Chapter 1

MAIN DEVELOPMENTS IN THE ECE ECONOMIES IN 1997 AND THE OUTLOOK FOR 1998

1.1 The global context

(i) The broad picture

The international economic context in 1997 was generally quite favourable until the summer. But sentiment started to change with the gradual unfolding of an economic and financial crisis in Thailand, which had unexpectedly strong contagious effects. It spread first in Asia and then spilled over to emerging market economies in Latin America and Europe. It also contributed to a major setback in stock prices in the industrialized countries in October. International financial markets continue to be very volatile in mid-November.

The growth of output in the world economy picked up slightly in 1996 following a slowdown in 1995. Recent forecasts for 1997, prepared in late summer, are for only a moderate strengthening of economic growth.[1] A somewhat higher rate of output growth in the advanced industrialized countries and the transition economies is offset by a slowdown in the developing countries, mainly in Asia. The volume growth of world trade accelerated somewhat in 1997, after slowing down significantly in 1996. But this pattern may now be affected by a sharper than forecast deceleration in Asia and Latin America against a backdrop of financial crises and restrictive policies. It is therefore very likely that world output growth in 1997 will be less than in 1996.

In *western Europe*, cyclical growth forces have strengthened in the first half of the year. In *North America*, the expansion has gathered renewed momentum in the United States and Canada is still in a strong cyclical upswing. In contrast, the recovery in Japan has faltered leading to renewed stagnation.

In the *transition countries*, performance is still quite varied, but for all of these countries in aggregate output should increase in 1997, for the first time in this decade. This reflects to a large degree the bottoming out of the recession in Russia.

In *Latin America and the Caribbean*, economic growth is expected to reach 4.5 per cent in 1997, up from 3.5 per cent in 1996.[2] The economic recovery during 1996 and 1997 was mainly export led, reflecting, *inter alia*, rising demand from the advanced industrialized countries.

In *Africa*, the recovery underway since 1994 had gained stronger momentum in 1996 when real GDP rose by nearly 4 per cent, the highest growth rate in this decade. Forecasts for 1997 are for broadly the same rate of output growth (an increase by 4.2 per cent).[3]

In the developing countries of *Asia*, economic growth started to slow down significantly in a number of countries in 1996, a development which continued in the course of 1996. There was a deceleration in the newly industrializing economies[4] and also in south-east Asia, although the rate of growth remained considerably above the average growth of world output in 1996.

The rate of economic expansion has remained very high in *China*, although economic growth has slowed down in the course of 1997 due to more sluggish domestic demand and weaker export growth. Inflation has fallen to quite low rates, with falling prices for a range of goods.[5]

(ii) The currency crises in the Asian emerging market economies

The emerging economies of Asia grew rapidly in the 1980s and in the first half of the current decade. GDP growth rates in the developing countries of eastern and southern Asia were nearly twice as high, and about three times higher in China, as total world output. In fact, these

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1 See IMF, *World Economic Outlook* (Washington, D.C.), October 1997 (data available on the IMF internet website).

2 United Nations, Economic Commission for Latin America and the Caribbean, *Economic Survey of Latin America and the Caribbean 1996-1997, Summary* (Santiago, Chile), 1997.

3 United Nations, Economic Commission for Africa, *Report on the Economic and Social Situation in Africa, 1997*, E/ECA/CM.23/3, 27 March 1997.

4 Hong Kong, Republic of Korea, Singapore and Taiwan Province of China.

5 "China may see rates fall", *Financial Times*, 21 October 1997.

countries combined accounted for slightly more than half of the rise in world output over the period 1991-1996.[6]

Economic growth, however, slowed down in 1996 against the background of a sharp deceleration in world trade. There was a sharp slowdown in the region's export growth, which reflected the combined impact of weakening import demand in western Europe and North America, a steep fall in the demand for electronic products, and deteriorating price competitiveness vis-à-vis Japan. In fact, most of these countries have traditionally pursued an exchange rate policy which pegs their currency more or less closely to the dollar.[7] This meant that the marked rise in the dollar against the yen since mid-1995 therefore led to an appreciation of their currencies as well. The resulting adjustment pressure came on top of a sharp depreciation of the Chinese yuan in early 1994, which had boosted the price competitiveness of Chinese firms for labour-intensive goods (table 1.1.1). Nevertheless export growth in 1994 and 1995 was still very favourable, *inter alia*, because of the sharp appreciation of the yen, a surge in global demand for electronic products, and the mounting efforts of Japanese firms to relocate production overseas.[8]

However, after a long period of very rapid economic growth, several countries (Indonesia and Malaysia) had adopted restrictive policies to check rising inflationary pressures and to reduce their sizeable current account deficits, which were being financed by private foreign capital inflows. Monetary policy was also tightened in Thailand but the ensuing higher interest rates posed problems for the fragile financial sector against the background of falling property and stock prices.[9]

The deteriorating growth performance in some of these dynamic economies led to questions about their ability to return to the high growth path of preceding years and the sustainability of their external imbalances. Financial markets also started to spot weaknesses in the financial sector in Thailand, where balance sheets in the banking system were burdened with a high proportion of non-performing loans.[10]

There was a considerable surge in capital flows into the region in 1994 to 1996. Net private capital flows to east Asia and the Pacific (excluding Japan) rose to $108.7 billion in 1996 compared with $19.3 billion in 1990.[11] The background to this aggressive lending was ample world liquidity and a portfolio redistribution with greater weight being given to regions with a perceived higher rate of return on assets, a process which was also driven by a greater willingness of international investors to take on higher levels of market risk.[12]

The larger part of these inflows represented short-term debt.[13] Capital inflows were not only attracted by expectations of a higher rate of return on fixed assets but also by arbitrage opportunities offered by the positive gap between domestic and international interest rates. These inflows, in turn, fuelled a rapid growth of credit, a large part of which, however, financed the demand for real estate, equities, and consumer goods rather than the creation of productive capacity. Real estate, in turn, was used as collateral for a large proportion of the loans extended by the domestic banking sector. All this took place in an environment characterized, in general, by weak financial supervision and insufficiently tight lending standards. In many instances, domestic banks or the non-financial sector borrowed foreign currency-denominated funds unhedged, in view of a perceived low risk of depreciation of the national currency. The ensuing sharp rise of asset values in the property and stock market and the rapid credit expansion became mutually reinforcing, given that banks witnessed at the same time a sharp rise in the value of their collateral.

The result has been considerable exposure of the financial and banking system to the property and equity markets. This speculative bubble burst first in Thailand when economic conditions started to deteriorate in 1996. Stock market and property prices fell; to defend the exchange rate, domestic interest rates were raised to high levels, accentuating the balance sheet problems in the banking sector; and at the same time, the central bank was running down its foreign reserves. There was also a

6 United Nations, *World Economic and Social Survey 1997* (United Nations publication, Sales No. E.97.II.C.1), p. 233, table A1.

7 Most countries have a regime of managed floating (China, Indonesia, Malaysia, Singapore, South Korea) with the dollar being the reference currency. Thailand had pegged the baht to a basket of foreign currencies, in which the dollar had a weight of 80 per cent. Hong Kong has had a fixed exchange rate against the dollar since October 1983 within the framework of a currency board. The Philippines officially had a freely floating currency, but de facto the central bank intervened to narrowly limit the fluctuations of the peso against the dollar in recent years. Indonesia followed a policy of a crawling peg with steady depreciation against the dollar, but the central bank had already started to widen the exchange rate band in order to restrain strong capital inflows in 1996.

8 UNCTAD, *Trade and Development Report, 1997* (United Nations publication, Sales No. E.97.II.D.8), p. 14.

9 BIS, *67th Annual Report*, 1st April 1996-31st March 1997 (Basle), June 1997, p. 45.

10 Ibid., p. 107.

11 World Bank, *Global Development Finance, 1997* (Washington, D.C.).

12 There was also a large increase in private international lending to other emerging economies in Latin America and Europe in 1995 and 1996. These funds had dried up temporarily in the immediate wake of the Mexican peso crisis in early 1995, the so-called "tequila effect". BIS, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending*, Second Half 1996 (Basle), July 1997.

13 The proportion of short-term bank debt in Asia stood at 61.5 per cent of these countries' total outstanding bank debt at the end of 1996, which was "the highest among the major groups of outside area countries". BIS, *The Maturity, Sectoral …*, op. cit., p. 3.

perception that the domestic economic and financial environment had started to deteriorate in South Korea. In contrast, in Indonesia, Malaysia and the Philippines, high domestic interest rates and sustained economic growth continued to attract substantial new bank loans from abroad in the second half of 1996.[14]

Against this background, international investors began to reappraise their aggressive lending policy and started to focus on the risk factors involved, such as high and rising current account deficits, large foreign debts and internal imbalances reflected in asset price inflation, overbuilding in the property market and excess industrial capacity. There were also increasing concerns about the financial systems, with domestic banks carrying a large and rising proportion of non-performing loans in their portfolios.

In Thailand, speculative selling of the currency mounted significantly in the early months of 1997. Despite attempts of the monetary authorities to counter these pressures, the baht was floated on 2 July, and immediately depreciated sharply. This had an *effect* on other currencies in the region, which also came under strong selling pressure. On 11 July, the authorities in Indonesia and the Philippines significantly widened the bands in which their currencies were allowed to fluctuate against the dollar. On 17 October the Taiwan dollar was allowed float. The direct consequence of all these measures was a sharp depreciation of all the south-east Asian currencies against the dollar. More recently, there has been strong selling pressure on the South Korean won, pushing the currency to a record low against the dollar in November. Altogether, there have been substantial depreciations since June 1997 (table 1.1.1.). In Hong Kong, however, the fixed exchange rate has so far held steady in spite of sporadic strong selling pressure.

Also, given the increasing importance of intraregional trade and the fact that these countries compete in broadly the same range of low-skilled, labour-intensive goods in world markets, any sharp currency depreciation in one country was bound to destabilize the existing pattern of trade and investment and trigger a process of "competitive devaluation".[15] The sharp currency depreciations, in turn, translated into a significant rise in the national currency equivalent of debt denominated in foreign currency. At the same time, the assets of the banking system deteriorated because of the decline in equity and real estate prices. Any cumulative depreciation was bound to unveil the underlying problem of the solvency of the banks, to which was added the prospect of the bankruptcy of many borrowers in the non-financial sector on account of higher interest rates, excessive indebtedness and the drying up of short-term loans.[16]

Both Thailand and Indonesia are now receiving financial assistance from the IMF to support the banking sector on condition that wide-ranging reforms and adjustment policies are carried out.

(iii) The collapse of international stock markets

The currency crises in the Asian emerging economies spilled over to the stock markets, where share prices increasingly appeared overvalued in view of the sharp deterioration of profit expectations in the corporate sector. Massive selling of shares has tended to go along with the conversion of the proceeds into foreign currency, and this accentuated the decline of the national currency.

The stock market crash in the Asian economies has also changed market sentiment in the industrialized countries. Stock prices in the United States and other industrialized countries (with the major exception of Japan) had risen sharply since 1995 and there were increasing concerns about the sustainability of the increase. Warnings about "irrational exuberance" by the Chairman of the United States Federal Reserve Board of Governors went unheeded.

International share prices fell sharply in the wake of the slight tightening of monetary policy in the United States in late March 1997. But they recovered quickly against the background of robust economic expansion in the United States, persistent low inflationary pressures, and favourable profits growth in the corporate sector.

But following financial and economic crises in Asia, the surge in share prices in the United States petered out into broad stagnation in the summer. When, in October, the Hong Kong stock market fell by a cumulated 16.5 per cent there was also strong downward pressure on prices in western markets. In sum, there has been quite a sharp drop in international share prices since the beginning of October. In Asia, they have fallen on average by nearly 40 per cent compared with their previous peak in 1997. Among the major industrialized countries the fall has been much smaller, ranging from 8 per cent in the United states to 21 per cent in Japan (table 1.1.2).

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14 BIS, *The Maturity, Sectoral …*, op. cit.

15 The regional pattern of industrialization has been described by the "flying geese paradigm". Broadly speaking this is a development process in which relative comparative advantages shift over time from the lead country to the followers, with trade and foreign direct investment being the transmission belts. But this process of cooperation is at the same time associated with potential conflicts among countries, given the costs of adjustment and restructuring which result from the competitive pressures created by the "followers". UNCTAD, *Trade and Development Report, 1996* (United Nations publication, Sales No. E.96.II.D.6), pp. 75-103.

16 "La crise financière en Asie", *La Lettre du CEPII*, No. 161 (Paris), October 1997.

(iv) Spillover effects to other emerging economies

There was also an acceleration of foreign capital inflows in Latin America in 1996, which reflected the reduced importance of the so-called "tequila" effect in the aftermath of the Mexican peso crisis. As in the years preceding the Mexican crisis, growth was again increasingly based on a surge in foreign capital inflows. The mirror image to this has been a widening current account deficit in the region in 1996 and in early 1997, as imports rose more strongly than exports. But this deficit was more than covered by foreign capital inflows, which included a higher share of foreign direct investment and a correspondingly lower share of volatile short-term capital.[17] Given nominal exchange rate targets, the heavy capital inflows put strong upward pressure on exchange rates forcing central banks to tighten domestic credit and to attempt to sterilize the excess liquidity. Nevertheless, in many countries, foreign capital flows did lead to currency appreciation. The appreciation of the dollar against the yen and the deutsche mark in the first half of 1997 appears to have accentuated the rise in the external value of many Latin American currencies.

The contagious effect of the financial crises in Asia was therefore also felt in Latin America. So far, it has mainly affected Brazil, where stock prices fell by nearly 40 per cent between 22 October and 12 November. The government has raised domestic interest rates and tightened fiscal policy to curb the budget deficit.[18]

There were also repercussions in the stock markets of some of the transition countries, with marked falls in share prices in Moscow, Warsaw and other markets. Several of the transition countries have also experienced a surge in international lending. The proportion of short-term foreign banking debt is quite high in some countries, such as in Russia (46 per cent) and the Czech Republic (49 per cent).[19]

In southern Europe, the Greek drachma, which has been pegged to the ECU, came under strong downward pressure in late October as foreign investors started to sell Greek government bonds on a large scale. There was a sharp decline in stock prices in November. The Bank of Greece sharply increased its key money market rate to defend the exchange rate[20] and the government has announced a package of measures designed to reduce the budget deficit by 2 percentage points to 2.4 per cent of GDP in 1998.[21]

(v) The global impact

The financial crisis in Asia raises a number of specific issues pertaining, *inter alia*, to the broader implications of exchange rate targets for domestic economic policy, the effective supervision of banks, and the impact of financial globalization on stability and growth. These issues cannot be discussed in a short overview – all that is possible here is to point to some of the possible consequences in the short-term.

The immediate effect of the financial crises and the ensuing adjustment policies will be a significant slowdown in domestic demand, which via strong intraregional trade linkages will spill over to other countries in the region. The region (including Japan) accounts for some 22 per cent of world imports and 23 per cent of world exports in 1996.[22]

The buoyant economic growth of the Asian economies in recent years led to a considerable rise in their import demand and in the importance of their markets for the exports of the industrialized countries. These trade linkages are especially strong for Japan. The ASEAN-4 and the NIEs accounted for some 37 per cent of all Japanese merchandise exports in 1996. This compares with shares of 16 per cent for United States exports and a much lower proportion (5 per cent) for western Europe (table 1.1.3). The importance of the Asian markets is still very much smaller for the central and east European countries.

