count on privatization revenues, multilateral funding and some borrowing in international markets, but their room for manoeuvre is limited especially as official reserves tend to be low. In these cases, failure to reach agreement with the IMF, delays in privatization or further upheavals in the international financial markets could require a tightening macroeconomic policy and/or precipitate a crisis.

#### (ii) Current account developments

##### (a) Eastern Europe and the Baltic states

The aggregate current account deficit of eastern Europe continued to grow in 1998 (table 3.7.1), to an estimated \$17 billion (4.5 per cent of GDP). In most countries current account imbalances worsened throughout the year, accelerating in the last quarter as the full impact of slowing western demand, falling imports into Russia (and certain other CIS) and, often, appreciating real exchange rates, began to be felt. In virtually all cases, the current account deficits being reported in the last months of 1998 were larger than had been expected, even under the more pessimistic projections made earlier in the year. The imbalances would have been even greater but for the considerable drop in the import prices of commodities and intermediate goods (section 3.6). In several countries, current account deficits were constrained by the tight international financing conditions affecting all emerging market economies.

TABLE 3.7.1

Current account balances of eastern Europe, the Baltic countries and European members of the CIS, 1996-1998  
(Million dollars and per cent)

	1996	1997	January-September		1998	Per cent of GDP		
			1997	1998		1996	1997	1998 <sup>a</sup>
<b>Eastern Europe<sup>b</sup></b> .....	-13 189	-14 662	-10 269	-10 139	-16 974	-3.7	-4.2	-4.5
Albania .....	-107	-271	-121	-21	-50*	-4.0	-12.0	-1.7*
Bosnia and Herzegovina .....	-748	-1 046	..	..	..	..	..	..
Bulgaria .....	16	427	380	-91	-273	0.2	4.2	-2.1
Croatia .....	-858	-2 434	-1 085	-862	-1 554	-4.3	-12.1	-7.3
Czech Republic .....	-4 292	-3 211	-2 564	-481	-800*	-7.6	-6.2	-1.5
Hungary .....	-1 678	-981	-686	-1 337	-2 298	-3.7	-2.1	-4.8*
Poland .....	-1 352 <sup>c</sup>	-4 268 <sup>c</sup>	-3 638 <sup>c</sup>	-3 846	-6 810	-0.9	-3.0	-4.3
Romania .....	-2 571	-2 338	-1 277	-1 849	-2 633 <sup>d</sup>	-7.3	-6.7	-6.9
Slovakia .....	-2 098	-1 347	-1 102	-1 542	-2 300*	-11.2	-6.9	-11.3*
Slovenia .....	39	37	-16	58	-6	0.2	0.2	-
The former Yugoslav Republic of Macedonia .....	-288	-275	-161	-168	-250*	-6.5	-7.4	-7.1
<b>Baltic states</b> .....	-1 425	-1 889	-1 145	-1 854	..	-8.2	-9.5	-11.3
Estonia .....	-423	-563	-349	-370	..	-9.7	-12.0	-9.7
Latvia .....	-279	-345	-222	-456	..	-5.4	-6.2	-9.7
Lithuania .....	-723	-981	-574	-1028	..	-9.2	-10.2	-13.0
<b>CIS</b> .....	10 207	934	1 096	-8 012	..	2.1	0.2	-3.2
Belarus .....	-516	-799	-525	-797	..	-3.8	-6.0	-7.4
Republic of Moldova .....	-188	-267	-208	-280	..	-11.1	-13.9	-23.3
Russian Federation .....	12 096	3 335	3 011	-5 625	..	2.8	0.8	-2.7
Ukraine .....	-1 185	-1 335	-1 181	-1 310	..	-2.7	-2.7	-4.1
<b>Total above</b> .....	-4 408	-15 617	-10 318	-20 005	..	-0.5	-1.8	..

Source: National balance of payments statistics; press reports; UN/ECE secretariat estimates.

<sup>a</sup> Full year except for Baltic states and CIS which are January-September.

<sup>b</sup> Eastern Europe aggregate excludes Bosnia and Herzegovina.

<sup>c</sup> Convertible currencies.

<sup>d</sup> Official forecasts.

The growth of east European trade in goods<sup>503</sup> and services quickened slightly in the first three quarters of 1998 (table 3.7.2). The dollar value of exports increased by 8 per cent (perhaps 11-12 per cent in terms of volume), although service exports ceased to grow. Fragmentary statistics for merchandise trade in the last months of the year indicate a sharp fall of export growth as the international environment deteriorated (section 3.6). Imports of goods and services rose by 9 per cent (some 12-13 per cent in volume) in the first nine months of 1998 with service imports tending to rise strongly.

The development of trade in services indicates that the deterioration in merchandise trade (reflecting the external environment) was not uniquely responsible for the worsening of current account balances. In fact, domestic factors seem to explain some of the \$1 billion decline in eastern Europe's surplus on services in 1998. This had increased since the beginning of the decade, helping to offset the steady growth in the merchandise trade deficit. The recent change mainly reflects a stagnation of receipts from services (including tourism) and a further expansion of imports of business services (associated with the

development of a market economy). If the demand for foreign business services continues to grow quickly, the negative trend in the overall services balance may be difficult to reverse. Most countries reported larger net inward transfers, mainly remittances from nationals working abroad. Net income payments were largely unchanged, smaller interest payments (due to declining international interest rates) being offset by larger outflows of other income, including, increasingly, foreign investment income.

Among the central European countries, exports of goods and services expanded at a rapid pace (although growth rates slowed as the year progressed). However, current account balances deteriorated in Hungary, Poland and Slovakia, all of which experienced strong GDP growth. In Hungary the improvement in the current account, underway since the launching of the 1995 stabilization programme, ceased in the first half of 1998. Although monetary and fiscal policies remained prudent and the real exchange rate was kept roughly constant (chart 3.7.1), the current account deficit more than doubled.<sup>504</sup>

<sup>503</sup> This section is based on balance of payments statistics, which may show a different development of merchandise trade than the customs statistics used in sect. 3.6.

<sup>504</sup> Attention is drawn to the difference between the growth rates of merchandise trade in table 3.7.2 (based on the balance of payments) and the much higher rates calculated from customs statistics (table 3.6.1). Attempts to reconcile the two have been made, but large differences remain unexplained. OECD, *Economic Surveys: Hungary* (Paris), 1999, pp. 144-145.



TABLE 3.7.2

Foreign trade in goods and non-factor services of eastern Europe, the Baltic countries and European members of the CIS, 1996-1998  
(Per cent)

	Growth rates						Growth rates					
	Exports			Imports			Exports			Imports		
	1996	1997	Jan.- Sept. 1998 <sup>a</sup>	1996	1997	Jan.- Sept. 1998 <sup>a</sup>	1996	1997	Jan.- Sept. 1998 <sup>a</sup>	1996	1997	Jan.- Sept. 1998 <sup>a</sup>
<b>Eastern Europe</b>												
Goods and services <sup>b,c</sup>	5	7	8	14	7	9						
Goods .....	3	10	10	14	8	9						
Services .....	13	-2	-	13	-3	6						
<b>Albania</b>												
Goods and services ...	24	-40	20	33	-27	36						
Goods .....	19	-35	23	36	-25	33						
Services .....	33	-49	14	21	-38	52						
<b>Bulgaria</b>												
Goods and services ...	-8	-	-10	-9	-4	1						
Goods .....	-9	1	-12	-10	-3	3						
Services .....	-5	-2	-2	-3	-6	-7						
<b>Croatia</b>												
Goods and services ...	11	2	2	7	15	-3						
Goods .....	-2	-7	7	4	15	-2						
Services .....	33	15	-3	21	15	-4						
<b>Czech Republic</b>												
Goods and services ...	6	-	14	13	-3	4						
Goods .....	1	5	17	10	-1	5						
Services .....	22	-12	4	28	-14	-1						
<b>Hungary<sup>b</sup></b>												
Goods and services ...	12	..	3	8	..	5						
Goods .....	11	..	4	10	..	4						
Services .....	18	..	-1	-1	..	10						
<b>Poland</b>												
Goods and services <sup>c</sup>	7	11	14	30	16	15						
Goods .....	7	12	16	32	18	15						
Services .....	6	10	1	18	-5	17						
<b>Romania</b>												
Goods and services ...	3	2	-3	11	-	9						
Goods .....	2	4	-3	11	-1	8						
Services .....	5	-9	-1	7	5	16						
<b>Slovakia</b>												
Goods and services ...	-	1	16	27	-6	20						
Goods .....	3	-	19	31	-8	21						
Services .....	-13	5	3	11	3	12						
<b>Slovenia</b>												
Goods and services ...	1	-	6	-	-	5						
Goods .....	-	-	7	-1	-1	5						
Services .....	5	-4	-1	2	2	5						
<b>The former Yugoslav Republic of Macedonia</b>												
Goods and services ...	-6	2	9	-2	5	10						
Goods .....	-5	5	10	3	9	10						
Services .....	-17	-17	-	-20	-12	13						
<b>Baltic states</b>												
Goods and services ...	21	20	10	25	20	16						
Goods .....	13	24	12	19	21	17						
Services .....	46	12	8	62	14	15						
<b>Estonia</b>												
Goods and services ...	6	25	19	12	21	19						
Goods .....	-4	28	21	11	21	19						
Services .....	27	19	15	19	23	20						
<b>Latvia</b>												
Goods and services ...	25	10	9	38	11	18						
Goods .....	9	24	14	17	18	22						
Services .....	56	-8	-1	202	-11	3						
<b>Lithuania</b>												
Goods and services ...	32	24	6	28	25	14						
Goods .....	26	23	6	27	24	12						
Services .....	64	29	6	36	33	20						
<b>3 European CIS</b>												
Goods and services ...	21	6	-9	20	8	-8						
Goods .....	13	7	-9	20	6	-10						
Services .....	68	3	-11	17	33	19						
<b>Belarus</b>												
Goods and services ...	30	24	2	27	25	6						
Goods .....	23	28	2	27	26	5						
Services .....	95	2	1	18	15	34						
<b>Republic of Moldova</b>												
Goods and services ...	6	9	-14	23	14	-2						
Goods .....	11	8	-16	33	15	-3						
Services .....	-22	18	-2	-14	10	10						
<b>Ukraine</b>												
Goods and services ...	19	-	-13	17	2	-14						
Goods .....	9	-1	-14	17	-1	-17						
Services .....	69	3	-13	22	40	18						
<b>Russian Federation</b>												
Goods and services ...	11	-1	-13	5	5	-5						
Goods .....	9	-2	-14	9	6	-5						
Services .....	23	7	-6	-7	2	-7						

Source: UN/ECE secretariat, based on national balance of payments statistics.

<sup>a</sup> Over same period of 1997.

<sup>b</sup> 1997 Hungarian data are estimated.

<sup>c</sup> Excludes "non-classified current transactions" reported by Poland.

The doubling of outflows of net investment income, associated with foreign direct investment, to almost \$1 billion was an important factor in this regard. In Poland a loss of competitiveness (reflected in the appreciation of the real exchange rate) contributed to the deterioration of the trade and current account balances (although exports remained buoyant for much of the year). Following the Russian devaluation, there was a marked fall in net receipts from unclassified trade in

goods and services (which includes cross-border trade with Russia and Ukraine).<sup>505</sup> In Slovakia, the already high current account deficit was exacerbated by a lax fiscal stance, setting the stage for the abandonment of

<sup>505</sup> These exchanges are not recorded in the customs statistics. Net receipts fell by about \$140 million a month (or to \$1.7 billion at an annual rate) following the Russian crisis.

the currency band (October 1) in the wake of the Russian devaluation. In the *Czech Republic*, the lagged effect of the devaluation of 1997 and tight monetary policies compressed domestic demand, helping to boost export growth. However, this expansion eventually slowed as the real exchange rate appreciated strongly and external demand weakened. Nonetheless, the current account imbalance improved in 1998, by almost 5 per cent of GDP. In contrast to most transition economies, the *Czech Republic's* surplus on services improved, mainly because of tourism.