Nevertheless, the Asian region was an important source of growth for the western market economies as a whole. This support has been fading in the course of 1997, a tendency which is likely to persist and to slow down world trade in 1998.

On the other hand, the sharp depreciation of their currencies and the associated improvement in price competitiveness will most likely lead to an export offensive by Asian exporters in western markets. Exports will be the main source of their economic growth given the depressed state of their domestic demand.

This, in turn, will put downward pressure on domestic prices and profit margins of competing producers in the industrialized countries and the transition economies. The depreciation of the Asian currencies will probably put downward pressure on the yen, as well as on exchange rates in Latin America and in the transition economies.

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17 United Nations, Economic Commission for Latin America and the Caribbean, op. cit., p. 9.

18 *Financial Times*, 13 November 1997.

19 Debt with a maturity of less than one year outstanding at the end of 1996. See BIS, *The Maturity, Sectoral …*, op. cit., pp. 8-9. For a detailed discussion of foreign capital flows into the transition economies, see chaps. 3 and 4 below.

20 The overnight interest rate was raised temporarily to 150 per cent.

21 *Financial Times*, 13 November 1997.

22 Data exclude re-exports from Hong Kong.

The relative importance of the Asian region in the imports of the industrialized countries is similar to their importance in exports. Shipments from the east and south-east Asia (including China) accounted for 35 per cent of total imports into Japan in 1996; the figure for the United States is smaller, but still considerable (some 23 per cent). The share was below 7 per cent in western Europe and about 4.5 per cent for central and eastern Europe (table 1.1.4).

A surge in imports from the Asian countries combined with weak export growth from the industrialized countries to the region could trigger a significant deterioration in the foreign trade position of many industrialized countries, notably the United States, with the consequent danger of trade policy tensions.

In western Europe and North America, an open issue is the quantitative impact of the fall in share prices on the spending propensity of private households. Any restraining effect is likely to be larger in the United States than in western Europe, given that shares account for a higher proportion of households' net worth in the United States. Moreover, there is probably a long and variable lag between changes in asset values and spending propensity. The short-term effect of the fall in stock prices on household spending is therefore probably relatively small.

Commercial banks in western Europe and the United States are probably facing the risk of defaults on considerable amounts of lending to Asian banks. Notably some large United States banks have significant loan exposure in south-east Asia. Nevertheless, the overall impact on non-performing loan ratios and charge-offs is judged to be moderate.[23]

In Japan, the overriding concern is the stability of the banking and financial sector system, which has still not recovered from the severe losses suffered from the bursting of the asset price bubble at the beginning of this decade. The recent sharp fall in the Nikkei stock index has highlighted once again the lingering balance sheet problems of banks and insurance companies. To this is now added the significant exposure to bad loans in south-east Asia. An important problem in this connection is that Japan's banking system depends on unrealized gains in stock values to meet the BIS capital adequacy ratio. These unrealized gains have been significantly reduced with the recent sharp fall in stock prices. There is now a danger that with the erosion in the value of such collateral, there is a need to liquidate foreign assets (stocks and bonds), which are predominantly dollar-denominated. Any large-scale selling of these would put downward pressure on bond prices with a concomitant rise in effective interest rates. This would have spillover effects to other regions of the world economy.

It is still very difficult to judge the likely overall impact of recent developments in the international financial markets on economic developments in the ECE region in 1998. In western Europe, the issue is whether the trade effects and the downward correction in the stock market will affect business and consumer confidence with negative effects on spending behaviour. The impulses which exports have provided to economic activity in 1997 will also be weaker due to the forecast slowdown of import demand in the United States. More generally, this raises the issue of the robustness of the current recovery and whether it can be sustained in the face of a deteriorating external economic environment in 1998 and, possibly, higher interest rates at home. Should the present recovery falter again, as it did in 1994, there are likely to be serious consequences for the labour markets and, probably, for social peace as well. At present there are some important differences in the cyclical positions of different countries in western Europe and, partly related to this, in the situation in the various labour markets. It is also likely, that some will be more vulnerable than others to the changing economic conditions in Asia. Similarly, any rise in long-term interest rates in the United States, would have spillover effects in western Europe, which, as in 1994, could be quite different from country to country and disturb the current pattern of convergence. In addition, any rise in long-term interest rates could trigger significant negative wealth effects associated with falling bond prices, which would also be likely to put downward pressure on stock prices. More generally, there could be a danger of conflict among EU members about the appropriate economic policy response to changes in short-term economic prospects. This would not be a favourable environment for the introduction of a single currency in the European Union at the beginning of 1999.

1.2 Western Europe and North America

(i) Output and demand

In *western Europe*, the cyclical recovery has gathered momentum and this is reflected in a general strengthening of GDP growth in the second quarter of 1997 (chart 1.2.1 and table 1.2.1). The annual growth rate of real GDP is now forecast to be 2.6 per cent in 1997, slightly higher than forecast in the spring, and a clear improvement on the modest 2 per cent in 1996 (table 1.2.2). The improvement is also mirrored in rising business and consumer confidence.

In *North America*, the strong cyclical expansion in the United States has continued, while in Canada there has been a sharp cyclical rebound in 1997 (table 1.2.1).

23 *Standard & Poor's Credit Weekly*, 12 November 1997, p. 13.

The average annual growth rate of GDP in 1997 is now forecast at 3.7 per cent.

In contrast, hopes for a sustained economic recovery in *Japan* have once again been dashed. Cyclical growth forces appear to have been choked off by the tightening of fiscal policy and the damaging spillover effects from the financial turbulence in south-east Asia. Growth forecasts have been sharply reduced after the output collapse in the second quarter of 1997 and for the year as a whole real GDP is now expected to increase only by some 1 per cent, down from 3.6 per cent in 1996.

For the *industrialized countries* combined, the sharp slowdown in Japan is, however, more than offset by higher output growth in western Europe and North America. In the event, therefore, real GDP is expected to increase by 2.8 per cent in 1997, which compares with growth of 2.5 per cent in 1996.

In *western Europe*, the average GDP growth over the past year or so conceals significant differences in cyclical positions and in the growth performance of individual countries. Among the four major economies, the United Kingdom continues to be more advanced in the business cycle, the upswing having lasted for some five years. The degree of resource utilization has now increased to quite high levels as actual output growth has tended to outpace its underlying trend. In contrast, in France, Germany and Italy cyclical growth forces have only started to gather strength over the past year and there are still considerable margins of spare capacity.

Among several of the smaller economies, output growth has been quite robust since 1994 and the degree of resource utilization has been rising steadily, thus narrowing the gap between actual and potential output. This is the case for Denmark, Finland, the Netherlands, Ireland, Norway, and Spain. On average, real GDP in the 18 smaller west European economies is forecast to increase by 3.2 per cent in 1997, nearly one percentage point more than in the four major economies combined.

The strengthening of economic growth in *western Europe* in 1997 is mainly due to a sharp increase in export demand. Exports in most countries were stimulated by the robust growth of domestic demand in the United States, the United Kingdom, and in the developing countries. There was also continuing strong import demand in the transition economies. A major stimulus to exports was the gain in price competitiveness stemming from the sizeable appreciation of the dollar and pound sterling. The Japanese yen also appreciated in the first half of the year against the deutsche mark and other west European currencies. The sharp acceleration in export growth more than accounted for the entire rise in west European GDP in the second quarter of 1997 (table 1.2.3).

But the upturn was also supported by stronger domestic demand in the second quarter of 1997. Consumption expenditures and fixed investment expenditures rose, on average, by ¾ percentage points between the first and second quarters of 1997. Personal consumption expenditures were still restrained by weak growth of real disposable incomes, a reflection of wage moderation, weak employment growth and fiscal drag. Some offset was provided by the willingness of households in many countries to reduce savings. In addition, the strong rise in share prices over the past years has boosted households’ net worth and this probably led to some increase in spending propensity. There was also a strengthening of business fixed investment in machinery and equipment. Construction investment has been relatively weak because of an excess supply of residential and industrial buildings in a number of countries. Changes in stockbuilding provided increased support to domestic demand growth in the second quarter (table 1.2.3). The strengthening of domestic demand was associated with a rise in import demand that to a large degree offset the stimulus deriving from higher exports. But, on balance, changes in real net exports have increasingly supported domestic activity levels over the first two quarters of 1997.

On the supply side, the increased cyclical momentum reflects in the main a rise in industrial activity, notably in manufacturing. Manufacturing output in western Europe rose by some 3 per cent in the first half of 1997 (compared with the same period of 1996. Demand has focused notably on intermediate and investment goods. Activity levels in the motor car industry were supported by special government incentives in Italy designed to stimulate purchases of new cars, which, via demand for foreign cars, spilled over to other countries in the region. In the United Kingdom, the rate of expansion of manufacturing activity continued to be quite subdued, *inter alia*, because of the dampening impact of the appreciation of sterling on exports of manufactures. In general, the upturn in manufacturing output in western Europe has outpaced the growth of productive capacity by a good margin and, accordingly, there has been a relatively strong rise in capacity utilization rates in the first half of 1997. In general, there are still quite large margins of spare capacity, but in some countries (Finland, Ireland, Netherlands, Spain) the balance of firms judging capacity to be more than sufficient relative to expected production is now rather small against the background of buoyant output growth.

In *Germany*, robust export growth has been the mainstay of rising economic activity levels since the third quarter of 1996. Private consumption strengthened in the second quarter of 1997, partly supported by a fall in household savings. Business investment expenditures on machinery and equipment have been rising since the beginning of 1996 but have failed so far to gain significant momentum. The weakness of business fixed investment can be partly attributed to the existence of still large margins of spare capacity. Construction investment has remained sluggish and forecasts are for a decline in 1997 compared with 1996. This reflects, *inter alia*, the excess supply of multi-family buildings, reduced tax incentives for investment in dwellings, and the completion of major infrastructure projects in eastern Germany. In sum, growth in aggregate domestic demand in 1997 is likely to be small. In contrast, improved competitiveness led to a boom in exports which, seasonally adjusted, rose by 3.5 per cent between the first and second quarters of 1997 and were some 12 per cent above their level in the second quarter of 1996.

In *France*, exports were also the main driving force behind an acceleration in GDP growth in the second quarter to 1 per cent from only 0.3 per cent (table 1.2.1) in the first. But these figures tend to exaggerate somewhat the cyclical momentum as they are not adjusted for variations in the number of working days.[24] Final domestic demand has remained weak. Changes in stockbuilding were the main factor behind the rise of total domestic demand in the second quarter. Household consumption expenditures broadly stagnated in the first two quarters of 1997, with moderate growth in real disposable incomes being offset by a rise in the savings ratio. Fixed capital formation has remained sluggish, a small decline in the first quarter followed by stagnation in the second. There was, however, a slight increase in fixed investment in the non-financial business sector in the second quarter.

In *Italy*, real GDP rose by 1.6 per cent in the second quarter of 1997 following a cumulative decline by 0.5 per cent in the two preceding quarters. There was a significant rebound in manufacturing output, influenced by favourable calendar effects and a strong increase in demand for motor cars on account of the government's incentive scheme for new car purchases, which has been extended until July 1998. Overall growth in household consumption expenditures remained subdued. Personal disposable incomes have been depressed by higher taxes as part of the fiscal measures designed to curb the budget deficit. But consumer expenditures have been supported over the past few years by a significant decline in the household savings ratio. Business fixed investment has been supported in the main by higher spending on transport equipment since the third quarter of 1996. Construction investment has continued to fall. Exports benefited from the favourable external demand and a moderate decline of the real effective exchange rate, which had appreciated significantly in 1996.

In the *United Kingdom*, the economy has maintained the momentum gained in the final quarter of 1996. Quarterly GDP rose by about 1 per cent in each of the first three quarters of 1997. Economic growth since the final quarter of 1996 has corresponded to an annual rate of close to 4 per cent. This is significantly above the estimated trend growth rate of output, and the output gap is now likely to be very small. There may now be some risk of overheating and economic policy has been tightened to slow down the expansion of domestic demand. Personal consumption and exports are the main supports of economic growth in the first half of 1997. Household incomes were supported not only by favourable developments in the labour market, but also by windfalls from the conversion of mutual financial companies to non-mutual status.[25] This has contributed to the strong growth of household expenditures on consumer durables and to rising house prices. Manufacturing fixed investment (including leased assets) fell in 1996, but there was a marked rebound in the first two quarters of 1997: in the first half of 1997 it was nearly 10 per cent higher than in the same period of the preceding year. Fixed capital formation in other sectors was more subdued, probably held back by high interest rates. There was a notably sharp decline in government fixed investment expenditures. Total gross domestic fixed capital formation rose by 2 per cent in the second quarter of 1997 compared with the preceding quarter, when there was only a slight increase. Exports have displayed so far considerable resilience to the loss in competitiveness caused by the sharp appreciation of sterling. Exporters have possibly accepted lower profit margins to defend market shares and have also benefited from the strengthening of demand in continental Europe. But there are some indications that export orders may have weakened in the third quarter.

Among the *smaller west European economies*, the general picture in 1997 has been one of a very favourable growth performance reflecting a combination of strong domestic and foreign demand. It is worth noting that since 1994 the majority of these countries have achieved economic growth rates that have been significantly above the west European average. Compared with 1996, the forces for growth in 1997 have remained broadly unchanged or strengthened somewhat in Denmark, Finland, Ireland, the Netherlands, Norway, Portugal, Spain and Turkey. In Sweden, there was a significant slowdown in 1996, but economic activity has picked up

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[24] Adjusted for calendar effects, the growth in real GDP was some 0.75 per cent in the first quarter up from 0.5 per cent in the preceding quarter.

[25] This process involves an increase in personal wealth in the form of financial assets (shares), and the associated interest and dividend payments will enhance personal incomes. Alternatively, the increase in net worth could raise the spending propensity, i.e. trigger a decline in current period savings.

again in 1997. Economic activity strengthened also in Switzerland in the second quarter, after several years of economic stagnation. In *Israel*,[26] there has been a significant slowdown in economic growth in 1997 following three years of robust expansion. This development reflects, *inter alia*, tighter economic policies and a sharp fall in the number of immigrants.

Domestic demand in the smaller economies was supported, in general, by a combination of strong private consumption, robust fixed investment and favourable export growth. Business fixed capital formation was particularly buoyant in Denmark, Finland, Ireland, the Netherlands and Norway. In Norway, strong growth in investment related to oil and gas has been a mainstay of economic growth in 1997. Fixed investment was also the main support of economic growth in Portugal, Spain and Turkey. The strength of residential investment remains uneven among the various countries. Thus, in Denmark and Norway, low interest rates and rising house prices continue to stimulate residential investment. A strong recovery in residential investment in Finland reflects in the main state-subsidized housing projects. In contrast, in Sweden a slump in residential investment reflects the phasing out of government subsidies.

In the *United States*, the cyclical upswing has now lasted for some six and a half years[27] and economic activity has remained strong in the first three quarters of 1997. Labour markets are very tight and the unemployment rate has fallen to a postwar low. But there are as yet no significant upward pressures on wages and prices. Operating rates in manufacturing industry rose to 83.4 per cent in September 1997, the highest rate since April 1995 and two percentage points above the long-term average for 1967-1996. Manufacturing output rose by 4.5 per cent in the first nine months of 1997 over the same period of 1996. Real GDP increased by 3.8 per cent in the first three quarters of 1997 compared with the same period of previous year.

The upswing continues to be broadly based on domestic demand and exports. Consumer confidence rose to its highest level in 30 years. Private consumption was supported by gains in aggregate incomes, due to increasing demand for labour, and favourable growth of entrepreneurial and dividend incomes. Rising asset prices have increased households' net wealth and probably raised the spending propensity. Business fixed investment in machinery and equipment, notably information processing equipment, have remained buoyant. In contrast, expenditures on industrial buildings weakened in the first two quarters but picked up again in the third. Residential investment rose in each of the first three quarters of 1997. Domestic demand was also supported by considerable stockbuilding in the business sector in the first two quarters (table 1.2.3), but a considerable slowdown in inventory accumulation was a major drag on domestic activity levels in the third quarter. Exports continued to be a mainstay of economic growth, displaying a surprising resilience so far to the appreciation of the dollar. Against the backdrop of strong domestic demand, imports have surged and this constitutes a considerable leakage from domestic output and incomes. Changes in real net exports subtracted from economic growth in each of the first three quarters of 1997.

In *Canada*, economic activity has gained increasingly strong momentum since the second half of 1996. The significant relaxation in the stance of monetary policy in 1995 and 1996 and the associated decline in interest rates provided a considerable stimulus to the interest-sensitive components of domestic demand. Business non-residential investment is booming and there was also strong growth in housing construction. Consumer spending on big ticket items has been buoyant, but an increasing proportion of the increased spending is being financed by borrowing. As in many other countries, the strong rise in the value of financial assets has boosted spending propensity. The other side of the picture has been a conspicuous decline in the personal savings ratio, from 7.8 per cent in the first half of 1994 to a postwar low of 0.9 per cent in the second quarter of 1997. Export growth faltered in the second quarter following strong growth in the first. Strong output growth has led to a high degree of resources utilization as reflected in a significant rise in capacity utilization rates in the manufacturing sector.

In *Japan*, there was a marked acceleration in GDP growth in the first quarter, as households brought forward expenditures on a large scale in anticipation of an increase in sales tax as from 1 April 1997. As a consequence, consumer spending fell sharply in the second quarter, which together with weakening residential investment and government spending led to a steep decline of GDP by 2.9 per cent as compared with the preceding quarter. This decline more than offset the cumulative output gains of the three preceding quarters. Weak domestic demand has depressed demand for foreign goods, while exports benefited from the depreciation of the yen and favourable demand growth in major markets, notably the United States. As a result, there has been a considerable surge in the merchandise trade surplus and a significant improvement in the current account balance. Domestic demand remained sluggish in the third quarter and the overall picture was one of a stagnating economy. Against the backdrop of the currency crises in south-east Asia and the lingering

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[26] Israel has been a member of the United Nations Economic Commission for Europe since July 1991.

[27] The trough of the business cycle was in March 1991.

structural adjustment problems in the financial sector, business confidence has weakened.

(ii) Labour markets, costs and prices

Overall employment in western Europe edged up slightly in 1997 following virtual stagnation in 1996. The modest improvement masks, however, significant differences among countries, with robust employment gains in the United Kingdom and a number of smaller countries (Denmark, Finland, Greece, Ireland, the Netherlands, Norway and Spain) offset by significant declines in Germany, Sweden and Switzerland. Employment stagnated in Italy and there were only small gains in France and some smaller economies such as Austria and Belgium. Overall, this differential performance reflects the cyclical desynchronization among the various countries and the usual lags between output growth and employment growth.

In Germany, the employment situation continued to deteriorate in the first half of 1997, mainly because of the unfavourable trends in the construction industry. Employment also continued to fall in industry, with most of the reduction attributable to the recent intensification in rationalization and restructuring, while jobs growth in the tertiary sector was not strong enough to offset the losses in the industrial sector. The decline in employment has been further aggravated by the reduction in the number of participants in training and job creation schemes. Forecasts are for a decline in total employment by 1.5 per cent in 1997 compared with 1996.

In France, employers remained very cautious in their approach to new hiring in the first half of 1997, with greater use of flexible working-time arrangements and temporary staff. Manufacturing employment continued to fall, in part a reflection of the sharp drop in car production following the ending of the scrapping premium for new vehicle purchases in October 1996. Total employment is expected to increase only marginally for the year as a whole. Most of the new employment will continue to be created in the tertiary sector. The French government has launched a scheme designed to *provide* new jobs for young people with local authorities and non-profit making associations.

Similarly in Italy, the employment growth generated by the services sector in the first half of 1997 was barely sufficient to offset the continuing decline in industrial employment.

In the United Kingdom, employment rose 1.8 per cent, year-on-year, in the first half of 1997, with much of the expansion in the services sector. Although manufacturing employment also increased in this period, by some 0.7 per cent, there were sharp monthly falls in the sector in July and August, as the strength of sterling brought falling export orders and tougher competition from importers. Forecasts are for an annual employment growth rate of about 1.5 per cent in the total economy this year.

Among the smaller west European economies, average annual employment growth in 1997 is expected to exceed 4 per cent in Ireland, to be around 2-2.5 per cent in Denmark, Finland, Luxembourg, the Netherlands, Norway and Spain, and some 1.5 per cent in Greece and Portugal. The general background to this is sustained and robust output growth.

There is some evidence that labour markets may be tightening in those countries where output growth has been strong over the past few years, one indicator being growing shortages of skilled workers in individual sectors of the economy where capacity utilization rates have risen to quite high levels. This pertains to the United Kingdom (mainly in services) and among the smaller economies, *inter alia*, to Denmark, Ireland (construction sector) and the Netherlands (construction and engineering industries) and Norway.

In the United States, non-farm payroll employment growth averaged some 2.2 per cent, year-on-year, in the first three quarters of 1997, slightly stronger than the same period in 1996. Much of the expansion was in private sector services employment, but there was also jobs growth in manufacturing and a substantial rise in construction. With the unemployment rate already at a low level, part of the recent increase in the demand for labour in the United States has been met by greater labour force participation.[28] Skilled labour shortages are evident in many industries and regions in the United States, particularly in high technology and energy extraction industries.

Job creation has been increasingly robust in Canada, employment rising on average by 1.7 per cent, year-on-year, in the first three quarters of 1997, with a notable strengthening in each quarter and two thirds of the growth in full-time jobs. The rate of new hiring has been particularly strong in construction, followed by manufacturing, and parts of the tertiary sector such as business and personal services, reflecting the surge in domestic demand.

Employment growth is rarely fully mirrored in decreases in the level of unemployment as the activity rate of the population of working age tends to be somewhat flexible, in line with both changing demographic factors and perceptions of employment opportunities. The latter will tend to be cyclical; as economic expansion picks up,

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[28] After changing little since the late 1980s, labour force participation began to rise in early 1996 – from 66.6 per cent in January 1996 to a record high of 67.3 per cent in March 1997, and it remained at 67.1 per cent in the second quarter. *Federal Reserve Bulletin* (Washington, D.C.), August 1997, p. 652.

more people will be drawn into the labour force, and this has happened in most countries as the present recovery has gathered pace. Employment growth has been sufficiently strong in some countries in 1997, however, to ensure an easing of the unemployment rate in the course of the year (table 1.2.4). There has been a decrease of at least 0.5 percentage point between January and August in Canada, Finland, Ireland, Portugal, Spain, the United Kingdom and the United States, and smaller reductions in Denmark and the Netherlands.

Notwithstanding these improvements, the average unemployment rate in western Europe has remained stubbornly at 10 per cent in the first half of 1997 – and the average annual rate has not been below this level since 1992. While this masks wide differences between countries, the problem is particularly acute in France, Germany and Italy.

In *western Europe*, the average rate of consumer price inflation fell to 1.9 per cent over the first three quarters of 1997 compared with the same period of 1996. Among the four major economies, quarter-on-quarter data for 1997 show a deceleration in France and Italy, but some volatility in Germany and the United Kingdom (table 1.2.5). Inflation in the United Kingdom was notably higher than in the other major west European economies in the first three quarters of 1997, a reflection of the strong growth in domestic demand. Retail price inflation rose to 3.5 per cent, year-on-year, in the third quarter, though in part this reflected the pass-through of higher interest rates to higher mortgage costs.

In general, the subdued inflation in Europe reflects sluggish private consumption demand, significant margins of spare capacity and moderate wage growth. The stronger dollar put upward pressure on import prices, but against a background of intense competitive pressures, the pass-through at the consumer level has remained limited. Wage settlements, in general, have been moderate in 1997, which in combination with favourable productivity growth dampened the growth of unit labour costs.

Among the higher inflation countries, Greece has had notable success in reducing its rate of consumer price inflation, largely by pegging the exchange rate of the drachma to the ECU. There has also been some easing of inflation in Israel in 1997, a result of restrictive economic policies and sluggish demand. In Turkey, the annual inflation rate fell to some 80 per cent in 1996 down from more than 100 per cent in 1994. But this decline appears to have been arrested in 1997, which reflects, *inter alia*, central bank financing of the high fiscal deficit.

In the *United States*, consumer price inflation has remained very subdued in 1997. The consumer price index rose by only 2.5 per cent over the first three quarters compared with the same period of 1996. The annual inflation rate for 1997 as a whole is likely to be lower than in 1996. The favourable United States inflation performance during the current cyclical upswing has been quite surprising given the continuing strength of output growth, buoyant private consumption demand, and tight labour markets. The decline in energy prices in the first half of the year has had some impact in 1997, as has the fall in non-oil import prices resulting from the appreciation of the dollar which has both reduced the input costs of some domestic producers and intensified competitive pressures in some domestic markets. Efficiency gains from rationalization have helped to contain costs, while industrial capacity has been augmented by the rapid growth of fixed investment. In addition, labour costs have been more subdued than might have been expected, partly due to moderation in the costs of health benefits, but also to lingering fears over job security, which may have influenced pay bargaining.[29] It is possible that the slight wage cost pressures that emerged in 1996 may have accelerated in 1997, but the evidence is somewhat contradictory.[30]

Consumer price inflation has also been very mild in *Canada* in the first three quarters of 1997, in spite of the strengthening of private consumption demand since the final quarter of 1996. This partly reflects the pass-through of falling energy prices to consumer prices and, possibly, the rapid expansion in industrial capacity. Labour cost pressures have also been weak; employment has risen, but there is still considerable slack in the labour markets, and unit labour costs were unchanged in the second quarter reflecting very little wage growth and continuing productivity gains.

In *Japan*, the surge in consumer price inflation in the second quarter of 1997 was due to the increase in the consumption tax in April, but otherwise inflationary pressures have remained very weak.

Changes in *international commodity prices* in dollar terms have been generally restrained in the first three quarters of 1997. A major influence has been the fall in crude oil prices in the first half of the year from their peak in January 1997, against a background of relatively ample supplies and a mild winter, which dampened demand. Excluding energy, the HWWA index[31] of world prices of raw materials in dollar terms rose by only some 2.5 per cent in the third quarter of 1997 compared with the same period of 1996; if energy is included, however, the index

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29 For a fuller discussion of the factors restraining inflationary pressures in the United States see *Federal Reserve Bulletin* (Washington, D.C.), June and September 1997.

30 The wages and salaries component of the employment cost index in private industry suggests that the slight acceleration of wage cost pressures in 1996 has continued in 1997, but this is not supported by other indicators.

31 Index published by the Hamburg Institut für Wirtschaftsforschung.

fell by almost 4 per cent. In many countries of western Europe, however, these mild price pressures from imported raw materials have been amplified by the appreciation of the dollar against the national currencies, although the pass-through to final consumer level appears to have been rather limited.

(iii) External balances

There was a significant rebound in the volume growth of merchandise trade in *western Europe* in 1997, following a marked slowdown in 1996. The volume of exports of goods rose by some 7.5 per cent in the first half of 1997 (table 1.2.6). This acceleration reflects not so much the upturn of the business cycle in western Europe itself, but, rather, stronger demand from countries leading in the business cycle (United States, United Kingdom). Export growth was also supported by robust demand from the developing countries and the transition countries. An important factor in the improved export performance of continental Europe was improved price competitiveness, largely on account of the appreciation of the dollar and pound sterling, and which is reflected in a fall of the real effective exchange rate (see below). Demand for imports in western Europe, on average, was less buoyant, reflecting the still relatively moderate strengthening of domestic demand growth.

There was also continuing strong growth in real merchandise exports from the United States. There are traditional lags between currency appreciation and changes in trade volumes, but it seems that the dampening impact of the stronger exchange rate may have been offset to some extent by the cyclical upturn in western Europe. Buoyant domestic demand is reflected in very strong import growth in both Canada and the United States. In Japan, the weaker yen was a major factor in a pronounced strengthening of export growth.

In total, real exports of goods in industrialized countries rose by about 11 per cent in the first half of 1997 compared with the same period of 1996. Imports rose by 9 per cent over the same period.

The *current account balance* remained in comfortable surplus in France and Italy in the first half of 1997 (table 1.2.7). In Germany, where the current account has been in deficit since unification, there was a small surplus in the second quarter, which, however, was still offset by the negative balance in the preceding quarter. In the United States, the current account deficit remained high in the first half of 1997, although it was somewhat lower than a year earlier. The current account position has deteriorated in Canada. In contrast, there was a surge in the current account surplus in Japan, which only partly reflects a higher surplus in goods trade.

(iv) Economic policy and monetary conditions

The stance of *fiscal policy* in western Europe has remained tight in 1997. The efforts to curb budget deficits continue to dampen, as in 1996, overall economic growth. The structural general government budget deficit is estimated to fall for the EU countries combined to 2.2 per cent of potential GDP in 1997, down from 3.5 per cent in 1996.[32] The decline in short- and long-term interest rates (in comparison with 1996) has helped the process of budget consolidation by reducing interest payments on outstanding debt. Governments in France, Germany and Italy have had to adopt additional fiscal measures in the course of the year to meet their deficit targets for 1997.[33] There was also some tightening of fiscal policy in the United Kingdom designed to restrain household consumption expenditures. It is now generally expected that nearly all of the EU countries will have budget deficits in 1997 which will comply more or less strictly with the Maastricht Treaty criterion.

In the *United States*, fiscal policy was broadly neutral in 1997. But the favourable impact of the sustained recovery on tax revenues led to a further significant improvement in the financial position of the government sector. The federal government budget deficit fell to only $22.6 billion in Fiscal 1997 (which ended on 30 September 1997), corresponding to only 0.3 per cent of GDP. This was the lowest ratio since 1974. The swift progress in budget deficit reduction reflects a combination of tight fiscal policies (reflected, *inter alia*, in declining defence expenditures) and the growth in tax revenues. The surge in equity prices has boosted capital gains taxes.

There has also been swift progress in government budget consolidation in *Canada*, reflecting the combined effect of expenditure cuts and, more recently, the growth in tax revenues. In fact, the general government budget was in small surplus (equivalent to 0.5 per cent of GDP) in the second quarter of 1997. This compares with a deficit equivalent to some 6 per cent of GDP in the first half of 1994.

Fiscal policy was also significantly tightened in *Japan* to reverse the steady deterioration in government finances over the past years. A number of fiscal stimulus packages was introduced to support economic activity, but their impact was short-lived and probably offset by the restraining effects of balance sheet adjustment problems in the financial sector. It appears that the

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32 OECD, *Economic Outlook*, No. 61 (Paris), June 1997, annex table 31.

33 In fact, in early November, a new tax estimate in Germany revealed another shortfall in tax revenues for 1997 and 1998. To meet the established deficit targets for the federal budget, the government decided to postpone payments to redeem the stock of debt left behind by the Treuhand and the banking sector of the former GDR.

restrictive impact of the fiscal measures introduced in 1997 on economic activity has been much larger than expected.