In south-east Europe, the pace of trade in goods and services of the republics of the former SFR of Yugoslavia tended to pick up in 1998. In *Slovenia* this followed two years in which the value of these exchanges stagnated. A decline in competitiveness may have contributed to the worsening of the current account, which nonetheless remained roughly balanced. *The former Yugoslav Republic of Macedonia* posted its fastest growth of trade in goods and services since 1995, due in part to the shift in trade toward western Europe. However, there was little change in its large current account deficit. Trimming the large current account deficit was a key policy objective in *Croatia* in 1998. The tightening of fiscal and monetary policies (in part prompted by limited access to international funds) and some depreciation of the real exchange rate had the desired effect. However, exports of services stagnated as the anticipated surge in tourism receipts failed to materialize (they rose by only 5 per cent). The balance of payments data which have recently become available for *Bosnia and Herzegovina*, indicate the persistence of a large current account deficit, despite substantial official transfers. After a hiatus of five years, the central bank of Yugoslavia began to publish the balance of payments. They show that in 1997 the country ran a current account deficit of \$1.3 billion, consisting of a \$1.9 billion trade deficit and a \$0.6 billion surplus on the services account.<sup>506</sup>

In *Albania*, trade in goods and services recovered from the economic crisis of 1997, the upturn being stronger on the side of imports. Also, private transfers (workers' remittances) recovered, significantly improving the current account. The export performance of *Bulgaria* and *Romania* deteriorated in 1998. In addition to the negative external environment, the explanation in *Bulgaria* seems to be an appreciating real exchange rate (section 3.7(iv)), which caused a shift of over 8 per cent of GDP in the current account. The growth of the current account imbalance in *Romania* appears to be due primarily to a large loss of competitiveness and other supply side factors.<sup>507</sup> Tight monetary policy has kept consumption in check and external borrowing was restricted (causing a drawdown of official reserves).

The impact of the collapse of Russian trade on the *Baltic states'* trade in goods and services was greater than in eastern Europe. Moreover, real exchange rates appreciated in all three countries, which probably contributed to the slowdown in the (high) growth of exports of goods and services. Consumption continued to expand strongly in *Latvia* and *Lithuania*, contributing to the near doubling of their current account deficits in the first three quarters of 1998. The tightening of monetary policy, weakening consumer demand, and higher net receipts from tourism<sup>508</sup> seem to have slowed the deterioration of the current account in *Estonia*. Nonetheless the external imbalances of all three countries remain very high.

### (b) European CIS

A further decline in Russia's merchandise exports and buoyant imports in the early part of the year, together with a sizeable increase in interest obligations (on both internal and external debt), shifted the current account into deficit (\$5.6 billion) in the January-September period. In the third quarter of the year, the combination of a banking crisis, the loss of external financing and the devaluation of the rouble caused imports to fall sharply, and the current account reverted to surplus. Large merchandise trade surpluses in the last months of the year point to a positive current account balance for all of 1998.

Despite severe limits on new financing, the current account deficits of the other European CIS increased in the first three quarters of 1998. In *Ukraine*, financial constraints contributed to the contraction of the merchandise trade deficit, but the other components of the current account deteriorated, led by a \$1.3 billion loss of net transport revenues (mainly from natural gas pipelines). Economic policies did little to curb the growth of the large external imbalance in the *Republic of Moldova* which left the country vulnerable to contagion from Russia's financial problems. Expansionary monetary and fiscal policies in *Belarus* placed pressure on the current account, but it was the only European member of the CIS in which trade in goods and services expanded.

### (iii) External financing and FDI

#### (a) Funds raised on the international markets

The Asian crisis and the following period of market turbulence has led to a major setback in the international borrowing activities of the transition economies, reversing years of progress toward greater market access. In October 1997, the profound shift in investor sentiment away from emerging markets caused the premia on secondary market debt to rise (chart 3.7.2) and substantially increased the cost of new funds. In consequence, many countries shelved or cancelled their plans to borrow or issue equities. Even short-term trade credits, previously available to many CIS countries, appear to have dried up.<sup>509</sup>

<sup>506</sup> *Trziste Novac Kapital* (Belgrade) July-September 1998. The reported trade balance of \$1.9 billion has been adjusted to incorporate exports of processed goods lowering it to \$1 billion.

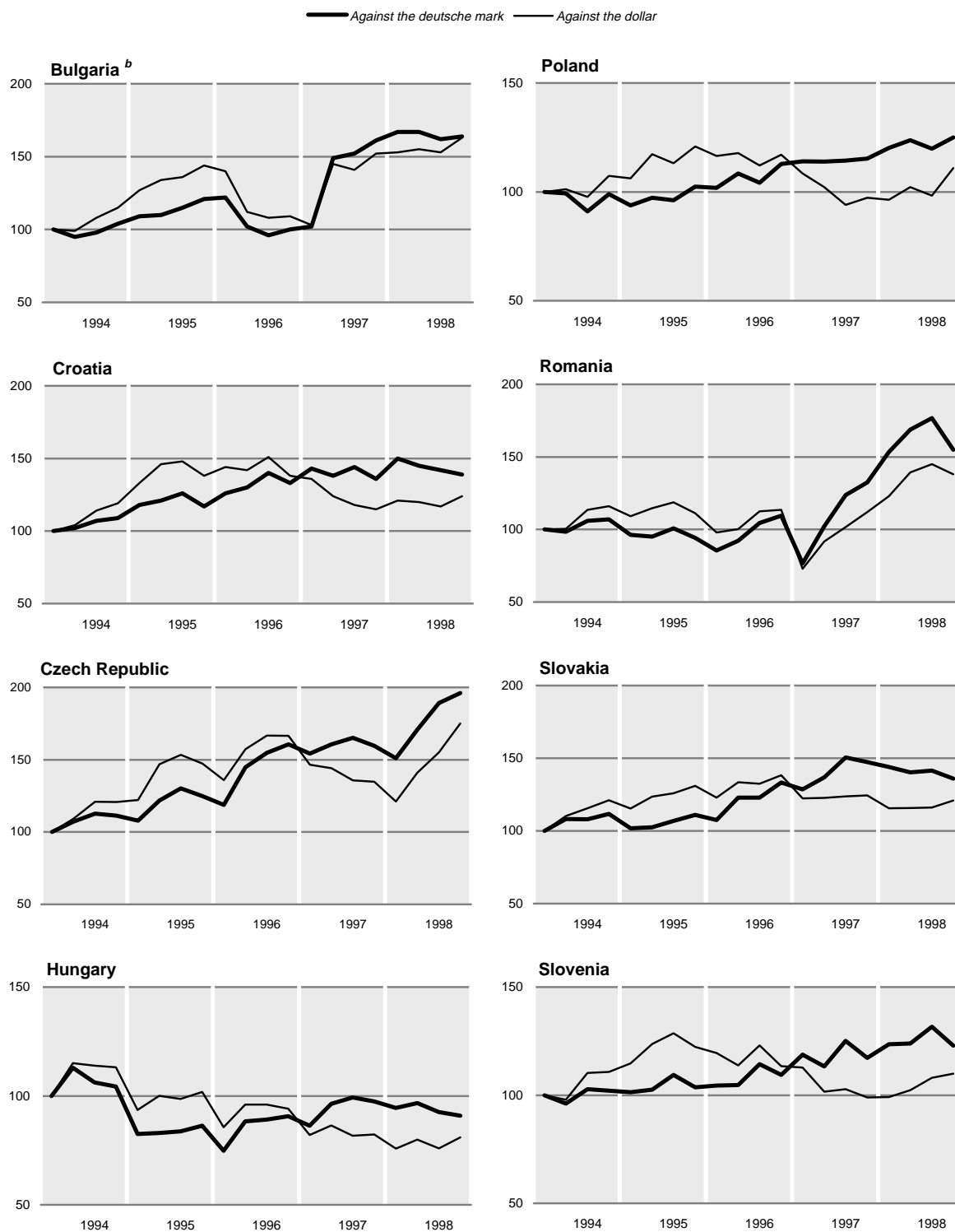
<sup>507</sup> The closure of some loss-making enterprises has adversely affected exports.

<sup>508</sup> Tourism reflects some unrecorded cross-border trade, including important links with Finland.

<sup>509</sup> The loss of access to trade credits has prompted the EBRD to launch a programme of trade finance for the affected countries.

CHART 3.7.1

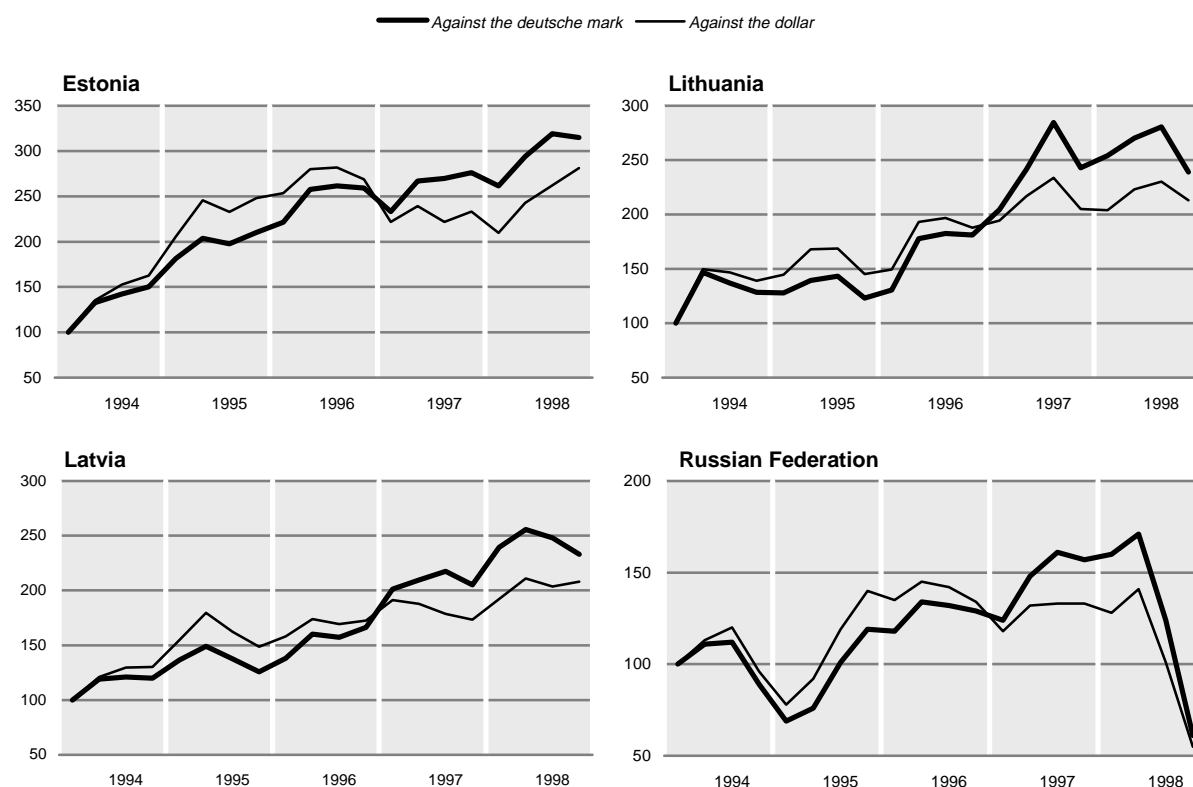
Real exchange rates based on unit labour costs <sup>a</sup> for selected transition economies, 1994-1998  
(1994 QI=100)



(For source and notes see end of chart.)