Monetary policy, in general, has continued to support the strengthening of economic activity in western Europe. In Germany, the Bundesbank has held the discount rate steady at 2.5 per cent since April 1996. The open market rate for securities repurchase agreements (the “repo-rate”), which is used for fine-tuning of the money market, was reduced by 0.3 percentage points to 3 per cent in August 1996. The decision of the Bundesbank on 9 October 1997 to raise the repo-rate to 3.3 per cent was the first increase in official interest rates since 1992. This could be seen as a turning point of the current interest rate cycle, but the increase was too small to constitute a fundamental change in the stance of monetary policy. The Bundesbank was apparently concerned about the inflationary risks associated with the weakness of the deutsche mark against the dollar and the ample liquidity in the economy. But the move was also seen as promoting the convergence of short-term interest rates for those countries that are likely to be among the initial members of EMU from the beginning of 1999. In the immediate wake of the Bundesbank’s decision the central banks of Austria, Belgium, Denmark, France and the Netherlands also raised slightly their corresponding official interest rates. In other countries, where short-term interest rates are much higher than in Germany, the stance of monetary policy had, in fact, been eased in 1997. This was the case of Italy (June 1997), Portugal (May 1997) and Spain (five consecutive reductions up to the beginning of October 1997). Behind this decline in interest rates were declining inflation rates and progress in budget consolidation. In the case of Spain, the reduction in official interest rates was also probably intended to stem the upward pressure on the exchange rate arising from strong capital inflows. In any case, average monthly short-term interest rates in Italy were still some 3.9 percentage points higher than German rates in September 1997. The corresponding differential was some 2 percentage points for Portugal and Spain.

In the *United Kingdom*, the central bank was given the operational responsibility by the new government for setting official interest rates as from 6 May 1997. The move was preceded by a decision to raise the base rate by 0.25 percentage points to 6.25 per cent. This interest rate was raised further in four consecutive steps to a five-year high of 7.25 per cent in early November 1997. The central bank fears that the continuing strong growth of domestic demand and the tighter labour markets could rekindle inflationary pressures and that the official inflation target will be overshot.

Against this background there was hardly any significant change in short-term interest rates in most west European countries during the first nine months of 1997 (chart 1.2.2), but the decision of the Bundesbank put upward pressure on short-term rates in October. In contrast, short-term rates fell significantly in Italy (0.6 percentage points), Portugal and Spain (some 0.8 percentage points) between January and September 1997. Short-term rates also continued to fall in Switzerland. In the United Kingdom, they were nearly 0.9 percentage points higher in September 1997 than at the beginning of the year.

In the *United States*, the Federal Open Market Committee (FOMC) of the Federal Reserve decided to raise slightly the target interest rate for federal funds by a quarter of a percentage point, to 5.5 per cent, in March 1997. (The discount rate has been unchanged at 5 per cent since the end of January 1996.) Since March, the stance of monetary policy has not been tightened further, although the rate of economic expansion has continued to exceed the estimated growth of potential output in 1997 and the economy is operating close to full capacity. The background to this policy stance has been the strikingly subdued rate of inflation despite tight labour markets. In addition, the strong dollar has put downward pressure on import prices.

In contrast, the central bank of *Canada* raised the bank rate by 0.25 percentage points to 3.75 per cent at the beginning of October. The decision was mainly motivated by the increasing momentum of the recovery and the danger of mounting inflationary pressures associated with the reduction of spare capacity in the economy. Already in mid-year there was a slight tightening of monetary policy which appears to have been motivated by concerns about the exchange rate.

Accordingly, there has been little increase in United States short-term rates so far in 1997. The upward tendency in Canada was only slightly more pronounced. It is noteworthy that short-term rates in Canada have been below United States rates since spring 1996. With the successive relaxation of monetary policy the interest rate differential has widened significantly over time in favour of United States dollar-denominated assets. The differential amounted to 2 percentage points in September 1997 compared with 2.3 percentage points at the beginning of the year.

The stance of monetary policy has remained unchanged in Japan since September 1995, when the discount rate was lowered to a postwar low of 0.5 per cent. Adjusted for inflation, short-term interest rates were negative (at about 1.5 per cent) in Japan in the third quarter of 1997.

There was little change in short-term interest rate differentials between the United States and Germany during the first nine months of 1997. The differential rose from 2.3 percentage points in January 1997 to 2.6 percentage points in June, but fell back to 2.3 percentage points in September. With the rise in short-term rates in Germany, the differential narrowed in favour of deutsche mark denominated assets in October.

Long-term interest rates continued to fall in *western Europe* in the first nine months of 1997 and, in general, they are now at relatively low levels (chart 1.2.3). There was temporary upward pressure on yields in the first quarter of 1997, reflecting spillovers from the United States bond market, where continuing robust economic growth fostered expectations of a tightening of monetary policy, which, indeed, occurred in late March. The process of rather swift interest rate convergence has continued, with yields in Ireland, Italy, Portugal and Spain falling significantly more than the "floor" yields in France and Germany. In general, this reflects a combination of favourable inflation and budget performance, which have reinforced expectations that EMU will from its inception have a wider rather than a narrow membership. There was also a conspicuous decline in long-term bond yields in the United Kingdom.

In the United States, yields on 10-year government bonds peaked at some 7 per cent in April, but with the slowing of economic growth in the second quarter of 1997 and moderate inflationary pressures rates fell back in the second quarter. Yields continued to fall in the third quarter and in September 1997 were some 0.3 percentage points lower than in January 1997.

In Japan, the average monthly yield on 10-year bonds fell to only 2.2 per cent in September 1997, probably the lowest of such interest rates in the world economy. Adjusted for the current inflation rate, long-term interest rates were below 0.5 per cent in September 1997. But these exceptionally low rates have failed so far to stimulate the interest-sensitive components of demand.

The dollar appreciated strongly against the deutsche mark in the course of 1997: the average monthly exchange rate peaked in August, when it was some 18.5 per cent higher than in December 1996 (chart 1.2.4). The demand for dollars was supported by interest differentials, both long-term and short-term, in favour of dollar-denominated financial assets. Lingering expectations of a possible tightening of monetary policy in Germany tended temporarily to support the deutsche mark. Perceived uncertainties about the timing and membership of EMU have also influenced the exchange rate. The demand for dollars weakened somewhat in September and October against the background of accentuating currency crises in south-east Asia and a slight tightening of monetary policy in Germany.

The other significant development in the foreign exchange markets in 1997 has been the sizeable appreciation of the pound sterling against the deutsche mark and other west European currencies (chart 1.2.5). The average monthly deutsche mark/pound sterling exchange rate rose by nearly 14.5 per cent between December 1996 and August 1997. Accordingly, the dollar appreciated by only some 3.5 per cent against the pound sterling over the same period. As was the case for the dollar, demand for sterling weakened somewhat in September.

Since the exchange rates of most other west European currencies against the deutsche mark were relatively stable, they depreciated by broadly the same amount against the dollar and sterling as the deutsche mark.

The appreciation of the dollar against the yen since the second half of 1995 was partly reversed in the second quarter of 1997 (chart 1.2.5), but the dollar started to appreciate again in the following months. The yen/dollar rate rose by 6.1 per cent between December 1996 and September 1997. There has therefore been quite a sizeable appreciation of the yen against most west European currencies, with the exception of the pound sterling.[34]

The dollar/yen exchange rate was influenced by the renewed weakness of the Japanese economy which supported expectations that the Japanese central bank was unlikely to raise official interest rates in the short run. The demand for yen was also affected by the spreading currency crises in south-east Asia and the implications of adjustment policies on exports from Japan to the region. Both factors have tended to strengthen demand for the dollar. In contrast, the surge in the Japanese current account surplus in 1997, and the associated fears of trade policy tensions, appear to have temporarily supported the yen.

The appreciation of the dollar and pound sterling have been major factors in a pervasive and, in general, significant improvement of the price competitiveness of companies in continental Europe in the course of 1997. The mirror image of this was the deteriorating competitiveness of United States and United Kingdom products. In the case of France and Germany, the relative price competitiveness of the early 1990s was restored in summer 1997 (chart 1.2.5). In the United Kingdom, the rise in the real effective exchange rate in 1997 has wiped out all the gains in price competitiveness achieved with the sizeable depreciation of sterling that occurred in the wake of the suspension of United Kingdom membership in the ERM in autumn 1992 (chart 1.2.5). In Italy, the real effective exchange rate was still significantly lower in summer 1997 than in the period preceding the ERM crisis in late summer 1992, but there has been a substantial deterioration in competitiveness since early 1995. The real effective exchange rate of the dollar which has been tending to rise since the second half of 1995, appreciated

[34] The average monthly yen/deutsche mark exchange in September 1997 was 7.8 per cent lower than in December 1996.

further during the first nine months of 1997. In April 1997 it was at its highest level of this decade. The dollar appreciated in real effective terms by 5 per cent between December 1996 and August 1997. In fact, compared with its previous low point in May/June 1995, the appreciation was 16 per cent. There has also been a substantial fall in the Japanese real effective exchange rate since mid-1995 which has fully reversed the sharp appreciation which occurred between early 1992 and spring 1995.

(v) The short-run economic outlook

Current *economic forecasts for 1998*, which were prepared in late summer and at a time when the crisis in world financial markets was still unfolding, indicate a moderate acceleration in GDP growth in western Europe. In the four major economies, real GDP growth should be about 2¾ per cent, which is about half a percentage more than in 1997. Higher output growth in France, Germany and Italy will be somewhat offset by a deceleration in the United Kingdom. The economic performance of the smaller economies is forecast to remain quite favourable, with an average growth rate of some 3 per cent in 1998, broadly the same as in 1997. The upshot is that there is likely to be a slight acceleration in the average GDP growth rate for western Europe as a whole, to somewhat less than 3 per cent. This improved performance is based on the assumption of a strengthening in domestic demand and a continuing robust export demand. Among the components of domestic demand, private consumption expenditures is expected to gain some more momentum, largely on account of the favourable impact of higher employment growth on aggregate personal incomes and, on average, a slight decline in the savings ratio. Forecasters also expect a marked strengthening of business expenditures on machinery and equipment. Export growth is expected to remain, on average, quite strong, albeit slightly less than in 1997. This deceleration reflects in the main the waning influence of the depreciation of west European currencies against the dollar, and the slowdown of domestic demand growth in the United States and the United Kingdom. Changes in real net exports should support overall economic growth in 1998.

The rise in output levels, however, is unlikely to lead to more than just a slight improvement in the labour markets. Employment could rise by some 1 per cent in 1998 and the average unemployment rate might fall slightly below 11 per cent. Inflationary pressures are likely to remain subdued.

These forecasts assume that *monetary policy* will remain accommodative, although further upward pressure on short-term interest rates in Germany is expected as the Bundesbank aims at fostering the process of interest rate convergence in the run-up to EMU. It remains to be seen to what extent the associated restrictive effects will be offset, on average, by the stimulus derived from declining short-term rates in Ireland, Italy, Portugal and Spain. *Fiscal policy* will have to remain tight given the targets embodied in the Stability and Growth Pact – but, in general, the restrictive impact is forecast to be significantly smaller than in 1997.[35]

In the *United States*, the rate of economic growth will slow down to some 2.5 per cent in 1998. The factors behind this slowdown are an assumed moderate tightening of monetary policy, the restraining effect of the dollar appreciation on exports, some cyclical weakening of investment, and a slowdown in personal consumption expenditures on account of a lower growth of employment and a rise in the savings ratio. Real net exports will remain a drag on domestic activity levels. Short-term interest rates are forecast to rise only moderately in the course of 1998 while long-term bond yields are not expected to rise much either. The major uncertainties concern the dollar exchange rate and the behaviour of wages. With unemployment at very low levels and a continuing growth in the demand for labour, there are fears that wage pressures could be mounting and might trigger a wage-price spiral. Also, the favourable impact of the dollar appreciation, if not continuing, on import prices will wane in 1998. A dollar depreciation will lead to upward pressure on import prices.

In *Japan*, growth forecasts for 1998 have been downgraded significantly given the persistent weakness of economic activity in the wake of the output collapse in the second quarter of 1997. Real GDP is likely to increase by only some 1.5 per cent, with the major support coming from increased exports. A lot will depend on the Japanese government’s policy response to the deteriorating economic prospects and the spillover effects from the crisis in south-east Asia. The government is committed to fiscal rigour in view of the recent deterioration in government financial balances and the high level of government debt, but there are pressures to introduce new measures to stimulate economic activity.

The short economic outlook for the world economy, however, is now surrounded by a large margin of uncertainty on account of the turbulence in global financial markets. This crisis is not yet over. Stock markets are still very volatile in early November and the economic crisis in east Asia has spread recently to South Korea, a country with considerably more economic weight than the countries so far affected. There are also still lingering doubts about the sustainability of the fixed exchange rate regime in Hong Kong. A lot will depend

[35] In a forecast prepared earlier in 1997 the OECD estimated that, on average, the structural budget deficits in the EU countries would decline to 2.1 per cent of potential output in 1998, only slightly down from 2.2 per cent in 1997. OECD, *Economic Outlook*, No. 61 (Paris), June 1997, p. A34, annex table 31.

on whether the fall in stock prices will continue with ensuing negative effects on the balance sheets of the financial and banking sector, notably in Japan.

There are various channels through which the ongoing crises in global financial markets will affect the "real economy" in 1998.

Economic growth in 1998 will be affected by the wealth effect of the sharp fall in equity prices. This will tend to dampen the spending propensity of private households. The slowdown in economic growth in Asia will, moreover, curb the region's demand for foreign goods. In view of the excess industrial capacity generated in several of these countries over past years, it can also be expected that there will be a much reduced demand for western investment goods. This will probably mainly affect Japan, but will also remove a source of dynamic demand growth for producers in western Europe and the United States. Depending on the extent of the slowdown of export demand, there will be second round effects. A stronger than expected slowdown in domestic demand in the United States would be associated with reduced import growth and subsequential negative effects on exports from western Europe and Japan. Similarly, continuing weak domestic demand in Japan will have negative spillover effects in western Europe and North America. A further risk is the spillover of the crisis to Latin America, a market which is important for United States producers. In Brazil growth forecasts have already been cut against a background of higher interest rates and harsh fiscal policy measures introduced to curb the budget deficit.

Depressed domestic demand in East Asia implies that the mainstay of economic growth in the region will be exports. The sharp depreciation of exchange rates has entailed a substantial improvement of price competitiveness. There will therefore be intensified import competition from these countries on western markets, with ensuing downward pressures on domestic prices for traded goods.

On the other hand, the process of portfolio diversification underway will tend to favour the demand for government bonds in western countries, which in turn will put downward pressure on long-term bond yields. So far, however, investors seem to have favoured dollar-denominated bonds. Yields on United States 30-year treasury bonds fell from 6.41 per cent at the end of September to 6.13 per cent on 12 November. In contrast, yields on German 10-year public sector bonds rose over the same period from 5.57 per cent to 5.71 per cent.[36]

Although there could be downward pressure on nominal interest rates in 1998, falling inflation could well mean that real interest rates will not fall proportionately and may even increase. On the other hand, the restraining impact of the fall in stock prices and the Asian crisis on United States economic growth could eliminate the need for a further tightening of United States monetary policy. This could also put downward pressure on yields at the longer end of the maturity spectrum. In fact, on 12 November the Federal Open Market Committee has decided to leave the federal funds rate unchanged at 5.5 per cent, a decision which was expected given the persistent volatility in financial markets.

In *western Europe*, the run-up to EMU must necessarily involve a convergence of short-term interest rates in countries adopting the single currency. Based on rough rules of thumb the average to which rates will converge is reckoned to be around 4-4.5 per cent. This would be tantamount to a further tightening of monetary policy in France, Germany and several other countries. But such a tightening would appear to be conflict with the tendency of inflationary pressures to fall and for some risk that domestic activity may weaken as a result of the crisis in international financial markets.

Much will now depend on policy responses to these changed circumstances.

1.3 Eastern Europe and the CIS

(i) Introduction and short-term outlook

For the first time since 1989 aggregate output in the ECE transition economies was growing in 1997. While there has been positive growth in most of the ECE transition countries during the last two years, the major change in 1997 is that the economic decline in Russia finally seems to be coming to an end. Although there has still not been a start to the recovery in Russia, there was no further deterioration either and this contributed to the positive outcome for the aggregate output of the ECE transition economies as a whole. In the first half of 1997 the pace of aggregate GDP growth in eastern Europe decelerated slightly from 1996 and performance in a number of countries was below official expectations. In contrast, the process of recovery accelerated substantially in the Baltic states: the three economies performed strongly and much better than expected. The picture in the CIS region was mixed but output grew in most of these countries. The economic performance of the transition countries has remained quite heterogeneous in 1997: while the recovery gained momentum in some of them, disappointing setbacks occurred in others.

The growth of some of the central European and Baltic states can be attributed both to strong export performance and to a continuing recovery in domestic demand. The return of consumer confidence in these countries reflects both the progress achieved in

[36] *Frankfurter Allgemeine Zeitung*, 13 November 1997, p. 34.

implementing market reforms and positive expectations for the future. However, large and rising current account deficits, an unexpectedly rapid rise of consumer spending, including spending on durables, as well as a boom in household credit in some countries (Poland, Croatia, some Baltic states, and the Czech Republic before the currency crisis) have started to raise concerns about the pressure of demand and the sustainability of current performance. In the course of 1997 the central banks have intervened on a number of occasions to try to cool down overheating economies.

In general, the progress towards price stabilization continued in most of the ECE transition countries in 1997 although there were some disappointing reversals. While the majority of these economies are either already within or approaching 1-digit rates of inflation, three digit rates re-emerged in Bulgaria, Romania and Tajikistan in 1997; inflation was also on the rise in Albania, Armenia and Belarus. These reversals – which resulted either from financial crises or from a considerable softening in the stance of economic policy – are indicative of the difficulties that the authorities in the transition countries are still facing in their attempts to establish macroeconomic stability. In general, further and concerted policy efforts will still be needed in order to preserve and reinforce the degree of disinflation and price stabilization that has already been achieved.

The recovery of output in the transition countries has so far been mostly driven by steady productivity gains: these have been generated in the process of economic restructuring which has led to a more efficient allocation of productive resources. Thus, since the process of transformation has brought about a major restructuring and reduction in the employed labour force in all the transition countries, the aggregate demand for labour has been quite sluggish during the recovery phase. Despite the relatively strong output growth in eastern Europe in the first half of 1997, total employment in the region has increased only marginally and in the Baltic states as a whole it even declined. The speed of restructuring in the CIS countries seems to be much lower than in eastern Europe, although total employment in the CIS region continued to fall in the first half of 1997. These developments have left the aggregate unemployment level in the ECE transition countries roughly unchanged from 1996.

The international trade of the east European and, especially, of the Baltic states continued to grow rapidly in the first half of 1997, both in volume and in value, with aggregate volumes growing at 2-digit rates. Rising domestic demand for final as well as for intermediate goods contributed to the persistence of high import demand in these economies. In turn, the robust growth of exports from the transition countries was stimulated by the cyclical expansion and somewhat stronger import demand in western Europe. However, trade in a number of east European and Baltic states remained highly imbalanced in 1997; as discussed in section 1.3(v), the large and in some cases widening external deficits are becoming a major concern to policy makers in these countries. These current account deficits have been accompanied by record financial inflows, which have both supported and resulted from the eastern countries' strengthening economic positions. This has allowed many of them to increase reserves and sustain output growth despite the deficits reaching a high proportion of GDP. However, the persistence of large capital inflows into several countries risks overheating domestic demand, placing upward pressure on the real exchange rate and, thus, indirectly exacerbating the current account imbalances.

Within the CIS countries, the process of restructuring the geographical composition of trade is still underway and the main tendency for a switch in trade from intra-CIS to non-CIS countries deepened in 1997. The value of total Russian trade (both imports and exports) declined in the first half of 1997 (compared with the same period of 1996), after several years of continuous growth. This development was mostly due to reduced trade with other CIS countries whereas trade with non-CIS countries was less affected. As to the rest of the CIS, the value of their aggregate trade with non-CIS countries increased substantially in the first half of 1997.

No major changes in the pattern of economic performance are expected in the ECE transition countries in the short run. Aggregate GDP growth in eastern Europe for 1997 as a whole is likely to decline slightly in comparison with 1996, due to the slowdown of activity in some of the larger economies in the second half of the year. The CIS, however, expects better end-year GDP figures compared with the first half of the year, mostly due to the expected start of a modest recovery in the Russian Federation. The strong output performance in the Baltic states is expected to continue at a high rate in the short run, although a slight deceleration is forecast in Estonia.

The authorities in most ECE transition economies seem to be quite optimistic about economic prospects in 1998 (table 1.3.1). In practically all the transition countries where official forecasts are available, governments expect either an acceleration of economic growth in 1998 or slightly lower rates than in 1997, although these should still remain quite high. Among the east European countries, the forecasts are somewhat more cautious for the Czech Republic and Romania, countries which are undergoing a process of macroeconomic adjustment. The authorities in Bulgaria hope that the slump is coming to an end and that a significant recovery will start in 1998. Fairly strong growth is expected in most of the other east European and Baltic states. The economic outlook for the CIS countries is also positive, not least because of the expected – albeit modest – recovery in Russia and the bottoming out of recession in Ukraine. If they perform as currently forecast, aggregate GDP in the transition economies could grow by as much as 3 per cent in 1998, which would be the best performance since the start of economic and political transformation.

It is questionable, however, whether the optimistic official views are justified in all cases. These forecasts generally assume a continued strong recovery in the main trading partners of the transition countries. But, it is still unclear as to the extent to which the global financial turmoil in the second half of 1997 will affect economic performance in the developed market economies and what spillover effects this might have on the transition economies. If the financial crisis continues and deepens, it is likely to have wide-ranging repercussions on economic performance in all parts of the world. Since the transition countries are highly dependent on import demand in the developed market economies, especially in western Europe, any eventual slowing down of growth in this region could have a disproportionately large negative effect on the transition economies.

It should also be kept in mind that due to their institutional fragility, the transition economies are especially vulnerable to shocks which may not only cause setbacks to output growth but may also cause serious disarray in their financial markets. Indeed, the disappointing downturns which have occurred in several transition economies in recent years have evolved from crises which demanded emergency austerity measures by the authorities. The major economic crises in Albania and Bulgaria as well as the currency turmoils in the Czech Republic and Romania are a warning to all policy makers in the region. The transition economies and their embryonic financial markets are still rather weak and fragile and even countries that are more advanced in the process of economic transformation are not immune to setbacks. Considerable care is therefore needed in setting policy because even small external disturbances or inconsistencies in the policy mix may lead to major disruptions in economic performance.

(ii) Output and demand

Economic growth continued in 1997 in most parts of *eastern Europe*. Aggregate GDP grew by 3.6 per cent in the first half of the year, which was slightly less than the 1996 average but substantially below the *ex-ante* forecasts (table 1.3.1). The divergent patterns of output performance among the east European transition countries, however, became even more pronounced in 1997. While positive growth continued and strengthened in some countries, the pace of recovery lost momentum in others. In addition, the central European region was badly hit in 1997 by the worst floods in decades. But the moderation in the average rate of growth in this region was mainly due to the economic downturn in parts of south-eastern Europe where the economies of Albania and Bulgaria suffered from devastating financial crises and Romania barely escaped a similar fate in the beginning of the year.

For several years Poland has been the fastest growing economy among the east European transition countries, and strong growth continued in 1997 for the fourth consecutive year. After hitting 7.3 per cent in the first quarter of 1997, GDP grew further by a record 7.6 per cent in the second quarter resulting in a 7.4 per cent year-on-year rate of growth in the first six months. The impressive pace of growth in Poland was reflected in most sectors of economic activity but, in particular, industrial output increased at a double digit rate in the first half of the year (see table 1.3.2). This output performance was supported both by exports – which continued to grow steadily (see table 2.1.3) – and by domestic demand which was buoyed by rising consumer confidence and spending. However, some slowdown in the rate of growth seems to have taken place in the second half of the year both as a result of the heavy floods in July and, especially, the restrictive measures introduced by the central bank to cool down an economy which had begun to show some signs of overheating.

After absorbing the pain of the 1995 stabilization package, the Hungarian economy strengthened considerably and in 1997 is likely to show its best performance in a decade. During the first half of the year Hungarian GDP grew by 3.2 per cent but the pace of recovery has been accelerating in the course of the year and end-year results will probably show an even higher rate. The main supply side factor behind the acceleration of the recovery in Hungary has been a remarkable performance in several manufacturing branches such as motor vehicles, computers and electrical engineering which – after several years of large inflows of FDI – are now dominated by multinationals. Industrial output in Hungary in the first half of 1997 grew by 7.9 per cent (table 1.3.2) and the volume of exports by 21 per cent (table 2.1.3). The export boom was mostly driven by exports of machinery and transport equipment which grew by 37 per cent (in $ value) in the first half of 1997 and reached 44 per cent of total Hungarian exports (table 2.2.4). On the demand side, real investment grew strongly in the first half of the year[37] while consumption recovered more slowly. Although the volume of retail sales in the first six months of the year was below its average in the same period of 1996 (table 1.3.3), a

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[37] By some 9 per cent, according to preliminary estimates of the Central Statistical Office.

recovery seems to have started towards the middle of the year.

Unlike Poland and Hungary, the Czech economy performed much below expectations: GDP grew at a modest 1.3 per cent in the first half of 1997 and industrial output even declined slightly (table 1.3.2).[38] In the wake of the exchange rate crisis in May and faced with growing external imbalances, the authorities were forced to adopt a series of austerity measures aimed at restoring macroeconomic equilibrium. In particular, the government made substantial cuts in its expenditure and the central bank introduced tight monetary restrictions in support of the exchange rate. These measures curbed final domestic demand and led to a marked deceleration of growth.[39] It appears that – although painful and costly – this necessary adjustment is starting to pay off: already in the second half of the year there were signs of improvement in the external balances and an acceleration of output growth in some sectors, particularly in manufacturing. However, it would be premature to conclude that the problems of the Czech economy have been resolved. The main factors underlying the current crisis are rooted in the slow speed of microeconomic restructuring in the country and the authorities have still to address these problems in all their complexity.

As compared with the other central European transition countries, Slovakia stands somewhat apart in terms of economic performance. Output continued to grow very strongly in 1997 (GDP grew by 6.0 per cent in the first half of the year) but there is increased questioning about the sustainability of such a growth rate. The Slovak economy is suffering from problems similar to those in the Czech Republic: a lack of enterprise restructuring, deteriorating competitiveness on international markets, and growing external imbalances. In addition there has been a sizeable budget deficit in recent years. Slovak growth in recent years was mostly supported by expanding domestic demand which, in turn, was boosted by rising real incomes and government spending, mostly on large infrastructural investment projects. Industrial output grew rather modestly in 1996 (2.8 per cent) and even less in the first half of 1997 (2.0 per cent) while the rate of growth of retail sales remained quite high (table 1.3.3). A strong contagion effect from the Czech exchange rate crisis was felt in May and June but, on this occasion, the National Bank of Slovakia managed to defend the currency against speculative attack through interventions on the foreign exchange market and a severe tightening of monetary policy. The effect of this financial turmoil on output was almost negligible in the first half of the year but, if monetary austerity continues, the dampening effects may become more pronounced in the second half. Besides, as the external imbalances in Slovakia cannot be sustained indefinitely at their current levels a major macroeconomic adjustment may be only a matter of time.

In 1997, the upward trend in output continued in both Slovenia and Croatia, albeit at lower rates than initially expected, especially in the case of Croatia (see table 1.3.1). In both countries a major supply side factor has been the strong performance of services (above all, financial services and tourism). There have been delays in the process of enterprise restructuring and hence a strong recovery in manufacturing output has so far failed to materialize. In the first half of 1997, industrial performance in the two countries was dominated by different tendencies. Industrial output in Croatia grew at a relatively high rate (4.8 per cent) but it was mostly driven by growing domestic demand as manufacturing exports stagnated. In contrast, industrial output in Slovenia was growing relatively slowly in this period because of competition from imported consumer and investment goods; but there was a partial offset from growing exports (according to preliminary estimates, in January-July 1997 the volume of Slovenian exports was 8.4 per cent higher than in the same period of 1996).[40] Domestic demand in both countries has been buoyant in recent years thanks to rising real incomes which continued to rise in the first half of 1997. In this period the volume of retail trade in Croatia increased by 5.9 per cent and in Slovenia by some 7.5 per cent (table 1.3.1). However, the unchecked expansion of domestic demand is also one of the main factors behind the growing external imbalances which have reached very high levels in both countries (tables 1.3.4 and 3.1.1).

A number of south-east European transition countries encountered serious difficulties in 1997. After several years of strong growth which, however, was not based on sound fundamentals, the Romanian economy seems to have been sliding into recession in 1997. Romania faced problems at the beginning of the year when the exchange rate became the target of speculative attacks. After an almost twofold nominal depreciation –

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[38] It should be noted that the Czech statistics are in the middle of a major methodological reorganization. Apart from revising backwards the national accounts for the last several years, it includes major changes in the accounting methodologies. Thus, for example, as of 1997, the officially reported index of "industrial production" is based on monitoring a basket of selected products and differs in coverage from the previously reported index of "industrial output in constant prices". This makes the 1997 industrial output figures incomparable with those of previous years.

[39] Investment appears to have been affected most seriously. Preliminary estimates of the Czech Statistical Office indicate that real gross fixed capital formation fell by 2.2 per cent in the first quarter of 1997 and by 5 per cent in the second quarter (reported by the Czech News Agency, CTK-Business News, 9 October 1997).

[40] Institute of Macroeconomic Analysis and Development, *Slovenian Economic Mirror*, Vol. III, No. 8 (Ljubljana), September 1997, p. 6.

which seems to have been a necessary adjustment – and a strong response from the central bank, the nominal exchange rate stabilized and a relative degree of stability in the financial system was re-established. The Romanian government – elected in late 1996 on a programme of decisive reform and a promised break with the piecemeal policies of the past – started an ambitious but painful programme of structural reforms. However, in the short run, the austerity measures undertaken by the government and the monetary authorities have squeezed both the demand and the supply sides of the economy. Indeed, real incomes in 1997 have fallen sharply and, as a result, the volume of retail trade in the first half of the year dropped by almost 31 per cent (table 1.3.3). Following several years of fast expansion, the growth of industrial output decelerated sharply in the first half of 1997 (table 1.3.2) and even turned negative in the second half of the year.[41] It is not yet clear how long it will take the Romanian economy to absorb the shock of this adjustment but its lagged effects are likely to persist into 1998.