CHART 3.7.1 (concluded)

Real exchange rates based on unit labour costs<sup>a</sup> for selected transition economies, 1994-1998  
(1994 QI=100)



Source: UN/ECE secretariat, based on national sources. Deutsche Bundesbank for German unit labour costs in the producing sector.

Note: An increase in the index indicates an appreciation of the real exchange rate. Indices of real deutsche mark and dollar exchange rates have been calculated as the ratio of indices of domestic unit labour costs in marks (and dollars) and unit labour costs in Germany (and the United States). Gross wages and labour productivity are for industry except in Estonia for which gross wages in the whole economy were used. Unit labour costs for Germany are for the producing sector (manufacturing and mining and quarrying), but for the United States they reflect the whole economy. The indices are not adjusted for seasonal variation.

<sup>a</sup> Based on unit labour costs in industry.

<sup>b</sup> Based on consumer price indices.

In March 1998, conditions eased as the markets began to believe that the worst of the global crisis was over. Terms improved (although premia remained above their pre-October 1997 levels), prompting Croatia, Hungary, Slovakia and Slovenia (all investment grade risks) to arrange new funds. Substantial funds were raised by Russia (\$7.3 billion) and Ukraine (\$1.1 billion), the latter, however, having to borrow at particularly unfavourable terms. However, global market conditions deteriorated again in mid-year and in August Russia devalued. Premia on emerging market debt skyrocketed (chart 3.7.2), and lending virtually ceased. In the remainder of the year, the transition economies issued only two bonds, DM 500 million by Hungary and \$1 billion by Poland's Poltelecom (shortly after its privatization). Due to these unfavourable conditions and the downgrading of the credit ratings of several countries, the volume of medium- and long-term funds obtained by the transition economies fell to about \$22 billion in 1998,<sup>510</sup> compared with nearly

\$30 billion in 1997. Bank lending has held up better than bond issues and sovereign borrowing better than that of the corporate and financial sectors.

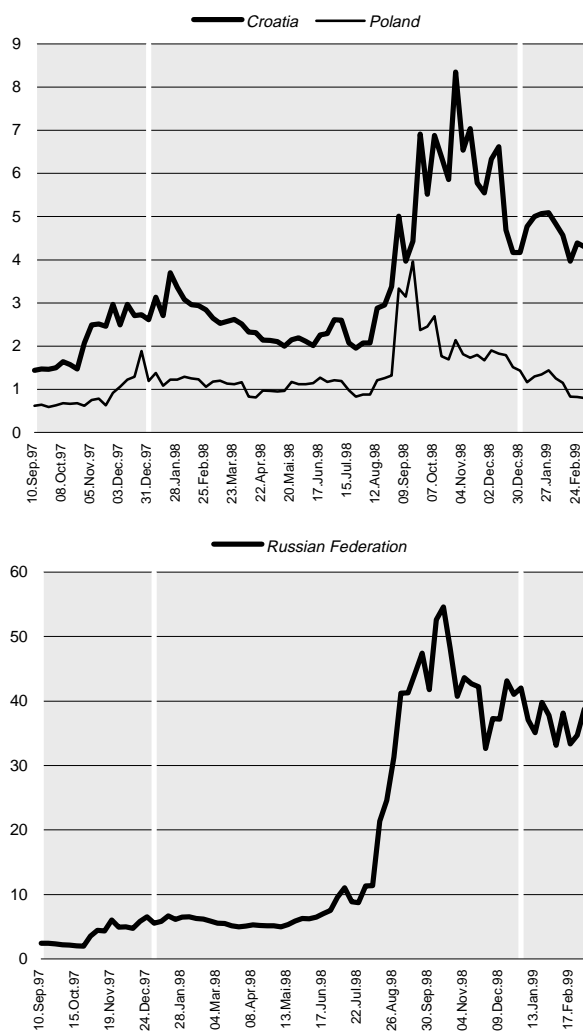
In early January 1999, the Brazilian crisis unsettled the markets once again, which may help to explain why only Hungary and Croatia issued bonds (of €500 million and €300 million, respectively) in the first two months of the year.

Despite the upheavals in 1998, most countries maintained their sovereign *international credit ratings* (table 3.7.3). In fact, Hungary was raised a notch by Moody's in May and Poland by Fitch IBCA in November. In the same month, Bulgaria received a rating from Standard & Poor's. The downgrades were concentrated among the countries in the speculative category, although Slovakia lost its investment grade rating. The reasons for these latter changes include domestic financial instability, losses in the terms of trade, inconsistent macroeconomic policies, the slow progress of economic reforms, and a weakened financial position

<sup>510</sup> Some \$19 billion of this was raised in January-October. UN/ECE, *Economic Survey of Europe, 1998 No. 3*, table 4.3.4.

CHART 3.7.2

Premia on selected transition economy bonds,  
September 1997-February 1999  
(Percentage points)



Source: *Financial Times*, various issues.

Note: The premia are over United States treasury bonds.

after contagion from the Russian crisis. In general, investors have differentiated between eastern borrowers. For example, Hungary has retained market access and during an unpropitious period (January 1998) was able to issue a bond on the best terms it has ever obtained (37.5 basis points over LIBOR). Other countries, when they were able to borrow, had to pay much more (Croatia paying 375 basis points over LIBOR) and the premia on the secondary market debt of many countries have remained high.<sup>511</sup>

<sup>511</sup> For example, the spread on Slovakia's benchmark eurobond was over 500 basis points in February 1999.

### (b) Foreign investment

There was a modest increase in the total volume of FDI flows into the European transition economies in the first three quarters of 1998. Fragmentary data, mostly for eastern Europe, indicate that FDI inflows for the whole year will be little changed from 1997 (table 3.7.4).<sup>512</sup> Only about half of the countries reported larger inflows, but in several instances the increases were significant. This was the case for Poland which has emerged as the major destination for FDI in the region and seems to have achieved an exceptionally steady growth of inward investment.

These developments reflect the vast differences in the investment climate prevailing in the individual countries and in the evolution of their privatization programmes. The programmes are in different stages, ranging from near completion (in Hungary) to those just getting underway. Actual sales of state assets in 1998 generally fell short of expectations, in part because of the usual delays in the political decision-making process. In addition, the authorities often postponed sales due to the sharp fall in asset prices. The valuation of state property was depressed by the crash of stock markets in August and declining world prices of basic commodities and intermediate goods.

The explanations for the pattern of FDI flows in 1998 are complex. Only in Poland did favourable growth prospects (at least, until recently), candidacy for EU membership and privatization – all viewed as important influences on foreign investment decisions – all seem to move together to boost FDI. Among the other EU candidate countries, only the Czech Republic and Estonia reported higher inflows; in Estonia they were heavily influenced by the privatization of two banks in the summer, but thereafter other sales were postponed. The absence of large privatizations seems to explain the decline of FDI in Hungary (since 1995), but flows to the Czech Republic rose markedly although there were no sales of large state assets.<sup>513</sup> Neither are changes in FDI flows explained by economic prospects. Those of the Czech Republic were rather subdued in late 1997 and early 1998 while Hungary was looking forward to another year of high growth.

<sup>512</sup> Recent estimates suggest that foreign direct investment into all emerging market economies declined from \$117 billion in 1997 to \$111 billion in 1998. Due to the subdued outlook for growth, a further decline has been forecast for 1999. Institute of International Finance, Inc. (IIF), *Capital Flows to Emerging Market Economies* (Washington, D.C.), 27 January 1999.

<sup>513</sup> In the Czech Republic, the adoption of a state incentive scheme to support foreign investment in late April 1998 seems to have had the desired effect. In the first half of 1998 at least, FDI inflows reflected the establishment of new joint ventures and injections of additional capital into existing financial institutions and businesses under partial foreign ownership. Czech National Bank, *Monthly Bulletin*, No. 7, 1998.

TABLE 3.7.3

## International credit ratings of eastern Europe, the Baltic countries and the CIS

Rating	Moody's		Rating	Standard & Poor's		Fitch-IBCA	
	Country	Date received		Country	Date received	Rating	Country
<b>Investment grades</b>							
Aaa-Aa			AAA-AA			AAA-AA	
A2			A	Slovenia	May 1996	A	
A3	Slovenia	May 1996	A-	Czech Republic	November 1998 <sup>a</sup>	A-	Slovenia
Baa1	Czech Republic	September 1995	BBB+	Estonia	December 1997	BBB+	Czech Republic
	Estonia	September 1997					Poland <sup>b</sup>
Baa2	Latvia	December 1997	BBB	Latvia	January 1997	BBB	Hungary
	Hungary	May 1998 <sup>b</sup>		Hungary	1998		Estonia
Baa3	Croatia	January 1997	BBB-	Croatia	January 1997	BBB-	Croatia
	Poland	June 1995		Lithuania	June 1997		
				Poland	April 1996 <sup>b</sup>		
<b>Sub-investment (speculative) grades</b>							
Ba1	Lithuania	December 1997 <sup>b</sup>	BB+	Slovakia	April 1996	BB+	Lithuania
	Slovakia	September 1998 <sup>a</sup>					Slovakia
Ba2			BB			BB	Kazakhstan
Ba3			BB-			BB-	
B1	Kazakhstan	September 1998 <sup>a</sup>	B+	Kazakhstan	September 1998 <sup>a</sup>	B+	Bulgaria
B2	Bulgaria	December 1997 <sup>b</sup>	B	Bulgaria	November 1998	B	Republic of Moldova
	Turkmenistan	November 1997					
	Republic of Moldova	July 1998 <sup>a</sup>					
B3	Russian Federation	August 1998 <sup>a</sup>	B-	Romania	October 1998 <sup>a</sup>	B-	Romania <sup>a</sup>
	Ukraine	September 1998					
	Romania	November 1998 <sup>a</sup>					
			CCC+			CCC+	
			CCC			CCC	Russian Federation <sup>a</sup>
			CCC-	Russian Federation	September 1998 <sup>a</sup>	CCC-	

Source: Press reports.

Note: Foreign currency, long-term, sovereign debt ratings.

<sup>a</sup> Indicates a downgrade.

<sup>b</sup> Indicates an upgrade.

Toward the end of 1998 and early 1999, privatization picked up in a number of countries. The improvement in world market conditions raised valuations somewhat, making sales more attractive to governments. However, constraints on capital market borrowing and the need for funds was the prime motivation in Romania<sup>514</sup> and Russia.<sup>515</sup> Foreign investors, on the other hand, benefited from asset prices which were still lower than in the first half of 1998.<sup>516</sup>

Also arranged at this time (but not because cash was needed) was the initial public offering (IPO) of equity by the TPSA (Polish Telecommunications) which yielded

\$622 million (the largest IPO in the region).<sup>517</sup> Despite this large deal, the total value of equity issued by the transition economies fell from \$3 billion in 1997 to around \$2 billion in 1998.<sup>518</sup>

Although FDI investors are assumed to take the long view, the persistent turmoil in international markets, declining commodities prices, the Russian crisis and steadily worsening global economic prospects raised concerns in 1998 about future FDI flows. In fact, scattered data for the last few months of the year indicate that at least some projects in the pipeline did go ahead.<sup>519</sup> FDI flows into Poland actually accelerated during the year and Romania completed several key deals in November-December. However, the turmoil in Russia

<sup>514</sup> In Romania, foreign investors bought stakes in RomTelecom, the Romanian Development Bank and, in early 1999, in Petromidia (\$740 million).

<sup>515</sup> In December the Russian authorities sold a 2.5 per cent share of Gazprom for \$660 million. The funds were intended to cover part of the federal budget deficit.

<sup>516</sup> For example, it has been reported that the sales price of Poltelcom, the Polish telecommunications company, was two thirds of what it would have fetched earlier in the year (see below).

<sup>517</sup> This represents only the part of the IPO allocated to foreign institutional investors.

<sup>518</sup> International equity issues of the transition economies are presented in UN/ECE, *Economic Survey of Europe, 1998 No. 3*, table 4.3.6.

<sup>519</sup> The lumpiness of FDI flows caused by large privatizations might make any crises-induced changes in FDI trends difficult to identify.

TABLE 3.7.4

Indicators of foreign direct investment in east European, Baltic and European CIS countries, 1997-1998  
(Million dollars and per cent)

	FDI flows										Cumulative inflow <sup>a</sup>		
	FDI inflow (million dollars)			FDI abroad (million dollars)		Net FDI (million dollars)		FDI inflow per capita (dollars)		FDI inflow/GDP (per cent)		(million dollars)	(per capita)
	1997	1998 <sup>b</sup>	1998 <sup>c</sup>	1997	1998 <sup>c</sup>	1997	1998 <sup>c</sup>	1997	1998 <sup>c</sup>	1997	1998 <sup>c</sup>	1998	1998
<b>Eastern Europe</b> .....	9 116	8 470	13 155	-736	-900	8 380	12 255	82	119	2.6	3.5	53 162	481
Albania .....	48	27	36	-	-	48	36	15	11	2.1	1.2	374	120
Bulgaria .....	505	156	141	2	-	507	141	60	17	5.0	1.1	1 092	131
Croatia .....	388	624	854	-157	-91	231	763	87	191	1.9	4.0	2 102	469
Czech Republic .....	1 300	1 213	1 617	-25	-50	1 275	1 567	126	157	2.5	2.9	10 383	1 010
Hungary .....	2 085	1 353	1 935	-431	-481	1 654	1 454	205	191	4.6	4.1	17 397	1 720
Poland .....	3 077	3 858	6 326	-36	-162	3 041	6 164	80	163	2.1	4.0	14 922	385
Romania .....	1 215	723	1 598	9	-	1 224	1 598	54	71	3.5	4.2	4 040	180
Slovakia .....	161	301	401	-72	-105	90	296	30	75	0.8	2.0	1 438	267
Slovenia .....	321	153	165	-26	-11	295	154	161	83	1.8	0.8	1 271	638
The former Yugoslav Republic of Macedonia .....	16	62	83	-	-	16	83	8	41	0.4	2.3	143	71
<b>Baltic states</b> .....	1 142	1 371	1 828	-170	-44	973	1 784	150	242	5.8	8.4	4 929	653
Estonia .....	267	364	485	-137	5	130	489	184	339	5.7	9.3	1 550	1 085
Latvia .....	521	214	286	-6	-66	515	220	212	118	9.4	4.8	1 671	689
Lithuania .....	355	793	1 057	-27	17	328	1 075	96	286	3.7	9.8	1 708	462
<b>European CIS</b> .....	7 128	2 204	2 939	-2 662	-1 085	4 466	1 853	33	14	1.4	0.9	19 751	93
Belarus .....	192	88	118	-2	-2	190	115	19	11	1.4	0.9	423	41
Republic of Moldova .....	72	52	69	-	1	71	70	16	16	3.7	4.2	274	63
Russian Federation .....	6 241	1 483	1 977	-2 617	-1 091	3 624	887	42	13	1.4	0.7	16 311	111
Ukraine .....	623	581	775	-42	7	581	781	12	15	1.3	1.9	2 742	54
<b>Total above</b> .....	17 386	12 045	17 922	-3 567	-2 028	13 819	15 893	52	54	2.0	2.4	77 842	235

Source: UN/ECE secretariat Foreign Investment Database, based on national balance of payments statistics.

<sup>a</sup> FDI inflows are cumulative from 1988.

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

<sup>c</sup> Full year data except for Albania, the Czech Republic, Slovakia, The former Yugoslav Republic of Macedonia, the Baltic states and the European CIS for which extrapolations of January-September rates were used.

(already in late 1997) seems to have deterred FDI. Inflows fell from over \$6 billion in 1997 to an estimated \$2 billion in 1998. In Hungary, FDI had declined prior to these recent crises.

### (c) Total net financial inflows

Despite the turbulence in international financial markets, the total net flow of funds into eastern Europe and the Baltic states<sup>520</sup> is estimated to have increased in 1998, thus prolonging the 1997 capital surge<sup>521</sup> (tables 3.7.5 and 3.7.6). This group of countries fared much better than emerging market economies as a whole, which saw a marked decline of capital imports in both 1997 and 1998.<sup>522</sup> However, the impact of the various shocks was nonetheless significant, as reflected in the composition of flows and their volatility. In particular, net inflows from bond issues<sup>523</sup> and medium- and long-

term loans declined while the importance of short-term funds<sup>524</sup> increased. The latter inflows amounted to almost \$10 billion in the first half of the year (chart 3.7.3), chiefly into Poland, Hungary and the Czech Republic.

The large volume of short-term flows made the transition economies more vulnerable to the greater volatility of international markets in 1998. The most serious episode of contagion was triggered by the Russian crisis in August. At least \$3 billion of short-term funds left eastern Europe in the third quarter of the year<sup>525</sup> (mostly from Hungary, the Czech Republic, Slovakia, and Poland) resulting in a deficit on capital account (chart 3.7.3). In the Baltic states, only in Estonia were there comparatively large outflows of portfolio investment (some left Latvia as well) and other short-term capital.

<sup>520</sup> First three quarters of 1998 only.

<sup>521</sup> In the Baltic states capital inflows have increased steadily for several years.

<sup>522</sup> IIF, op. cit.

<sup>523</sup> In table 3.7.6 bonds are included in portfolio flows.

<sup>524</sup> This includes portfolio and short-term capital and unrecorded capital flows ("errors and omissions"). It should be noted that portfolio flows also include net issues of external bonds which are not subject to the volatility associated with portfolio investment in local currency denominated securities.

<sup>525</sup> These observations are made on the basis of quarterly data. Monthly data for Hungary and Poland indicate that outflows continued in October, and this may have occurred in other countries as well.

TABLE 3.7.5

Net capital flows into eastern Europe, the Baltic countries and the European members of the CIS, 1995-1998  
(Billion dollars and per cent)

	Capital and financial account flows <sup>a</sup>									Changes in official reserves <sup>b</sup>					
	Billion dollars						Capital flows/GDP			Billion dollars			Reserves/GDP		
	1995	1996	1997	Jan.-Sept.		1998 <sup>c</sup>	1996	1997	Jan.-Sept. 1998	1996	1997	Jan.-Sept. 1998	1996	1997	Jan.-Sept. 1998
				1997	1998										
<b>Eastern Europe</b> .....	23.7	15.6	21.0	16.0	17.5	25.5	4.4	6.0	6.4	1.5	5.2	7.4	0.4	1.5	2.7
Albania .....	-	0.2	0.3	0.1	0.1	0.1	5.7	13.9	3.5	-	-	0.1	1.7	1.9	2.6
Bulgaria .....	0.3	-0.8	0.8	0.7	0.4	0.7	-7.8	7.6	4.2	-0.8	1.2	0.3	-7.6	11.8	3.1
Croatia .....	1.8	1.3	2.7	1.3	1.1	1.8	6.4	13.2	6.8	0.4	0.2	0.2	2.1	1.1	1.4
Czech Republic .....	8.8	3.5	1.4	2.0	2.2	2.7	6.1	2.8	5.7	-0.8	-1.8	1.7	-1.5	-3.4	4.5
Hungary .....	7.0	0.2	0.8	0.1	1.6	3.1	0.5	1.8	4.3	-1.5	-0.2	0.2	-3.2	-0.4	0.6
Poland .....	2.7	5.3	8.1	6.5	9.3	12.5	3.7	5.6	8.3	3.1	2.6	5.5	2.1	1.8	4.9
Romania .....	1.5	2.8	4.0	3.0	1.2	2.1	7.9	11.5	4.4	0.2	1.7	-0.7	0.6	4.8	-2.4
Slovakia .....	0.9	2.3	1.4	0.9	1.2	2.1	12.4	7.2	8.1	0.2	0.1	-0.3	1.3	0.3	-2.0
Slovenia .....	0.3	0.5	1.3	1.2	0.3	0.2	2.9	6.9	1.9	0.6	1.3	0.3	3.1	7.1	2.3
The former Yugoslav Republic of Macedonia .	0.3	0.3	0.3	0.2	0.2	0.2	6.3	8.4	7.6	-	-	-	-0.2	0.9	1.3
<b>Baltic states</b> .....	1.1	1.7	2.4	1.5	2.3	1.8	9.9	12.1	14.3	0.3	0.5	0.5	1.7	2.5	3.0
Estonia .....	0.3	0.5	0.8	0.5	0.3	0.5	12.0	16.2	9.1	0.1	0.2	-	2.3	4.2	-0.7
Latvia .....	-	0.5	0.4	0.3	0.5	0.2	9.1	7.4	10.9	0.2	0.1	0.1	3.6	1.2	1.2
Lithuania .....	0.8	0.7	1.2	0.8	1.5	1.1	9.3	12.7	18.8	-	0.2	0.5	0.2	2.5	5.8
<b>CIS<sup>d</sup></b> .....	2.5	2.8	2.8	2.4	0.8	1.0	4.6	4.4	1.9	0.9	0.4	-1.5	1.5	0.7	-3.5
Belarus .....	0.7	0.5	0.8	0.5	0.7	0.1	3.4	6.0	6.6	-0.1	-	-0.1	-0.4	-	-0.8
Republic of Moldova .....	0.2	0.2	0.3	0.3	0.1	0.1	14.4	16.6	10.8	0.1	0.1	-0.2	3.3	2.7	-12.5
Ukraine .....	1.6	2.1	1.7	1.7	-	0.8	4.6	3.5	-	0.9	0.4	-1.3	2.0	0.8	-4.1
Russian Federation .....	2.4	-14.9	-1.4	4.7	1.4	0.9	-3.5	-0.3	0.7	-2.8	1.9	-4.3	-0.7	0.4	-2.1
Russian Federation <sup>e</sup> .....	10.4	-6.8	5.7	9.3	6.7	0.9	-1.6	1.3	3.2	-2.8	1.9	-4.3	-0.7	0.4	-2.1
<b>Total above<sup>f</sup></b> .....	37.7	13.3	31.9	29.3	27.4	29.1	1.5	3.6	5.1	-0.1	8.1	2.1	-	0.9	0.4

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

<sup>a</sup> Including errors and omissions.

<sup>b</sup> A positive sign indicates an increase in reserves.

<sup>c</sup> Full year data except for Albania, the Czech Republic, Slovakia, The former Yugoslav Republic of Macedonia, the Baltic states and the European CIS for which extrapolations of January-September rates were used.

<sup>d</sup> Excluding Russia.

<sup>e</sup> Excluding errors and omissions.

<sup>f</sup> Russian Federation excluding errors and omissions.

These data indicate that the loss of access to private capital following the Russian devaluation was not limited to medium- and long-term funds and suggests a sharp tightening of the balance of payments constraint for many countries. Incomplete returns indicate that a recovery of short-term flows into eastern Europe started in November and continued into early 1999. Foreign funds seemed to have sparked the upturn in several local stock markets (although not in the Baltic states).

The inflow of short-term funds into many countries during the past two years has been due, first of all, to anti-inflation policies which have kept domestic interest rates and differentials high. For example, in Poland, which received short-term flows of \$4.5 billion in the first half of 1998, the interest rate premium was around 9-13 percentage points.<sup>526</sup> Second, foreign investors were

attracted to the local bond markets by falling inflation rates, which led to increases in bond prices and capital gains. Third, foreign capital flowed into local stock markets, particularly into countries deemed at the time to have good growth prospects.