The most serious transformational crisis so far among the east European transition countries occurred in Bulgaria.[42] After plunging by 11.7 per cent in 1996, Bulgarian GDP has continued to decline in 1997, by 9.8 per cent in the first half of the year. The Bulgarian authorities and, in particular, the new government elected in 1997, launched a series of reforms aimed at speeding up the process of enterprise restructuring and financial rehabilitation. These included the creation of a currency board which started operating on 1 July 1997. Real incomes and hence final consumer demand were particularly badly hit by the crisis as savings and wages were eroded by hyperinflation. According to preliminary estimates (which may be very unreliable due to the distortive impact of the hyperinflation) the volume of retail trade in the first half of 1997 was some 47 per cent lower than in the same period of 1996 (table 1.3.3). Although the speed of economic decline markedly decelerated in the course of 1997 and public confidence began to rise as some modest signs of recovery appeared in the second half of the year, the carryover effects of the crisis are of such magnitude that their negative impact will affect the Bulgarian economy for some time to come.

The Albanian economy is in a highly depressed state after the collapse of the fraudulent pyramid schemes in early 1997. Moreover, a number of state and market institutions – weak as they were – practically disintegrated in the following period of severe political turmoil. Official data on current economic developments and performance in 1997 are too scanty to reveal the actual state of the economy, but media reports provide evidence of continuing serious economic difficulties. In the short run, Albania will rely mainly on flows of official assistance from the international financial institutions.[43]

The economic situation in the remaining south-east European transition countries was not very sound in 1997 either. There continue to be considerable delays in the reporting of national accounts and other macroeconomic aggregates in some of the successor states of the former SFR of Yugoslavia (apart from Slovenia and Croatia) and at the moment of writing this *Bulletin* very few data were available on macroeconomic developments in 1997. Yugoslavia posted quite high growth rates of industrial output in the first half of 1997 (table 1.3.2); however, it is likely that, for the year as a whole, performance will fall short of the ambitious targets set by the authorities at the beginning of the year (see table 1.3.1). In The former Yugoslav Republic of Macedonia there have been some encouraging signs of increased consumer confidence and, according to preliminary data, the volume of retail trade grew very rapidly in 1997 (see table 1.3.3). However, these data do not appear to be reflected in a matching rate of output growth; industrial output grew only marginally during the same period while the trade balance continued to deteriorate (tables 1.3.2 and 1.3.4).

There was notable growth in output in the *Baltic states* in 1997. The upturn was especially strong in Estonia where the growth rates of both GDP and industrial output in the first half of the year were well above earlier forecasts (table 1.3.1). Indeed, there was accelerating growth in all economic sectors in Estonia, largely boosted, as in Hungary, by sizeable inflows of FDI in recent years. Consumer demand was also picking up in the course of the year supported by growing real incomes. Another factor that added to the expansionary pressures was the continuing inflow of short-term capital from abroad. With increased consumer spending, there has been a large rise in the volume of retail sales in 1997 (table 1.3.3). The unexpected strength of the boom has raised concerns that the economy may be overheating, concerns which are underlined by the fact that the Estonian monetary authorities, which operate a currency board, have very few policy instruments with which to dampen the expansionary pressures.

The pace of growth accelerated also in Latvia in 1997: in the second quarter the rate of growth of GDP jumped to 6.5 per cent from 2.6 per cent in the first quarter, making for 4.6 per cent growth in the first half of

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41 Monthly industrial output in July dropped by 10.7 per cent year-on-year and in August it was 16.3 per cent below its level in the same month of 1996. National Commission for Statistics, *Monthly Statistical Bulletin*, Nos. 7-8 (Bucharest), July-August 1997.

42 For details see UN/ECE, *Economic Survey of Europe in 1996-1997*, pp. 75-84.

43 In August 1997, the newly elected Albanian government, assisted by the IMF, drafted a three-year reform programme aimed at economic reconstruction and a return to stability and growth.

1997. If maintained for the year as a whole, these rates would imply the largest annual increase in output since Latvia regained its independence. In Lithuania, GDP grew at a more modest 2.5 per cent in the first half of 1997 but, with activity picking up in the course of the year, the increase for the full year should be somewhat higher. The relatively good economic performance of Latvia and Lithuania has been related to – and is reflected in – rising consumer confidence. The volume growth of retail sales in both countries has surged in 1997 (see table 1.3.3), while final demand, and especially consumer demand, was probably growing faster than aggregate output. It should be noted, however, that both in Latvia and in Lithuania output growth in the first half of 1997 was mostly due to the expansion of services: transportation and communications in the case of Latvia; trade, tourism and transportation, in the case of Lithuania. Total industrial output in Lithuania was actually declining in 1997 (table 3.1.2) but this was mainly due to a drop in electricity production whereas manufacturing output was increasing.[44] In Latvia, after a poor first quarter, there was a marked improvement in industrial performance in the second and third quarters of the year (table 1.3.2).

Widespread expectations that growth would resume in Russia in 1997 failed to materialize but the decline does finally appear to have come to a halt. Although in aggregate the Russian economy was still stagnating in 1997, there were some positive changes in output together with a notable degree of macroeconomic stabilization. After a somewhat uneven performance during the first two quarters (there was a marginal -0.2 per cent decline of GDP in the first half of the year after growth of 0.3 per cent in the first quarter), some signs of recovery or near-recovery became more pronounced in the second half of the year (the January-September rate of growth of GDP was again positive, at 0.2 per cent). Industrial output in the first three quarters of the year increased by 1.5 per cent (over the same period of 1996) with growth accelerating in the third quarter. Consumer spending – and hence the volume of retail sales – was also starting to pick up in early autumn. There was a marked recovery of output in some manufacturing branches, such as motor vehicles and business equipment, and according to preliminary estimates, the 1997 grain harvest was considerably higher than in 1996.[45] Aggregate demand in 1997 was probably boosted by the measures undertaken by the Russian government to clear the backlog of arrears of wages (in the budgetary sphere) and pensions, since much of these additional payments probably went into higher consumer spending.

However, at the moment of writing this *Bulletin*, there were no clear indications that the Russian economy had definitely turned upwards and the outlook for a sustained recovery was still unclear. Moreover, performance was mixed across sectors and branches. For example, in the first half of the year, the decline in output continued in the energy, construction and transportation sectors as well as in most of light industry; at the same time, real investment in the Russian economy continued to fall and was some 9 per cent lower than in the same period of 1996.[46] It remains an open question as to whether the first signs of recovery will gain momentum and, if they do, how fast the Russian economy can grow in the post-stabilization phase.

Ukraine is probably the country where the transition depression has proved to be most stubborn: the economic decline, which has been underway for eight consecutive years, has continued in 1997. There were some encouraging signs, however, in economic performance: considerable progress was made in macroeconomic stabilization and the rate of economic decline appears to have decelerated in the course of the year. According to preliminary estimates, the fall in GDP in the period January-September slowed to -5.0 per cent from -7.5 per cent in the first half of the year. There was a similar trend for total industrial output (see table 1.3.2) while in some manufacturing industries there was some increase in production. This improvement in output was supported both by relatively strong exports to non-CIS countries and by the start of a recovery in domestic demand. Thus, the volume of retail sales in Ukraine in the period January-September was already 5.0 per cent up from the same period in 1996, whereas in the first quarter of the year retail sales were still below the level of a year earlier (table 1.3.3). These positive trends are expected to continue through the end of 1997.

Similarly to Ukraine and counter to expectations, an economic upturn has still not materialized in neighbouring Moldova either: in the first half of 1997 Moldovan GDP declined by 5.5 per cent while industrial output dropped even more (tables 1.3.1 and 1.3.2). The Moldovan economy is highly dependent on agriculture and two consecutive years of harsh weather (1996 and

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[44] For example, in the first three quarters manufacturing sales increased year-on-year by 1.7 per cent whereas the supply of electricity, gas and water dropped by 9.6 per cent. Department of Statistics, *Economic and Social Development in Lithuania*, No. 9 (Vilnius), 1997. In turn, electricity production in 1997 fell due to stoppages at Lithuania's nuclear power station.

[45] According to preliminary reports of the State Statistics Committee, Russia had harvested 92 million metric tons of grain by 6 October 1997, 30.7 per cent more than in 1996 (reported by Interfax News Agency, News Headlines, 10 October 1997). But the independent agricultural research organization SovEcon estimates Russia's net grain production in 1997 at around 85 million metric tons, an increase of some 20 per cent over the 1996 harvest. Bank of Finland, *Russian and Baltic Economies, The Week in Review*, No. 42 (Helsinki), 17 October 1997.

[46] Government of the Russian Federation/Working Centre for Economic Reform, *Russian Economic Trends*, No. 3 (Moscow), 1997, pp. 76-80.

1997) not only struck the agricultural sector badly but also had wide-ranging, negative repercussions on the rest of the economy. In addition, delays in payments for gas deliveries from Russia led to occasional cuts in gas supply in 1997, which added to the economic difficulties in the country. The failure to meet growth targets led to unexpectedly large budget deficits[47] and growing external imbalances (tables 1.3.4 and 3.1.1) which, in turn, pose a threat to the macroeconomic stability of the country.

In contrast, economic activity in Belarus was booming in 1997, at least according to the official statistics: in the first half of the year GDP reportedly grew at a rate of 11.0 per cent while industrial output was 13.9 per cent higher than in the same period of 1996. Although there are doubts as to the accuracy of these estimates, it does seem clear that the economy of Belarus was growing rapidly in 1997. However, there are concerns about the soundness of the driving forces behind this unexpected economic upturn and, hence, about its sustainability. Increased administrative control over prices and exchange rates as well as over the day-to-day management of the economy, coupled with loose monetary and income policies which have allowed an expansion of soft lending to the enterprise sector, have resulted in a significant – but not market-based – boost to both supply and demand. As suggested by the experience of other transition countries (Romania followed similar policies in 1995-1996) this performance is unlikely to be sustainable in the medium term and – if not corrected in time – is likely to result in a forced, abrupt and painful adjustment.

Developments in 1997 have been generally positive in the CIS countries from the Caucasian rim. In the first half of the year, growth was especially strong in Georgia (GDP reportedly increased by 14.7 per cent over the same period of 1996) boosted by a strong recovery of manufacturing and service activities, in part related to the construction of a new pipeline through the Caucasus. Economic activity was also increasing in Azerbaijan, primarily in the service sector, following the wide-ranging measures of economic liberalization which were undertaken by the authorities in 1997. It should be borne in mind, however, that recovery in these countries has started from a very low base, as the transition depression there was especially severe. On the other hand, developments in Armenia – which was the first of the CIS countries where output had stopped falling in 1994 – were not so favourable in 1997. After several years of relatively sound recovery, the pace of growth decelerated considerably and industrial output even fell in the first half of the year (tables 1.3.1 and 1.3.2).

Among the central Asian CIS states – according to preliminary and incomplete information – the most dynamic performance in the first half of 1997 was in Kyrgyzstan. After a slow start at the beginning of the year, economic activity picked up considerably in the second quarter (first half-year GDP grew by 6.8 per cent) a reflection of large increases in both industrial and agricultural output. According to preliminary estimates, output growth was even higher in the third quarter. In Kazakhstan there was a modest growth of GDP and industrial output in the first half of 1997, most likely because of increased production and export of oil and gas since the other sectors of the economy appear to have continued to stagnate. There was also positive GDP growth (at least in the first half of the year), for the first time after seven years of decline, in Tajikistan as well. After the signing in June of a peace accord between the government and the Islamic opposition, the prospects for an end to the bloody political rivalry improved considerably. However, after almost five years of civil war, the economy is devastated and restoring economic order – along with political stabilization – is likely to take a long time. The official statistics put GDP growth in Uzbekistan at 3.9 per cent in the first half of 1997 but the indications of a sound recovery are still missing. There have been reports of increasing problems in the financial system of the country, while monetary policy has remained persistently loose and the administrative control over the economy still remains quite extensive. The economic situation in Turkmenistan is unclear due to continuing gaps in statistical reporting, but the scarce available information indicates a further large fall in output in 1997. This seems likely to be due to severe shortcomings in the performance of the energy related sectors (especially gas and electricity production) and the negative repercussions of the poor cotton harvest of 1996.

It should be added that the statistical information about current economic developments in some of the central Asian CIS countries is in general still rather fragmentary and not always reliable. Conflicting information is often being reported on one and the same subject by official sources and independent agencies. Official statistics sometimes contain distortions due to political pressure from the authorities, while independent observers do not always have direct access to basic statistical sources. Much caution is therefore needed in interpreting and analysing the current economic situation in this region.

(iii) Costs and prices

[47] The budget deficit for the period January-July 1997 was estimated at roughly 10 per cent of GDP, the same level as for 1996 as a whole. Government of Moldova/European Expertise Service, *Moldovan Economic Trends, Monthly Update* (Chisinau/Brussels), September 1997, p. 14.

Inflation continued to fall during 1997 in the majority of the transition countries. Out of 25 countries,[48] the annualized rate of increase in consumer prices during the first three quarters of 1997 was less than 20 per cent in 19 countries and in 11 of them it was in single digits. Unit labour costs in industry have decelerated or fallen in most countries and profit margins have been able to rise without putting pressure on producer prices. However, both the underlying causes of inflation and the speed of disinflation vary greatly between countries. Moreover, performance was generally disappointing, especially in eastern Europe in that it fell short of targets and expectations and despite the reduction of inflation remaining one of the top priorities of policy.

(a) Consumer prices

In eastern Europe, the divergence in the rates and direction of national rates of inflation was even more pronounced in 1997 than in 1996 (table 1.3.5). Consumer price inflation continued to fall during the first nine months of 1997 only in Hungary, Poland and Yugoslavia. In others the downtrend came to a stop (Croatia) or was even reversed (Slovakia, The former Yugoslav Republic of Macedonia). Furthermore in those east European countries where inflation had picked up again in 1996 (Albania, Bosnia and Herzegovina, Bulgaria, Czech Republic, Romania and Slovenia) it continued to rise in 1997 although at notably varying rates.

In the Baltic countries inflation fell for the fourth consecutive year and the average monthly rates during 1997 remained below those in most of the east European countries. This was a particularly favourable performance considering their late start in the reform process compared with eastern Europe and, above all, the recent strong recovery in their demand. Disinflation was particularly strong in Latvia, but in Estonia the annualized inflation rate during the first two quarters remained in double digits.

In contrast to eastern Europe, there was a large reduction in inflation rates in most of the CIS economies during 1997 and, in several cases surpassed initial targets or expectations. This outcome was mainly due to the continuation of tight macroeconomic (mainly monetary) and stable exchange rate policies, and the spillover effect of the large and sustained fall in the Russian inflation rate. The quarterly rate of change in the latter has fallen steadily from 50 per cent in the first quarter of 1995 to 1.8 per cent in the third quarter of 1997. Furthermore, the recent recovery in output and productivity in some of the CIS countries was able to partly offset the recent acceleration in wage growth. Of the 10 CIS economies for which data are available, half of them will probably end the year with single digit rates of inflation (Azerbaijan, Georgia, Kazakhstan, the Republic of Moldova and Ukraine). In Russia the within-year rate of increase should be well under the 13 per cent foreseen at the beginning of 1997. Among the CIS, inflation accelerated only in Armenia, Belarus and Tajikistan, albeit in the former at a much lower rate. In all three of them loose fiscal and monetary stance of the government played the major role.