In the first weeks of 1999, these factors continued to influence capital flows into the Czech Republic, Hungary and Poland, among others. The introduction of the euro was also important because it involved the disappearance of several high yielding currencies and their replacement by a single currency carrying a relatively low rate of interest. This prompted investors to seek higher yields elsewhere, including in eastern Europe. Second, the "europhoria" of early January spilled over into the forint and zloty, currencies perceived by investors to have a link

<sup>526</sup> Nominal interest rate differentials relative to international interest rates on the dollar were around 20-23 per cent and the pre-announced

monthly rate of depreciation amounted to 10-11 per cent per annum. The differential was even larger compared with deutsche mark rates.



TABLE 3.7.6

Net capital flows into eastern Europe, the Baltic countries and the European members of the CIS, by type of capital, 1996-1998  
(Billion dollars)

	Eastern Europe					Baltic states				European CIS <sup>a</sup>			
	1996	1997	Jan.-Sept.		1998*	1996	1997	Jan.-Sept.		1996	1997	Jan.-Sept.	
			1997	1997				1997	1998			1997	1998
Capital and financial account .....	14.1	18.6	12.0	14.2	22.5	1.7	2.1	1.4	1.8	2.7	3.5	2.3	1.2
Capital and financial account <sup>b</sup> .....	15.6	21.0	16.0	17.5	25.5	1.7	2.4	1.5	2.3	2.8	2.8	2.4	0.8
of which:													
FDI .....	7.5	8.4	6.1	7.9	12.3	0.6	1.0	0.8	1.3	0.6	0.8	0.5	0.7
Portfolio investment .....	1.9	3.6	2.8	0.6	3.8	0.1	-0.1	-0.1	-	0.2	1.8	1.4	0.1
Medium-, long-term funds .....	3.3	4.4	3.3	2.3	4.1	0.6	0.9	0.6	0.3	0.6	0.4	0.5	0.6
Short-term funds .....	0.9	1.9	-0.3	3.2	2.0	0.4	0.4	0.1	0.2	1.1	0.4	-0.2	-0.3
Errors and omissions .....	1.5	2.5	4.0	3.3	3.0	-	0.2	0.2	0.5	0.1	-0.7	0.2	-0.3
Short-term investment <sup>c</sup> .....	4.2	8.0	6.4	7.1	8.8	0.5	0.5	0.1	0.7	1.4	1.5	1.3	-0.6

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

<sup>a</sup> Belarus, Republic of Moldova and Ukraine.

<sup>b</sup> Including errors and omissions.

<sup>c</sup> Portfolio investment, short-term funds and errors and omissions.

to the euro.<sup>527</sup> Finally, some investors appear to think that these two currencies are the next in line for a convergence play.<sup>528</sup> However, these sentiments were weakened when bad economic news (larger than expected current account deficits, negative export and output growth, etc) began to accumulate. The declines in exchange rates in February suggest that the change in sentiment has adversely affected capital inflows.

The deterioration of the investment climate in Russia since late 1997 is reflected in the slowdown in recorded capital imports (table 3.7.5). Foreign investment and new medium- and long-term borrowing declined – access to the capital markets was essentially ended already in June – and the pace of capital flight appears to have quickened.<sup>529</sup> Following the rouble crisis, Russia defaulted on the repayment of some Paris Club debt which has temporarily eased the pressure on the country's financial position. Due to their economic situations, the access of Belarus, the Republic of Moldova and Ukraine to foreign funds has become very limited. This is reflected in the sharp drop in net inflows of capital in the first three quarters of 1998 and the

drawdown of official reserves to finance current account deficits. Ukraine appears to have experienced relatively large capital flight during the course of 1998. All three countries have accumulated various arrears.

#### (iv) Sustainability of current account deficits

##### (a) Indicators of sustainability and results

The question of whether present current account imbalances in the European transition economies are sustainable has been a source of concern for some time. About half of them have been running persistent deficits of around 5 per cent of GDP (or more), a threshold often taken as sign of potential difficulties (table 3.7.1). In fact a number of countries meeting this criterion were forced to abandon their currency mechanisms in 1997-1998.

The concern about sustainability derives, first of all, from the deterioration of current account balances in 1998 (often by more than expected) and projections of higher deficits in 1999 and beyond. The outlook is for weak economic growth in the major markets of the transition economies and continuing stagnation (at best) in most of the CIS. What is more, access to international capital markets remains very limited and expensive while future FDI flows into many countries are uncertain.

The notion of sustainability of current account balances is related to three concepts.<sup>530</sup> Attention tends to focus on solvency, according to which an economy is solvent if the present discounted value of future trade surpluses is equal to current external debt.<sup>531</sup> A second

<sup>527</sup> The linkage is limited to the incorporation of the euro into the currency baskets used to set the exchange rates of the forint and the zloty. On 1 January 1999 Poland replaced the 55 per cent share previously accounted for by several European currencies with the euro, the dollar retaining its 45 per cent weight. In the case of Hungary the euro replaced the mark (70 per cent of the basket) in late 1998, the role of the dollar remaining unchanged.

<sup>528</sup> A reduction of domestic interest rates (around 11 per cent) to the EMU level (currently around 3 per cent) would yield large capital gains on local bonds. However, aside from Hungary's 10-year bond issue in January, the maturities of outstanding domestic securities are much shorter than any time frame for joining the EMU. Convergence would not be assured.

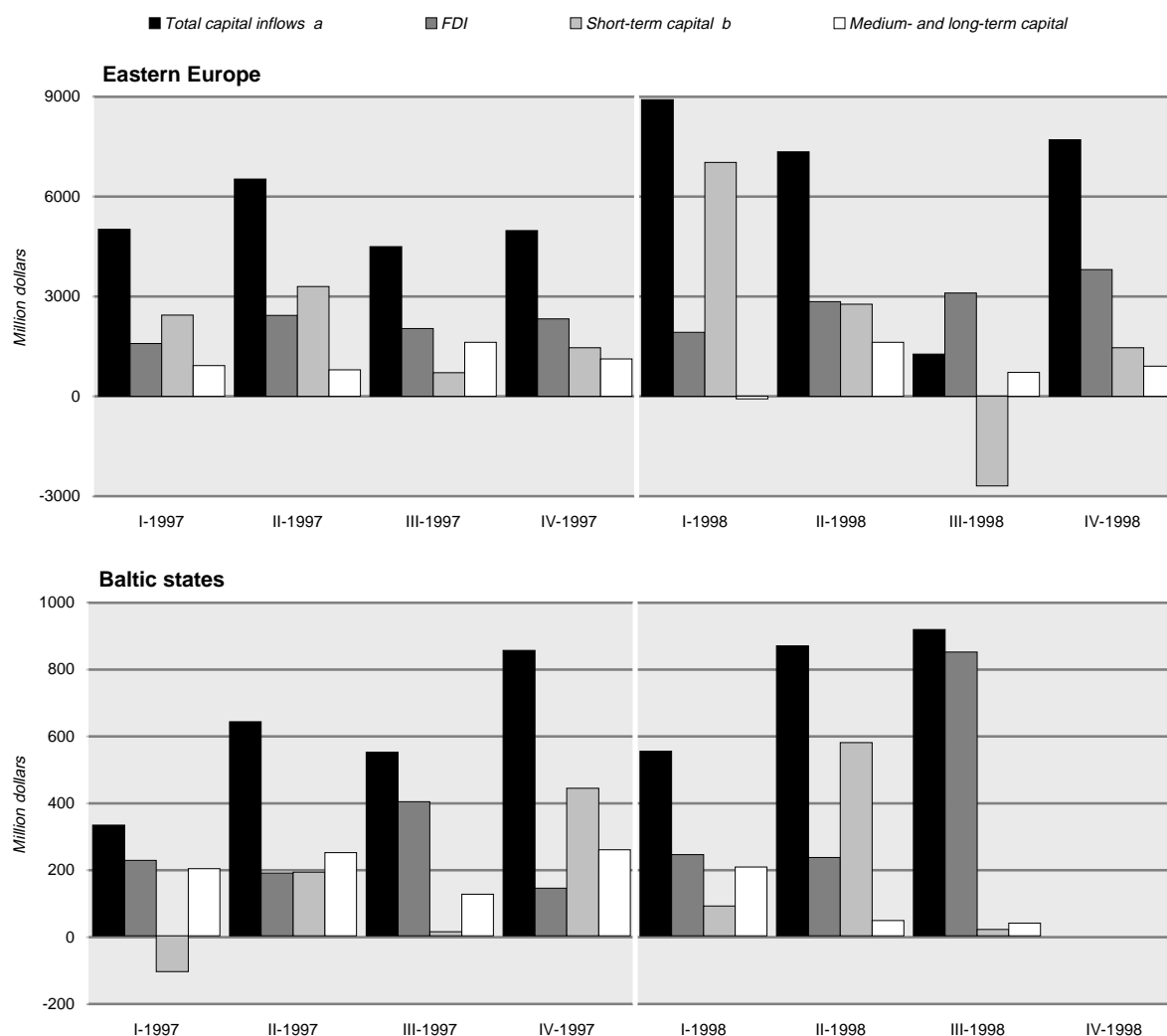
<sup>529</sup> The large negative errors and omissions item in table 3.7.5 suggests massive capital flight.

<sup>530</sup> G. Milesi-Ferreti and A. Razin, "Current account sustainability", *Princeton Studies in International Finance*, No. 81, October 1996.

<sup>531</sup> Unfortunately the practical applicability of the concept is very limited.

CHART 3.7.3

Net capital inflows into eastern Europe and the Baltic states, by type of capital, 1997-1998  
(Million dollars)



Source: UN/ECE secretariat, based on national balance of payments statistics.

<sup>a</sup> Includes errors and omissions.

<sup>b</sup> Short-term funds, portfolio investment and errors and omissions.

concept is the willingness of the debtor country to pay, i.e. it must be willing to divert output from domestic to external use, a task that may not always be economically or politically feasible. Finally, foreign investors must be willing to maintain their lending on more or less normal terms.

Recent studies indicate that there is no simple rule for determining whether or not a current account deficit is sustainable. According to the conventional wisdom, persistent imbalances above a certain threshold, generally taken as 5 per cent of GDP, are a cause for concern, particularly if they are financed by short-term debt or from official reserves. However, recent statistical analyses have cast doubt on the usefulness of this rule of

thumb.<sup>532</sup> Rather these studies conclude that current account sustainability should be considered on the basis of a broad range of indicators<sup>533</sup> which reflect the multiple economic and political problems that usually precede a crisis. The analysis here is limited to three key indicators: the real exchange rate, international reserves, and capital inflows.

<sup>532</sup> G. Kaminsky, S. Lizondo and C. Reinhart, "Leading indicators of currency crises", IMF, *Staff Papers*, Vol. 45, No. 1 (Washington, D.C.), March 1998. Milesi-Ferretti and Razin conclude that protracted current account deficits are more likely to result in an external crisis when the size of the export sector is small, the real exchange rate appreciates relative to historical averages and the level of domestic savings is low.

<sup>533</sup> Ibid.

### Real exchange rates and competitiveness

Most studies rank the real exchange rate as the most useful predictor of sustainability. An appreciating real exchange rate can indicate a declining competitiveness of a country's goods and services and causes the external balance to worsen. The persistence of these trends can spark a loss of investor confidence.

There are two main views of real exchange rate appreciation and their implications for economic policy.<sup>534</sup> According to the *misalignment view*, the appreciation of real exchange rates (generally measured by CPI- or PPI-based real exchange rates) is a consequence of the choice of a fixed or semi-fixed exchange rate and represents a loss of competitiveness. This occurs if domestic inflation does not converge immediately to the rate prevailing in a country's trade partners when the nominal exchange rate is fixed. According to the *fundamentals view*, by contrast, a rise of the real exchange rate (based on CPI or PPI) reflects an appreciation of the long-term equilibrium real exchange rate. It may reflect improvements in the productive efficiency of an economy resulting from fundamental shifts in the macroeconomy and structural change. The rise of the exchange rate may also be a correction of earlier depreciation – countries often devalue prior to fixing a new exchange rate – and a return to equilibrium.<sup>535</sup> If there has been no loss of competitiveness (i.e. no real misalignment of exchange rates has occurred), the current account imbalance can be interpreted as an optimal response of the economy to changes in the desired national savings and investment rates.

The two views imply different policy responses in the event of a persistent current account deficit. A misaligned exchange rate (i.e. declining competitiveness) implies that a growing imbalance is not sustainable and might be reversed only through a process of nominal and real depreciation of the exchange rate. On the other hand the fundamentals view (i.e. no change in misalignment or loss of competitiveness) holds that there is no need for corrections since the imbalances will eventually reverse themselves as the investment and savings fundamentals shift.

The analysis which follows relies on real exchange rates based on unit labour costs in industry (hereafter real exchange rates).<sup>536</sup> A rise in these exchange rates should reflect mainly a loss of competitiveness and not an

appreciation of the real equilibrium rate.<sup>537</sup> In nearly all the transition economies in the sample, the real exchange rate showed an upward trend since 1994 (more weight is given to the deutsche mark-based indices since the bulk of these countries' trade is with western Europe; table 3.7.7 and chart 3.7.1).<sup>538</sup> In general, the growth of local wages (measured in marks and dollars) exceeded productivity gains<sup>539</sup> and led to a loss of competitiveness.<sup>540</sup> Hungary has been the exception, with large productivity increases and a crawling peg exchange rate which has been adjusted to maintain a constant real exchange rate.

The results also indicate that countries with fixed or semi-fixed (nominal) exchange rate regimes (roughly in the upper half of table 3.7.7) experienced the greatest appreciation of real exchange rates and, typically, the largest deterioration of current account balances.<sup>541</sup> In the Czech Republic and Slovakia, external deficits proved unsustainable, and the exchange rate mechanisms were abandoned in May 1997 and October 1998, respectively.<sup>542</sup> By contrast, Hungary's constant real exchange rate policy (and a tight macroeconomic stance) resulted in a large decline in the current account deficit. This statistical relationship also reinforces the view that appreciation of real exchange rates has involved a loss of competitiveness rather than changes in the real equilibrium rate.

These findings suggest that a first step in approaching the question of current account sustainability is to focus on those economies with fixed exchange rate

<sup>537</sup> A rise in this exchange rate does not reflect an improvement in the country's efficiency (and equilibrium exchange rate) to the extent that it is captured by changes in labour productivity. The reliability of this indicator as a measure of competitiveness may decline if raw materials, intermediate goods and capital make up a large share of total costs. In 1998, import prices of such goods declined suggesting a downward pressure on real exchange rates. However, since profit performance seems to have deteriorated (sect. 3.5), there is likely to have been an erosion of competitiveness.

<sup>538</sup> The data in table 3.7.7 and chart 3.7.1 start in 1993 and 1994, respectively, but, in general, real exchange rates have risen since the beginning of the decade.

<sup>539</sup> These real exchange rates reflect unit labour costs in comparator countries. In Germany unit labour costs changed little during 1994-1998, although there has been a decline of 4 per cent in the last two years. In the United States unit labour costs increased steadily, and by about 9 per cent over the whole period. Also, see the notes to chart 3.7.1.

<sup>540</sup> Undoubtedly there has been some rise in real equilibrium exchange rates. However, it should be borne in mind that efficiency increases have probably not been large. Labour productivity growth has been modest (except in Hungary and Poland) particularly given that the figures represent a recovery of industrial production.

<sup>541</sup> This observation was first made on the basis of data through 1996. N. Roubini and P. Wachtel, op. cit.

<sup>542</sup> In the Czech Republic the currency was essentially pegged until February 1996, when a band of  $\pm 7.5$  per cent was introduced. The Czech koruna depreciated by 10 per cent in May 1997. In Slovakia, intervention bands were progressively enlarged from  $\pm 1.5$  per cent to  $\pm 6$  per cent in 1996. However, the exchange rate was effectively pegged since policy measures maintained it near parity. The Slovak koruna depreciated by around 9 per cent immediately after the fluctuation corridor was abandoned.

<sup>534</sup> The two views and their application to the transition economies have been summarized by N. Roubini and P. Wachtel, "Current account sustainability in transition economies", *NBER Working Paper*, No. 6468 (Cambridge, MA), March 1998.

<sup>535</sup> This involves a case of undershooting the equilibrium rate.

<sup>536</sup> The calculation of the real exchange rates is described in the note to chart 3.7.1.

TABLE 3.7.7

Changes in real exchange rates and current account balances, by type of exchange rate regime, 1993-1998  
(Per cent and per cent of GDP)

Period	Change in real exchange <sup>a</sup> (per cent)	Change in current account <sup>b</sup> (per cent of GDP)
<b>Currency board</b>		
Estonia ..... 1993-1997	171	-14.5
Lithuania ..... 1994-1997	83	-8.0
Bulgaria ..... 1997QI-1998	46	-8.2
<b>Peg</b>		
Latvia ..... 1993-1997	157	-25.4
Croatia ..... 1994-1997	75	-17.6
Czech Republic ..... 1993-1997QII	38	-8.9
Slovakia ..... 1994-1997	30	-12.1
<b>Managed float</b>		
Romania ..... 1997QII-1998	88	-4.0
Slovenia ..... 1993-1997	13	-1.3
<b>Crawling band</b>		
Poland ..... 1993-1997	12	-5.3
Hungary ..... 1994-1997	-14	7.3
<b>Float</b>		
Bulgaria ..... 1993-1996	-46	10.4
Romania ..... 1993-1996	-5	-2.2

Source: UN/ECE secretariat.

<sup>a</sup> Changes in real exchange rates based on relative unit labour costs against the deutsche mark. A positive number indicates an appreciation.

<sup>b</sup> A negative number indicates a deterioration of the current account balance (in percentage points).

policies and determine how their real exchange rates have developed in the recent past. The most rigid exchange rate mechanism is a currency board, in place in Estonia (1992), Lithuania (1994) and Bulgaria (July 1997).<sup>543</sup> The pegged exchange rate of Latvia (to the SDR) has been roughly equivalent from the viewpoint of stability.<sup>544</sup> It should also be borne in mind here that factors other than real exchange rate movements, above all a weakening external demand, have contributed to the worsening of current account balances in 1998.

In Latvia and Lithuania real exchange rates have appreciated substantially in 1997 and early 1998, which may help to explain the marked growth of their current account deficits in 1998.<sup>545</sup> In Estonia the current account imbalance increased only marginally in January-September 1998, perhaps because the appreciation of the real exchange rate slowed markedly in 1997 (due to smaller wage increases and accelerating productivity growth). However, the strong upward trend in this exchange rate resumed during 1998. Despite the long-term appreciation of their real exchange rates, the Baltic

states have had extended periods of rapid export growth (due in part to the reorientation of their trade toward the west), to which sizeable inflows of FDI are likely to have contributed.

In Bulgaria the real exchange rate seems to have appreciated sharply since the introduction of the currency board.<sup>546</sup> The combination of a fixed exchange rate, domestic market rigidities, and rapid wage growth suggests a decline in competitiveness which has contributed to a rapid worsening of the current account balance. Despite the strong depreciation of the lev in late 1996-early 1997,<sup>547</sup> exports have flagged and there has not been much FDI. Although the current account deficit is still modest, the erosion of competitiveness suggests that this situation may not last.

Following the sharp depreciation of the leu in 1996, there was a shift in Romanian policy to a managed floating rate system (the rate of depreciation of the leu was kept below the inflation rate) and the maintenance of high real interest rates. However, there was also a boom in wages while productivity and production declined, resulting in a considerable rise in the real exchange rate, far above its 1996 pre-depreciation level. This loss of competitiveness seems to partly explain the faltering of exports, buoyant imports and the larger current account deficit in 1998.

In the Czech Republic and Poland, countries with flexible exchange rate mechanisms, real exchange rates appreciated in the first half of 1998 and again toward the end of the year. However, this was a matter of rising nominal exchange rates, pushed up by large capital inflows, although accelerating wages also played a role in the Czech Republic.

Preliminary estimates for the last quarter of 1998 suggest a surge in unit labour costs in many transition economies. In many of them productivity fell while wages continued to rise (section 3.5), further undermining competitiveness and adding to concerns about the sustainability of current account deficits.<sup>548</sup> One policy option is to allow the nominal and real exchange rate to depreciate, as has already occurred to

<sup>546</sup> Reliable data to calculate recent real exchange rates based on unit labour costs are not available for Bulgaria. However, real exchange rates based on the CPI show a substantial appreciation after July 1997, above the level prevailing around the middle of the decade (chart 3.7.1).

<sup>547</sup> In Bulgaria the confidence generated by the announcement of a currency board policy caused the exchange rate to appreciate sharply prior to its actual implementation. Roubini and Wachtel have argued that the nominal rate at which the lev entered the currency board (1,000 leva per deutsche mark) was too high, implying a real overvaluation relative to its 1995 value, p. 33. However, in January 1999 Governor Gavriiski of the central bank of Bulgaria stated that the currency was not overvalued.

<sup>548</sup> Preliminary estimates for the fourth quarter of 1998 show a tendency for the deutsche mark real exchange rate to decline due to the strength of the currency at that time (chart 3.7.1). It should be noted that the calculations in this chart exclude the impact of the depreciation of several CIS currencies (especially the Russian rouble) which probably reduced the competitiveness of exporters to this area.

<sup>543</sup> Bosnia and Herzegovina also has a currency board but it is not considered here.

<sup>544</sup> Currently the lats fluctuates within a band of  $\pm 1$  per cent.

<sup>545</sup> In both countries, real exchange rates based on PPI show a slight decline in 1998. This growing difference between the PPI and unit labour cost-based real exchange rates may reflect a profits squeeze (sect. 3.5), also an indication of a loss of competitiveness.

some extent in the Czech Republic, Poland and Romania.<sup>549</sup> Where changes in nominal exchange rates have been ruled out,<sup>550</sup> restraints on wage growth (still high in many countries) could slow the decline in competitiveness.<sup>551</sup> Current account deficits could also be contained by tightening macroeconomic policies, which is apparently the intention of some governments.<sup>552</sup> However, this will offer only a temporary reprieve if competitiveness continues to slide.

### Official reserves

Two standard measures indicate that the official reserves of Albania,<sup>553</sup> Bulgaria, the Czech Republic, Hungary, Poland and Slovenia were more than adequate at the end of 1998 (table 3.7.8). In each case, reserves comfortably exceeded the recommended three months' coverage of imports of goods and services and the ratio of reserves to domestic money is relatively high.<sup>554</sup> These ratios generally improved in 1998 (although many countries temporarily lost reserves following the Russian crisis).

In Croatia, The former Yugoslav Republic of Macedonia and the Baltic states official reserves are high compared with domestic money but fall below the three months' import coverage threshold. There are no widely accepted guidelines for deciding which indicator should be given preference, although one study has concluded that import coverage is a more useful guide to current account sustainability.<sup>555</sup> Assessment of the Baltic states' position should take into account their favourable external debt levels (table 3.7.8 and below), particularly those of short maturity.

<sup>549</sup> The Romanian leu was allowed to depreciate faster in the last quarter of 1998, due to the lack of new finance and dwindling official reserves. In the Czech Republic and Poland, exchange rates depreciated sharply in February 1999, following the publication of poor macroeconomic results and several rounds of interest rate cuts.

<sup>550</sup> The phasing out of the currency board has been discussed by the Lithuanian authorities for some time. However, on the occasion of an IMF Mission, Prime Minister G. Vagnorius said that abandonment of the currency board was not under consideration. *ELTA*, 11 February 1999. In Estonia the currency board is enshrined in the constitution.