Service prices continue to be the fastest rising component of the consumer price index in most of the transition countries (table 1.3.5). This reflects, *inter alia*, the fact that most of the ongoing adjustments to administered prices are still concentrated in this sector. During the summer months seasonal *food prices* fell but in a few east European and CIS countries their average monthly rates of change in the first three quarters were higher than the other two main components of the index. *Non-food goods prices* are still the slowest rising component of the consumer price index (except in Yugoslavia), a reflection to some extent of the increasing competitive pressure from imports. This in turn has been amplified by the strong appreciation of many of these countries' currencies during the last few years against the dollar and, especially, the deutsche mark. Furthermore, developed market economies' export prices for manufactured goods in the first half of 1997 were some 6 per cent lower than in the same period of 1996.[49]

(b) Producer prices in industry

Price changes at the producer level are a rough indicator of the pressures on the cost side of the economy and, *ceteris paribus*, provide an early warning of developments in overall inflation in the short term. During the first nine months of 1997, the average monthly rates of change of producer price inflation accelerated in most of *eastern Europe* (table 1.3.5). There was some deceleration in Hungary and Slovakia, and rather more in Yugoslavia, but in both Hungary and Yugoslavia producer prices increased faster than consumer prices. In Poland, the increase in industrial producer prices accelerated for the first time since 1990 and also rose faster than consumer prices, which in fact continued to disinflate.

In the *Baltic countries* producer price inflation has continued to fall, especially in Lithuania where the monthly rate was less than one tenth of the rate prevailing in 1996. In all the Baltic countries the increase in producer prices was less than for consumer prices, especially so in Lithuania where the litas' peg to the

[48] Turkmenistan and Uzbekistan do not publish consumer price indices.

[49] See table 2.1.10.

dollar protected industry to a large extent from the effect of dollar appreciation on the costs of imported inputs.

In the CIS, producer price inflation continued to fall during 1997 with the exceptions of Armenia, Belarus and Tajikistan, where consumer price inflation also accelerated. In the majority of the CIS, in contrast to 1996, producer prices in 1997 increased less than consumer prices, which may reflect to some extent the recent recovery in consumer demand but also the still highly inefficient service sector.

(c) Wages and unit labour costs in industry

The growth of wages continued to fall in most transition countries during the first half of 1997. However, the year-on-year rate of change in *average nominal gross wages* in industry again rose faster than industrial producer prices with few exceptions (table 1.3.6).[50] *Real product wages*[51] fell strongly only in Romania and Kyrgyzstan and to a much lesser extent, in Yugoslavia, Armenia, Belarus and the Republic of Moldova. In most of eastern Europe, real wages increased in 1997, although by somewhat less than in 1996. In Hungary, they grew some 2 per cent (year-on-year) in the second quarter after falling by nearly 8 per cent in the two previous years. In the other three CEFTA countries,[52] real wage growth slowed down in 1997 but it still remained high: nearly 10 per cent in Poland and around 7 per cent in both the Czech Republic and Slovakia. In the Baltic countries, real wage growth accelerated, especially in Latvia where real wages in the first half were nearly one fifth higher than in the same period of 1996. In Lithuania and Estonia real wage growth was also much higher than in the east European countries, 14.5 and 11.5 per cent respectively. In spite of the continued slowdown in nominal wage growth in most of the CIS countries in 1997, the much smaller increase in prices enabled real wages to start to recover. In Russia, the long period of falling real wages finally came to an end in late 1996 and there was an upturn in the first quarter of 1997. By the third quarter of 1997, real wages were nearly 5 per cent higher than a year earlier, but they were still more than 40 per cent lower than in 1993.

Productivity growth in industry had generally weakened in 1996 and there were few signs of a widespread recovery in 1997. It improved or continued to increase only in four CEFTA countries (excluding the Czech Republic where the gain was less than 2 per cent, down from the 7-8 per cent per annum in the previous three years), Estonia and a few CIS countries, namely Belarus, Kyrgyzstan and to a lesser extent in Kazakhstan and Uzbekistan. In Russia, the six-year downtrend in industrial labour productivity was slightly reversed in 1997, thanks to a fragile recovery in output combined with continued labour shake-out.

Unit labour costs, however, continued to decelerate in most of the east European countries in 1997. They accelerated slightly only in the Czech Republic (due to poor productivity gains) and to a much lesser extent in Romania (mainly because of accelerated wage inflation). One of the most significant slowdowns in unit labour costs was in Poland where the very strong growth of industrial production and labour productivity largely offset the effect of a still high rate of increase in wages. In Croatia and The former Yugoslav Republic of Macedonia, unit labour costs actually fell for the second consecutive year, in both because of intensified labour shake-outs in industry. In all the CIS countries, except Turkmenistan, unit labour costs in the first half of 1997 rose less than in 1996. However, with labour productivity still falling or rising weakly, the rate of change in unit labour costs generally remains high. In most CIS economies, the downtrend in unit labour costs during the last two years was mainly due to lower wage growth. In contrast to most of the other transition economies, industrial labour costs accelerated in Latvia and Lithuania, in the former mainly because of accelerated wage growth and in the latter a combination of strong wage growth and a sharp decline in industrial productivity, mainly in the energy sector in the first quarter. Wage growth was also strong in Estonia, but a nearly 15 per cent increase in productivity considerably weakened the impact on unit labour costs.

In contrast to 1996, unit labour costs in industry in the first half of 1997 increased less than producer prices in most of the transition countries. In eastern Europe, *real unit labour costs* weakened considerably, with the exception of the Czech Republic: in Slovakia and Slovenia the rate of increase decelerated considerably and in the rest they actually fell. In most of the CIS economies, real unit labour costs either fell further (Armenia, Belarus, Kyrgyzstan and, to a much lesser extent, Russia) or increased at much slower rates than in 1996. Import price pressures in 1997 were subdued because of weak world market prices for commodities and intermediate goods plus the effect of stable or appreciating exchange rates. Given favourable productivity growth and/or real wage disinflation, unit profits in industry could increase in most of the transition economies without fuelling inflation.

(iv) Employment and unemployment

There was little improvement in the labour markets of the transition economies in the first half of 1997. In

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[50] There are no wage data for Albania, Bulgaria, Georgia and Turkmenistan.

[51] Average nominal gross wages deflated by the producer price index.

[52] Romania, which joined CEFTA in 1997, is not included here.

eastern Europe, the favourable trends in *employment* which had started in some countries in 1994-1995 and, then decelerated in 1996, did not gain any further momentum. Employment grew only in Poland and Romania, and in the latter the data should be treated with caution. In the other countries of the region, employment stagnated or continued to fall. Employment also continued to decline in most of the CIS, in some of them at considerably higher rates than in 1996. In the Baltic states, there was a small increase in employment in Lithuania, but it continued to fall in Estonia and Latvia.

The *level of unemployment* declined in eastern Europe, but this was mainly due to a large fall in Poland (nearly 500,000 people or more than 20 per cent in the 12 months to September 1997) which largely offset the increase in most of the other countries. *Unemployment rates* have continued to rise in most countries and at the end of September 1997 varied for the most part between 10 and 17 per cent. In the Baltic states, both the level and the rate of registered unemployment declined considerably in Estonia and Lithuania, but remained unchanged in Latvia. In September 1997, the average unemployment rate in the three countries was just below six per cent. The total number of unemployed in *the CIS* increased slightly during the 12 months to September 1997, and the officially registered unemployment rates still remained deceptively low, for the majority varying between 0.4 per cent and 4 per cent.

(a) Employment

The level of employment in the transition countries declined from some 193 million in 1989 to less than 170 million in 1996, or just above 12 per cent in aggregate. The fall was most pronounced in eastern Europe and the Baltic states (some 16 per cent). In the CIS countries, where restructuring was delayed or slow, the decline in employment was only about 11 per cent despite a much deeper and longer output recession.

The available quarterly data suggest that in the first half of 1997, employment in eastern Europe increased by 0.5 per cent. It had increased in 1996 in the Czech Republic, Poland and Slovakia, but a relatively high rate of growth (1.7 per cent) could only be sustained in Poland in 1997 (table 1.3.7), where strong output growth continued for a fourth consecutive year. Employment stagnated or even declined slightly in the Czech Republic where a series of austerity measures aimed at restoring macroeconomic equilibrium led to a marked slowdown in output. In spite of the continued strong growth of output, employment also stagnated in Slovakia which, to some extent, may reflect the presence of excess employment due to the lack of enterprise restructuring. In contrast, employment appears to have increased for the first time in Romania[53] and the fall in employment appears to have bottomed out in Hungary where the level of activity strengthened considerably in 1997. In the other countries for which data are available, employment continued to decline in the first half of 1997, at similar rates to those in 1996, although in Croatia the decline accelerated despite the continuing growth of output.[54] In Bulgaria, although quarterly data are not available, employment has probably declined sharply in 1997 given the large fall in output.[55] The slow recovery in east European employment in the first half of 1997 was thus mainly due to Poland which accounts for more than one third of total employment in eastern Europe. An increase of 256,000 new jobs in Poland largely offset the deterioration of employment in the rest of the region.

Despite the notable improvement in output, total employment continued to decline in Estonia and Latvia in the first half of 1997, although the rates of decline slowed down. In Lithuania, employment continued to increase slightly for the second consecutive year, mainly due to the growth of employment in services and in manufacturing.

In the *CIS*, despite the upturn in output which started in many countries in 1996 and which strengthened and became more widespread[56] in 1997, the fall in employment accelerated in the first half of 1997, which is probably a sign of the start of the much delayed restructuring of enterprises and the intensification of the overall reform process. Employment continued to decline in the majority of countries with the main exceptions of Tajikistan, Uzbekistan and perhaps Georgia. The continuing weakness of employment despite the recent economic upturn in some of the CIS suggests the

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53 It is difficult to judge how much of the 2.5 per cent increase in employment in the first half of 1997 was due to the lagged effect of the previous four consecutive years of economic growth and how much was just a statistical artefact due to the introduction of a new quarterly employment series with a full coverage based on the labour force survey introduced since 1996. The large increase in employment should be viewed with caution as the Romanian economy weakened and seemed to be sliding into recession during the course of 1997. Restructuring of inefficient industries has already led to bankruptcy in a number of small- and medium-size economic units and has resulted in the loss of some 200,000 jobs. In the view of some experts this figure could double by the end of the year. *BBC Summary of World Broadcasts*, EEW-0505, 25 September 1997. Furthermore, a lagged employment response to the recent measures is plausible. In the first quarter of 1997 employment increased by 5.5 per cent over the same period of 1996 but it declined by 0.6 per cent in the second quarter.

54 The decline of nearly 3 per cent in employment in the first half of 1997, against a background of continued economic upturn (GDP grew by 4 per cent and industrial output by nearly 5 per cent), might be partly explained by statistical deficiencies: Croatian quarterly data on total employment contain only workers in paid employment in business entities with more than 10 employees.

55 Bulgarian GDP fell by nearly 12 per cent in 1996 and continued to decline by 10 per cent in the first half of 1997.

56 In the first half of 1997, output recession continued only in the Republic of Moldova, Turkmenistan and Ukraine, while in Russia the GDP stopped falling.

presence of considerable degrees of excess employment which permits enterprises, particularly in industry, to increase their output significantly without increasing their work force.[57] The divergence between output and employment growth in some of the east European and Baltic countries suggests that excess employment, albeit to varying degrees, also exists in these economies.

(b) Unemployment

The total number of registered unemployed in the transition countries as a whole, fell during 1997 for the first time since the transition process started. Nearly 14 million people were unemployed at the end of September 1997, one per cent less than a year earlier (table 1.3.8).

In *eastern Europe* as a whole, the level of unemployment continued to fall during 1997 and at the end of September stood at 5.8 million, 4 per cent less than a year earlier and 23 per cent below its peak in March 1994. However, in contrast to 1996 and particularly 1995, when the decline was significant and widespread, in 1997 the fall in unemployment was confined to Hungary, Yugoslavia and, especially, Poland. In Hungary and Yugoslavia, where employment continued to decline, the fall in unemployment mainly reflects departures from the labour force. But in Poland, the decline was mainly due to an increase in the number of new jobs.[58] Unemployment increased sharply in Bulgaria and the Czech Republic (in the latter increasing by nearly one half and rising above its 1991 peak level).[59] In the other countries of the region, the number of unemployed continued to rise at rates of between 6 and 10 per cent. The decline in unemployment in the region as a whole was mainly due to Poland where the number of unemployed fell by nearly half a million in the 12 months to September 1997, reaching its lowest level since July 1991.

Given the rise in the number of unemployed in most of the east European countries and the contraction of the labour force in some of them, the average *rate of unemployment* fell only slightly and remained high (table 2). In September 1997, it was just above 11 per cent (0.4 percentage points less than a year earlier), with most countries falling within a range of 10 per cent (Hungary) to 17 per cent (Croatia). The notable exceptions were the Czech Republic, where the rate, despite increasing, still remained very low at 4.8 per cent,[60] and Romania where it also increased but stood at 6.9 per cent.[61] In contrast, unemployment rates remained exceptionally high in The former Yugoslav Republic of Macedonia and Yugoslavia, reaching some 42 and 25 per cent, respectively, even though the rate fell in the latter.[62]

Both the level and the rate of registered unemployment, in the 12 months to September 1997, declined considerably in Estonia and Lithuania, but was unchanged in Latvia. In September 1997, unemployment rates ranged between 4.6 per cent in Estonia and 7.1 per cent in Latvia.

In contrast to eastern Europe and the Baltic states the total number of unemployed in *the CIS* increased slightly, by about one per cent, in the 12 months to September 1997, reaching 7.9 million for the region as a whole. Nevertheless, officially registered unemployment rates still remained very low, and, in September 1997, varied between 0.4 per cent (Uzbekistan) and 4 per cent (Kazakhstan), the only exception being Armenia, where it exceeded 10 per cent.[63]

(v) External imbalances and financial vulnerability

The severe financial crisis which swept across south-east Asia in 1997 with strong repercussions on

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[57] For a detailed discussion see UN/ECE, *Economic Survey of Europe in 1996-1997,* pp. 111-114.

[58] Nonetheless, there was also the statistical effect of a narrower definition of the unemployed. Since January 1997, the number of registered unemployed neither includes people receiving pre-retirement benefits nor people attending training or internships with employers. GUS, *Poland,* Vol. V, No. 2 (Warsaw), September 1997, p. 15. Also in Hungary, from the beginning of 1997, the definition of registered unemployment has changed: those losing their entitlement temporarily are no longer counted as unemployed. The unemployment rate in March on the basis of the new definition was 11.0 per cent, while the figure calculated according to the old method was 11.6 per cent. National Bank of Hungary, *Monthly Report,* No. 5 (Budapest), 1997, p. 10.

[59] For several years, the Czech authorities have managed to keep unemployment at very low levels, *inter alia*, due to slow micro-level restructuring. Since June 1997, unemployment has 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 the workforce in order to increase productivity and improve competitiveness.

[60] Government officials estimate an unemployment rate of 5 to 6 per cent at the end of 1997 and it may climb up to 7 or even 8 per cent in 1998. Reuters News Service, 7 October 1997.