<sup>551</sup> Wage restraint might not be sufficient to prevent real exchange rate appreciation because unit labour costs in the major foreign markets have stagnated. An acceleration of productivity growth (for example, as a result of increased FDI or structural change) could also slow real appreciation but the prospects for this are doubtful in current circumstances.

<sup>552</sup> For example, the IMF has recommended stricter monetary policies and tax collection as measures to control the current account deficit in Lithuania. *ELTA*, 11 February 1999.

<sup>553</sup> Only one indicator is available for Albania.

<sup>554</sup> Domestic money is defined as M2 minus foreign currency deposits. This ratio has been much more favourable (higher) in the transition economies than in pre-crises South-East Asia, UN/ECE, *Economic Survey of Europe, 1998 No. 1*, table 3.2.1.

<sup>555</sup> G. Kaminsky et al., op. cit.

The reserve positions of Belarus, the Republic of Moldova,<sup>556</sup> Romania (including end-year privatization revenues), Russia, and Slovakia are low on both measures. All of them experienced currency crises in 1998 (in some cases triggered by the Russian GKO default), which often involved large permanent losses of reserves. In fact the pre-crisis weakness of their reserves increased their vulnerability to financial shocks.<sup>557</sup>

### Capital flows/FDI

The sustainability of the current account deficits of the transition economies depends on the continuation of capital inflows. For emerging markets in general, the prospects are for further declines in private capital imports.<sup>558</sup> In particular foreign net private debt flows are expected to fall again because the long-term loan and bond markets remain averse to risk. However, as 1998 progressed, market sentiment improved somewhat and foreign investors became more favourably inclined towards investment grade transition economy risks. As regards short-term inflows it is doubtful that they will recover to the scale of 1998 after the marked fall in domestic interest rates. Moreover, portfolio investors have become more careful as the economic outlook of the eastern countries has generally worsened.

The uncertain prospects for these types of financing underline the importance of (net) FDI inflows. In the first three quarters of 1998 FDI covered 78 per cent of the aggregate current account deficit of eastern Europe and 72 per cent of that of the Baltic states (table 3.7.8). The ratios, however, tend to be lowest in the countries with the least possibilities of access to the international capital markets.

Several features of FDI can contribute to the sustainability of current account deficits.<sup>559</sup> First, at least in the transition economies, FDI flows have been relatively stable, more so than other types of capital (section 3.7(iii)). Second, if FDI can be used to upgrade productive capacity, it can strengthen the basis for output growth and servicing external debt. Also, FDI is a non-debt creating source of finance.<sup>560</sup> In fact, despite the persistence of current account deficits, the sizeable FDI

<sup>556</sup> Only one measure is available for the Republic of Moldova.

<sup>557</sup> Low official reserves were the most common feature of those European transition economies where there were currency crises in 1997 and early 1998. UN/ECE, *Economic Survey of Europe, 1998 No. 1*, chap. 3.2.

<sup>558</sup> IIF, op. cit.

<sup>559</sup> It has been observed that the internationalization of financial markets is creating a much wider menu of portfolio choices and is leading to a situation where current account imbalances will be financed to a greater extent than in the past by FDI rather than debt instrument. In such a globalized world, movement of current account positions may have much less ultimate significance for policy makers than has been the case up to now. M. Knight and F. Scacciavillani, *Current Accounts: What is their Relevance for Economic Policy Making*, IMF Working Paper WP/98/71 (Washington, D.C.), May 1998.

<sup>560</sup> However, FDI flows do eventually create outflows in the form of profits. In Hungary profit repatriation has grown so large as to be a significant element of the current account imbalance (see above).

TABLE 3.7.8

Selected external financial indicators for eastern Europe, the Baltic countries and European members of the CIS, 1997-1998  
(Billion dollars and per cent)

	Gross debt		Net debt		Net debt/exports		Gross debt/GDP		FDI/Current account		Reserves			
	(billion dollars)		(billion dollars)		(per cent) <sup>a</sup>		(per cent)		(per cent) <sup>b</sup>		(billions)			
	1997	1998	1997	1998	1997	1998	1997	1998	Average	Jan.-	1997	1998	Months of imports <sup>a</sup>	Ratio to domestic money
<b>Eastern Europe</b>	125.57	138.80	72.6	75.5	52	50	36	37	95	78	52.98	63.30	4.3	58.1 <sup>c</sup>
Albania	0.76	0.76	0.5	0.3	157	112	34	26	60	131	0.31	0.44	4.7	..
Bulgaria	9.74	10.07	7.5	7.2	115	123	96	79	-216	171	2.25	2.83	5.4	131.5
Croatia <sup>d</sup>	6.66	7.67 <sup>e</sup>	4.1	4.9	48	55	33	36	25	63	2.54	2.82	2.9	87.7
Czech Republic	21.62	24.42 <sup>f</sup>	11.9	11.8	38	33	42	44	61	244	9.73	12.62	4.2	34.4
Hungary	23.75	26.75	15.3	17.4	59	66	52	56	101	77	8.41	9.31	3.8	53.2
Poland	38.50	41.38 <sup>e</sup>	18.1	14.9	56	39	27	26	-355	99	20.41	26.43	6.2	42.9
Romania	9.37	9.43 <sup>g</sup>	6.8	7.4	68	77	27	25	32	39	2.53	2.04	1.8	34.6
Slovakia	9.90	12.20 <sup>g</sup>	6.7	9.3	59	69	51	60	30	14	3.23	2.90	2.2	27.5
Slovenia <sup>d</sup>	4.18	4.92	0.9	1.3	8	11	23	25	-119	-255	3.31	3.60	3.8	52.1
The former Yugoslav Republic of Macedonia <sup>d</sup>	1.10	1.20 <sup>f</sup>	0.8	0.9	64	62	30	34	6	37	0.26	0.31	1.8	59.0
<b>Baltic states</b>	2.08	2.30	-0.4	-0.7	-3	-5	11	11	64	72	2.47	3.02	2.2	76.0 <sup>c</sup>
Estonia <sup>h</sup>	0.31	0.24	-0.4	-0.6	-12	-13	7	5	49	99	0.76	0.81	1.9	60.6
Latvia	0.37	0.38 <sup>f</sup>	-0.3	-0.4	-11	-10	7	6	322	36	0.70	0.73	2.1	66.7
Lithuania	1.40	1.68	0.4	0.2	7	4	15	16	24	78	1.01	1.49	2.4	100.8
<b>CIS</b>	136.91	157.26	120.8	148.0	88	122	27	47	-39	17	16.12	9.30	0.8	28.2 <sup>c</sup>
Belarus <sup>i</sup>	1.13	1.54	0.7	1.2	9	14	8	11	12	11	0.39	0.33	0.4	16.2
Republic of Moldova	1.23	1.23	0.9	1.1	75	106	64	75	27	19	0.37	0.15	1.2	..
Russian Federation	125.00	143.00	112.0	135.2	105	144	28	52	-23	12	13.02	7.80	0.9	36.0
Ukraine	9.56	11.50	7.2	10.5	35	59	19	28	31	45	2.34	1.02	0.6	32.5
<b>Total above</b>	264.56	298.36	193.0	222.7	67	78	30	41	434	53	71.57	75.62	2.8	54.1 <sup>c</sup>

*Source:* National statistics; IMF, *International Financial Statistics* (Washington, D.C.), February 1999; IMF estimates for Albanian and Russian Federation debt; press reports; UN/ECE secretariat estimates.

*Note:* Net debt equals gross debt less foreign exchange reserves.

<sup>a</sup> Exports of merchandise and services, and income receipts. Total imports of merchandise and services, and income payments. For Poland, excludes net receipts from non-classified current account items.

<sup>b</sup> FDI flows are net. A negative number indicates a current account surplus.

<sup>c</sup> Unweighted averages.

<sup>d</sup> Allocated debt only for Slovenia. Unallocated debt is included in Croatia and The former Yugoslav Republic of Macedonia; the debt figures of the latter include only medium- and long-term debt.

<sup>e</sup> November.

<sup>f</sup> September.

<sup>g</sup> October.

<sup>h</sup> Debt is foreign loans taken and guaranteed by the government.

<sup>i</sup> Principal debt (medium-term debt guaranteed by the government) plus arrears on deliveries of fuels and electricity.

flows into most east European and Baltic transition economies have often been associated with falling debt burdens<sup>561</sup> (table 3.7.8). Other things being equal, the sustainability of current account balances is increased if debt burdens are falling.

In many eastern countries, FDI flows remain heavily dependent on privatization programmes which, as noted above, are in various stages. In several instances,

constraints on access to international financial markets have prompted governments to accelerate sales of state property to cover budget and/or current account deficits.<sup>562</sup> Consideration of such sales has also been motivated by hopes for quick improvements in corporate governance (which may now take priority over the sale price) or to meet the conditions of IMF agreements. Meanwhile, however, the global investment climate has

<sup>561</sup> Although the debt of Hungary increased in 1998, the debt burden has fallen sharply since the first half of the decade, net debt export ratio declining from over 200 to 66 in 1998.

<sup>562</sup> For example, Bulgaria, Croatia, Slovakia, and The former Yugoslav Republic of Macedonia all expect sizeable receipts from the sale of their telecommunications firms.

deteriorated.<sup>563</sup> In western Europe, the main source of FDI and the major goods market for many transition economies, growth prospects are subdued and the outlook in most transition economies themselves is also weakening. Concerns about global overcapacity in many industries may adversely affect greenfield projects and follow-on investments in foreign investment enterprises (i.e. non-privatization related investments).

### (b) Prospects for individual countries

The prospects for sustaining current account deficits in the European transition economies vary considerably. By virtue of their adequate official reserves, international investment grade ratings and generally large FDI inflows, the projected financial needs of the leading reforming countries appear manageable.<sup>564</sup> Nonetheless, given the prospects for larger current account deficits in the Czech Republic, Hungary and Poland, authorities have announced that their evolution will be carefully monitored with a view to making any necessary policy corrections. In *Hungary*, a deficit of \$2.5-\$2.7 billion (nearly 6 per cent of GDP) and repayments of around \$2 billion are expected in 1999. The success of a €500 million bond issue in January suggests that the national bank will not have difficulty in meeting its borrowing requirement for the year.<sup>565</sup> The government is also examining the possibility of further sales of state assets and measures to encourage the reinvestment of profits (and thus reduce repatriation). The financing requirement of *Poland* in 1998 amounts to some \$7-\$8 billion. Several large privatizations should buoy already large inflows of foreign investment, and foreign currency reserves of some \$26 billion can be tapped. In the *Czech Republic*, a small current account deficit is not likely to increase significantly given the modest growth prospects. However, there is concern about the impact of rapidly rising unit labour costs on export competitiveness and domestic consumption.

The Baltic states hope to continue to finance large current account deficits with FDI – more privatization of large assets is planned – and through medium and long-term borrowing, since debt levels are low. The credits associated with the IMF stand-by arrangements of *Estonia*<sup>566</sup> and *Latvia* remained unused at the beginning of the year and thus offer a potential source of finance. However, unless these countries can curb the growth of unit labour costs (*Lithuania* was relatively successful in this regard in 1998), pressures on their current account balances will persist.

Bulgaria will have to rely heavily on official funding to meet its financial obligations in 1999. This includes EU macroeconomic funds and IMF (EFF) resources, disbursements from both facilities being subject to various conditions. The agreement with the IMF foresees an acceleration of the privatization programme (involving sales of Bulgarian Telecom, the Neftochim refinery and Bulbank, among others). A modest bond issue is planned for the second half of the year. In the longer term, the apparent loss of competitiveness under the currency board may become more of an issue.

Most other European transition economies face more serious external financing constraints and, as a result, the sustainability of the current account is the major problem confronting policymakers. In these cases the challenge is to adjust policies to achieve a current account balance consistent with available financing and the desired (or minimum tolerable) level of official reserves. Even without further turmoil in the global markets, considerable uncertainty surrounds the financial possibilities of some of these economies and several risk an external financing crisis.

Although the Croat and Slovak governments are aiming to reduce their current account deficits in 1999, both are faced with limited borrowing possibilities and significant financing requirements (including repayments of long-term debt): \$2.2-\$2.4 billion in Croatia and \$3 billion in Slovakia. Croatia's programme started well with a €300 million bond issue in February, but it also depends on an ambitious privatization programme (involving the telecommunications company (HPT), three banks and possibly the state oil company (INA)) moving ahead. Most of the funds associated with the IMF EFF (SDR 353 million) were still available at the beginning of 1998. Foreign investment in Slovakia remains low and its growth will largely depend on the privatization programme currently under consideration. In downgrading Slovakia's credit rating in October 1998, Fitch-IBCA cited the external large financial requirements and the loss of investor confidence as risks which could force the country into an external financing crisis. Slovakia does not have an IMF programme at this time.

A host of countries in deficit on current account and possessing only meagre foreign currency reserves have virtually no possibility of gaining access to the international capital markets. Financing constraints have already lead to cutbacks of energy imports by the Republic of Moldova, Belarus<sup>567</sup> and Ukraine and to

<sup>563</sup> These issues, including the possible repercussions of the troubled Russian economy on FDI in other transition economies, are discussed in UN/ECE, *Economic Survey of Europe, 1998 No. 3*, pp. 128-129.

<sup>564</sup> The current account of Slovenia has remained in virtual balance.

<sup>565</sup> The national bank has announced a borrowing requirement of \$1.7 billion for 1999.

<sup>566</sup> In January 1999, Eesti Telecom was privatized yielding some \$200 million, of which \$100 million was deposited abroad.

<sup>567</sup> In October Belarus applied to the IMF for assistance under the Compensatory and Contingency Financing Facility (CCFF), under which it could receive financial assistance (up to \$100 million) to compensate for its losses of export earnings (related with the Russian import compression) and increases in import expenditures (due to a poor harvest). However, it does not appear that the authorities are willing to meet the condition of significant monetary tightening. *Belarus Economic Trends*, November 1998.

increased payments arrears. Negotiations with the IMF have so far been inconclusive although its resources are indispensable. Only Romania has plans to acquire sizeable funds through privatization.

The \$2 billion target current account deficit and repayment obligations of Romania in 1999 total nearly \$3 billion. The government hopes to finalize an agreement with the IMF (which it failed to do in February) and conclude the sale of several large assets to strategic investors (including BancPost and Dacia, the automobile maker) to help meet its \$1.3 billion FDI target. The sharp downgrading of the country's credit rating last year (in part because of the bleak financing prospects) will make planned medium- and long-term borrowing very expensive. Fiscal and current account deficits are to be curbed with a 6 per cent surcharge on imports.<sup>568</sup> However, the financial conditions involved in the settlement of the miners strike are likely to make this more difficult. The balance of payments of *The former Yugoslav Republic of Macedonia* also remains fragile. The current account deficit is expected to remain large, financed largely from official sources. The completion of several large privatizations, including the state telecommunications company, is being counted upon to ease funding pressures. Plans to obtain a credit rating were derailed by the Asian crisis.

Steep falls in the value of the leu are expected to curb imports and reduce the current account deficit in the *Republic of Moldova*. Large arrears on payments due in 1998 and 1999 have led to rescheduling negotiations which are necessary even with the help of multilateral financing. Privatization plans, including Moldtelecom, have been set back by depressed asset values. *Ukraine* faces a major challenge in 1999 in financing a current account deficit (estimates range from \$400-\$900 million), debt repayments of \$1.5-\$1.6 billion (increasing to \$2.6 billion in 2000), and arranging natural gas financing with Russia (Gazprom) and Turkmenistan. Without IMF and other multilateral sources of funds Ukraine may not be able to avoid defaulting on some of its financial obligations.<sup>569</sup>

Assuming that imports remain at their current depressed level, *Russia* could generate a large current account surplus in 1999 (in January the merchandise trade surplus rose to \$2.1 billion). This surplus could help the federal government meet a large share of its external debt servicing obligations in 1999 (\$17.5 billion in principal and interest). However, capital flight remains

a major threat to its debt servicing capacity.<sup>570</sup> Russia is effectively excluded from the new funds market and, according to official estimates, FDI will amount to only \$2-\$2.5 billion. Thus a great deal hinges on reaching agreement with the IMF, which can provide access to \$7 billion in multilateral and bilateral funds. At the time of writing, the government has committed itself to servicing that part of the debt incurred by the Russian Federation (the so-called new Russian debt). However, Russia has already missed payments on the debt of the former Soviet Union, which was already rescheduled several years ago.<sup>571</sup>

The risks involved in the current outlook are mostly on the downside. Given the unexpectedly poor end-year current account results reported by several countries, pressures on the external balances may be greater than those reflected in current forecasts. One risk is the apparent acceleration of unit labour costs at the end of 1998 (important for price-sensitive exports). Even in countries where the nominal exchange rate has recently depreciated, it is uncertain whether it has been sufficient to prevent a further decline in competitiveness. Second, new shocks could once again curb access to the international financial markets. Third, FDI flows could fall short of expectations if the investment climate worsens or because planned privatizations do not go ahead. The risks are greatest for the most financially constrained countries, several of which could default on their external obligations. Needless to say, the failure of several countries to obtain adequate financing could have a further contractionary impact on the region as a whole.

#### (v) Short-term funds, macroeconomic instability and sustainability

Although capital inflows are essential to sustain a current account deficit, they can themselves threaten the sustainability of a country's financial position. Large capital inflows can boost domestic demand and the real exchange rate, causing the current account balance to worsen. This has been the experience of several transition economies since they started the reform process and liberalized the foreign sector.<sup>572</sup> In the first half of 1998, Poland, the Czech Republic, Hungary and the Baltic states all attracted relatively large inflows of short-term capital (often exceeding the FDI inflows; chart 3.7.2) which placed upward pressure on real exchange rates (chart 3.7.1) and current account deficits.

<sup>568</sup> The surcharge, which covers about 60 per cent of imports, was put into place in early October 1998. It is to be gradually reduced and fully eliminated by the end of 2000. The action appears to be in response to an IMF warning in October that current fiscal and monetary policies were unsustainable.

<sup>569</sup> Ukraine has failed to meet the IMF's conditions for disbursements of three monthly tranches.

<sup>570</sup> Although large trade surpluses emerged after the devaluation of the rouble in August 1998 and surrender requirements on export receipts were tightened, official reserves have barely changed, remaining below \$12 billion (including \$4 billion in gold).

<sup>571</sup> Some payments to the Paris Club of official creditors were missed in October and parts of the commercial debt (London Club) are technically in default.

<sup>572</sup> "Capital surges into the transition economies, 1990-1997", UN/ECE, *Economic Bulletin for Europe*, Vol. 49 (1998).



Subsequently, the devaluation in Russia triggered short-term capital outflows which caused sharp declines in exchange rates and/or losses of official reserves. Although some currency depreciation was welcome – the Czech, Hungarian and Polish authorities had been concerned about the impact of appreciating exchange rates on export growth – the correction occurred under crisis conditions and cost Hungary, for example, about \$2 billion in reserves. With the easing of tensions in the international markets in the last months of 1998, short-term flows returned to these countries, again pushing up exchange rates, often to pre-crisis levels. The appreciation was not welcome by the authorities since the growth of exports and output had faltered and current account deficits were widening. This appears to have been yet another example of short-term capital inflows, driven largely by financial factors, moving real exchange rates in the opposite direction to that required for external adjustment. In fact, economic fundamentals pointed to the need for a real depreciation.<sup>573</sup> This was the position taken by Czech and Polish officials in the final months of 1998 and early 1999 when they argued for lower interest rates (and thus some currency depreciation) to give exporters a boost. In Hungary, where exchange rate movements have been constrained by the  $\pm 2.25$  intervention band, exports have continued to grow at a high rate.

The potential adverse impact of capital surges on exchange rates, export competitiveness and current account balances are a source of concern to policy makers the world over. The phenomenon may be especially important for most transition economies since they appear to be facing relatively large price elasticities of demand for their exports.<sup>574</sup> This implies that a given appreciation of the real exchange rate has a greater negative impact on their export growth than for countries with lower elasticities. If this is correct, exports and the current account balances of the transition economies are particularly vulnerable to capital surges. Moreover, as their economic growth so far has been predominantly export-led (section 3.2), their overall macroeconomic performance would also be sensitive to capital surges.

<sup>573</sup> This recalls the Czech experience in early 1997, several months prior to the abandonment of the koruna band. Heavy demand for euro-koruna bonds drove up the exchange rate while export growth was coming to a standstill and the current account deficit was growing rapidly.

<sup>574</sup> See the price elasticity estimates in sect. 3.6. There would appear to be several reasons for high export price elasticities, all associated with the particular economic development of the former centrally planned economies. The quality of goods was generally lower than in the west (this was reflected in relatively low export unit values) and the export commodity structures of the transition economies were broadly similar, implying keen competition between them. Also the share of foods, raw materials and semi-finished goods in their exports – products facing higher price elasticities than high value added manufactured goods – is relatively large. Export price elasticities have probably declined during the transition process (but not necessarily in all countries) due to restructuring, FDI, and other factors, but they may still appear to be higher than in other countries. For various reasons, the import elasticities of demand in the transition economies are generally assumed to be lower than those of exports which would imply that an appreciation of the exchange rate could curb exports more than imports.

Other adverse consequences of recent short-term capital flows and exchange rate appreciation have been the erosion of profitability, and in some cases, large sterilization costs in relation to GDP. In a number of cases, interest rates were raised to protect exchange rates when short-term funds were withdrawn from following the rouble devaluation in August (section 3.2(ii)). In Hungary, at least, domestic interest rates have been kept higher than might be justified purely by macroeconomic conditions in order to deter speculative attacks on the currency.<sup>575</sup> (Conversely, the recent narrowing of interest rate differentials may make these countries even more vulnerable to currency speculation). More generally, there is considerable risk involved in financing persistent current account deficits with short-term credits, as several transition economies are doing. Thus while certain types of foreign short-term capital are essential for the functioning of a market system, in financing merchandise trade, for example, the economic usefulness of large volumes of short-term flows across borders is highly questionable.<sup>576</sup>

Given the apparent costs and risks to the transition economies, an important issue is how to respond to large short-term capital inflows. Cuts in domestic interest rates (when this has been made possible by falls in inflation) have not always helped to diminish inflows (and such a policy can anyway exacerbate current account deficits). Nor did the widening of the exchange rate corridor in Poland seem to be successful in this respect, although it is a widely recommended policy prescription. This apparent impotence suggests the need for additional instruments (preferably market-based) to control short-term capital. However, if market-based means are ineffective – as they have proved to be in other emerging markets – the case for considering direct controls on short-term capital, as a means of preserving macroeconomic stability and promoting economic growth, becomes very strong.

<sup>575</sup> Gy. Suranyi, President of the National Bank of Hungary. He added that real interest rates would also be kept high to curb domestic demand. *The Wall Street Journal Europe*, 17 December 1998. The recent Hungarian and Polish experiences show that even countries with good economic fundamentals are not immune to contagion. Paradoxically, the great strides they have made in developing highly liquid domestic securities markets have actually made them more vulnerable to changes in investor sentiment.

<sup>576</sup> This is a view which is increasingly shared even by members of the private financial sector. For example, see the comments of D. Lachman, Managing Director of Emerging Markets Economic Research at Salomon Smith Barney, to the IMF Economic Forum, "Financial markets: coping with turbulence", *IMF Survey* (Washington, D.C.), 14 December 1998.