[61] On 7 August 1997, as a part of the restructuring programme agreed with the IMF, the Romanian government shut down 17 unprofitable state-run enterprises, accounting for 30,000 jobs. The country is expected to end 1997 with an unemployment rate of 8 to 10 per cent, up from 6.3 per cent at the end of 1996, if restructuring and liquidation of unviable entities continue and a second wave of closures occurs before the end of the year. *Oxford Analytica East Europe Daily Brief(c),* 30 September 1997; see also "Romanian economic monitor", *PlanEcon Report,* Vol. XIII, Nos. 29-30 (Washington, D.C.), 11 September 1997.

[62] The exceptionally high rates in the two former Yugoslav republics, however, to a significant extent reflect deficiencies in the measurement of total employment and therefore of the labour force. For more details see UN/ECE, *Economic Bulletin for Europe,* Vol. 48 (1996), p. 33, footnote 71.

[63] These low rates of registered unemployment in the CIS reflect not only excess employment but also the omission of large numbers of the jobless who are willing to work but who, for various reasons, do not appear in the numbers *registered* as unemployed. This is confirmed by the much higher rates of unemployment, similar to those prevailing in eastern Europe, which emerge from the labour force surveys conducted in a number of these countries.

financial markets around the world raised certain concerns about the stability of the currencies and the financial systems in the transition countries. In fact some transition economies have also been subject recently to financial turmoil: Bulgaria was hit by a major financial crisis in 1996; and the collapse of large-scale pyramid schemes in Albania resulted in a grave economic and political crisis at the beginning of 1997. In the first half of 1997, speculative attacks on currencies caused serious disturbances on the financial markets of Romania and the Czech Republic; in the latter case the authorities were forced to abandon the fixed exchange rate regime which had been in place since 1990 whereas in Romania the exchange rate crisis resulted in a large devaluation and an upsurge in the inflation rate. These developments have attracted a lot of public attention as to the likely causes of the financial turbulence in the emerging markets, especially in south-east Asia but also in Europe, and have led some observers to ask whether currency-*cum*-financial crises may spread to other transition countries as well.

One of the sources of concern for the European transition countries are their growing external imbalances. Indeed, a number of these countries have been running sizeable and often increasing trade and current account deficits in recent years (tables 1.3.4 and 3.1.1). External imbalances *per se* do not necessarily lead to currency collapse and/or financial turmoil. As a matter of fact, they are a natural consequence of a process of recovery (as is the case in eastern Europe), which may result from the strengthening of consumer and investor confidence and a rate of growth of domestic demand and absorption which exceeds the growth of domestic output. On the other hand, balanced trade and current accounts *per se* are not a safeguard against financial distress: for example, Bulgaria, which experienced the most serious financial crisis among the European transition economies, was not among the countries with large external deficits (tables 1.3.4 and 3.1.1). Current account deficits were not the main – or at least not the sole – determinants of the collapse of the south-east Asian currencies either.

External imbalances – although useful as warning indicators – therefore need to be considered in the framework of a whole set of macro- and microeconomic issues which may contain the underlying factors behind currency and/or financial turmoil. Several can be mentioned. One of the important factors is related to the sources of financing of the current account deficit. If the latter is predominantly financed by a steady inflow of long-term capital and, in particular, by FDI which enhance the future growth potential of the country, then it should not, in general, be a cause of additional concern. Conversely, a high level of exposure to short-term capital inflows may increase the financial vulnerability of the country. Short-term flows, driven to a large extent by interest rate differentials, are characterized by higher volatility which may induce an overreaction to a perceived problem; if such flows are sufficiently large, their sudden retreat may result in “overshooting” and a currency crash. For example, it is considered that the relatively large share of short-term capital flows in the Czech capital account in recent years (see chapter 4) was one of the factors that undermined the stability of the Czech exchange rate regime resulting in a run on the currency in May 1997. The share of short-term capital inflows has been quite significant also in Croatia, Russia, Slovakia, Slovenia, the Baltic countries and – after the exchange rate adjustment in February 1997 – in Romania as well.

Another factor is related to the sources of the boom in domestic demand that causes the imbalance. If the trade and current account deficits are used to finance primarily investments in fixed capital which are expected to generate future returns in the form of an acceleration in the growth of domestic, tradeable output (eventually closing the deficits), then the country may be on the safe side. On the other hand, if they are mainly driven by persistent “consumers’ exuberance”, then there exists the danger that the deficits will also become persistent as they will not generate the compensatory expansion and upgrading of the productive capacities of the economy. As discussed above, a boom in consumption demand has been in place for some time in some of the east European transition countries. It became even more pronounced in 1997; moreover, in some cases it has been accompanied by a rapid expansion of consumption-related credit (Croatia, Estonia and Poland). This may be a warning to policy makers in the affected countries.

In addition, it should be noted that the true fundamental determinants of an external imbalance might not be easy to detect in “real time”. The detailed statistics that would allow the market participants to draw analytically sound conclusions are usually available only with a considerable lag, whereas investors have to make day-to-day decisions on their portfolios, usually on the basis of limited and incomplete information.[64] Thus the market may tend to overreact to any perception of an “excessive” current account deficit regardless of its main determinants.

External imbalances and capital inflows are usually accompanied by a real appreciation of the exchange rate, which is a macroeconomic consequence of this type of disequilibrium. This takes place through different channels – either through inflation or through nominal

64 Moreover, an analyst would need to dig deep into the very detailed trade and national accounts statistics in order to correctly detect and identify the true causal relations; to make things even more confused, in some cases a current account deficit may be driven by a combination of different factors. On some of the problems with current trade statistics, see chap. 2 below.

appreciation – depending on the exchange rate regime and on the policy response.[65] Regardless of the actual mechanisms of real appreciation, it may lead to a loss of competitiveness in the tradeables sector and a further deterioration of the external balance.

As is discussed in chapter 2, there has been a trend towards real appreciation in most of the European transition countries in recent years. It has occurred both in countries which adhere to a fixed or pegged exchange rate (the Czech Republic, Poland, Slovakia and the Baltic states) and in those which maintain a floating exchange rate regime (Croatia and Slovenia). In the Czech Republic, Slovakia and Slovenia this process was accompanied by a marked deterioration in competitiveness; Poland was less affected because of a higher rate of productivity growth. On the other hand, Hungary which avoided a large real appreciation and had the highest rate of productivity growth, also achieved the largest gains in competitiveness (see chart 2.2.1).

External imbalances may in principle also reflect overspending by the government (the so-called "twin deficit" problem). Twin deficits indicate simultaneous domestic and external weaknesses of the economy and if left unchecked, may eventually pose a serious threat to macroeconomic stability. Persistent, large fiscal deficits alone may lead to similar results, especially if they are monetized. Most of the transition countries which adhere to (or have completed) reform programmes monitored by the international financial institutions, have made substantial progress in reducing their fiscal deficits. However, given the fragility of their macroeconomic environment and the ongoing and turbulent process of restructuring, the potential dangers still exist. An unsustainable fiscal and quasi-fiscal deficit was one of the fundamental sources of the financial crisis in Bulgaria; the financial destabilization in Romania at the beginning of 1997 was also partly due to a dangerous escalation of the quasi-fiscal deficit. The emergence of a twin deficit problem was one of the important macroeconomic signals that prompted the stabilization programme in Hungary in 1995 resulting in a major macroeconomic adjustment. Judging by the developments in 1996-1997, it appears that the Republic of Moldova may also be starting to develop a twin deficit problem (see table 3.1.1 and the discussion in section 1.3(i)).

While external imbalances may be an important ingredient of a currency-*cum*-financial crisis they are by no means the only possible source. A major role in the currency crisis in Asia was played by the underlying structural weaknesses of the domestic banking and financial sectors against the background of a rapid expansion of credit and inadequate banking supervision.[66] Among the European transition countries, the financial crises in Bulgaria and Albania were also caused mostly by domestic factors (such as the weakness of the financial system and a lack of progress in restructuring).

The state of the banking system is one of the fundamental determinants of overall financial stability. Experience in a number of countries shows that financial turmoil often develops as a "double drain" crisis, that is, a simultaneous run on the currency and on the banking system as investors trying to escape from a depreciating currency withdraw their funds from the banking system. If the banks have been weakened by incautious lending and the low quality of their assets, they may collapse, even in the face of a minor run, and this will trigger an additional loss of investors' confidence and more instability. In fact, this is how the currency-*cum*-financial crisis in Bulgaria escalated very rapidly in mid-1996. A number of banks and, hence depositors, also fell victim to such a process in the wake of the currency crisis in south-east Asia.

The banking sector in most of the transition countries is still rather weak: banks are burdened with inherited and new bad loans; bankers are still learning how to implement sound banking practices in a market environment, and regulation and supervision are not always adequate for dealing with the specific situation of the transitional environment. Thus, a strengthening of the banking system should be a priority concern to policy makers in these countries trying to attain overall financial stability.

Whether or not external and/or domestic weaknesses will develop into a currency crisis depends on a number of additional factors and features of a given economy. Foreign currency reserves are one of the first shock absorbers at the disposal of the authorities in the event of a speculative attack on the currency. The higher the level of reserves in relation to the domestic money supply, the stronger is the barrier they can provide. But it is important to point out that – as has been demonstrated in numerous examples of currency crises in all parts of the world – if the attack is persistent, the authorities must eventually give up such a defence either because they run out of reserves, or because it becomes unacceptably

[65] If the capital inflow is accommodated through unsterilized intervention by the central bank, it will result in a monetary expansion with accompanying inflationary pressures and, in a fixed exchange rate regime, rising inflation will cause a real appreciation. Sterilized intervention (in which the central bank withdraws liquidity from the market by selling securities – see chap. 4) may provide a temporary relief in such cases. However, apart from being costly, such a contractionary intervention drives interest rates higher and may induce further capital inflows to the bond market. In general, any tightening of monetary policy (for example, aimed at curbing aggregate demand) will preserve or even increase the pressure on the real exchange rate. On the other hand, allowing the nominal exchange rate to appreciate in the case of a flexible exchange rate regime will at the same time result in real appreciation.

[66] For more details, see section 1.1(ii) above.

expensive to continue, or because refusing a currency devaluation may have other significant negative side effects. Thus, although most European transition countries at present are endowed with substantial foreign exchange reserves (see table 3.1.5), this is by no means a guaranteed shield against speculative attacks. In coping with such an attack on the currency, the authorities must also be careful not to set in motion another vicious circle: monetary austerity and contraction (which is often the main tool for defending the currency against a run) may tip the economy into a recession which will weaken further the banking system and this, in turn, may put further pressure on the currency.

Finally, with the globalization of financial markets the susceptibility of individual economies to "imported" adverse impacts has increased considerably. Financial turbulence tends to be "contagious" and spreads very fast affecting even economies with sound fundamentals which otherwise might not have been attacked. As is shown by the developments in 1997, the turmoil in south-east Asia started as a local currency crisis in Thailand but soon became a global epidemic affecting currencies and stock markets all over the world.

Contagion in currency crises can take various forms but two of them seem to be prevailing. First, if a group of countries exports similar products on the same markets and one of them devalues, it obtains a unilateral competitive advantage over the others. In turn, the latter will have an incentive to devalue as well in order to restore their competitive position. It is considered that such a process of competitive devaluation triggered a domino effect in south-east Asia once the peg of the Thai baht was abandoned.

It might be questioned whether the run on the Czech koruna in early 1997, which resulted in a similar departure from the currency peg, was contagious for the other European transition economies. Indeed, in the wake of the Czech crisis there were runs on the currencies of some neighbouring countries. However, these were limited, at least so far. The likely reason is that the exchange rate regimes in most of the "competitor-countries" are less rigid than that in the Czech Republic (with the exception of Slovakia where it is essentially the same) and allow for possible adjustments of the nominal exchange rate either under a crawling peg (Poland and Hungary) or under a floating regime (Croatia and Slovenia). Actually, in 1997 the direction of causality in central Europe was probably just the opposite: it was the Czech devaluation of 1997 that was the result of contagion caused by the loss of competitiveness vis-à-vis the neighbouring countries[67] that had built up in recent years because of adherence to a fixed exchange rate (see also chart 2.2.1). However, it remains to be seen whether the currency devaluations, in the south-east Asian countries, which are competitors for the ECE transition economies on the west European markets (e.g. in textiles and clothing), will lead to a further weakening of currencies in the ECE region.

The second form of contagion is related to investors' behaviour in a crisis. When signs of trouble are detected in one country, risk averse investors are often inclined to associate it with neighbouring countries (or countries with similar characteristics) as well. This effect has probably intensified with the diversification of investors' portfolios in the global market when collecting detailed information on the fundamentals of individual countries may be too costly and time-consuming. It is also frequently argued that investors often tend to display "herd" behaviour so that when one of them panics and starts to sell (or vice versa), it is very likely that others will blindly follow suit. Such types of behaviour may be self-fulfilling and so crises can develop even if all the fundamentals of a given economy are perfectly sound (e.g. when the turmoil initially spreads from a neighbouring country).

Due to their immature markets and weak institutional structures, the transition economies are especially vulnerable to external shocks and pressure. The recent experience in Albania and Bulgaria shows that once a crisis occurs in such an environment, it can have catastrophic consequences for the economy and for the whole population. Although – as discussed above – there cannot be complete immunity against speculative attacks, governments in the transition economies can still do a lot to minimize the risks of the emergence of a crisis. Adherence to consistent and prudential macroeconomic policies and the avoidance of unsustainable external and domestic imbalances can help to reduce the vulnerability of the economy to currency crises and other unexpected shocks. Institutional and structural reforms – especially the strengthening of the banks and other financial institutions, coherent and effective supervision and regulation of financial markets, enterprise reforms, etc. – are also essential elements of an overall strategy for financial stability. A stable and sound banking and financial system in general is a prerequisite for further financial liberalization and the full opening of the financial markets in the transition countries (including the liberalization of their capital accounts) and their integration into the global financial market.

[67] For an identification of clusters of competitive transition economies, see chap. 2.

TABLE 1.1.1

Exchange rates against the dollar, 1993-1997[a]
(Percentage change)

	Dec. 1993/ Jan. 1994	*Jan. 1994/ Jun. 1995*	*Jun. 1995/ Jun. 1997*	*Jun. 1997/ Oct. 1997*
China (*Yuan*)	49.8	-4.6	–	-0.1
Hong Kong (*Dollar*)	–	0.1	0.1	-0.1
Indonesia (*Rupiah*)	0.4	5.9	9.2	45.7
Malaysia (*Ringgit*)	5.5	10.2	3.2	31.0
Philippines (*Peso*)	-0.2	-7.4	2.7	30.2
South Korea (*Won*)	0.1	-6.1	16.7	4.3
Thailand (*Baht*)	0.3	-3.4	-0.6	53.0
Taiwan Province of China (*New Taiwan dollar*)	-1.0	-2.7	8.2	6.4
Japan (*Yen*)	1.4	-24.1	35.0	5.9

Source: Federal Reserve Bank of New York, internet website of the United States Federal Reserve Board; IMF, *International Financial Statistics* (Washington, D.C.), various issues*;* Reuters Business Briefing, online Database.

Note: Average monthly exchange rates. National currency units per dollar. A positive sign indicates a depreciation against the dollar.

TABLE 1.1.2

Changes in share prices, 1997
(Per cent)

Country	*Index*	*1 Oct. 1997/ 7 Nov. 1997*	*1997 High/ 7 Nov.1997*
France	CAC 40	-11.6	-12.7
Germany	DAX	-11.8	-16.6
United Kingdom	FTSE 100	-10.4	-10.6
United States	Dow Jones	-5.4	-8.2
Japan	Nikkei 300	-13.0	-21.0
Hong Kong	Hang Seng	-32.9	-39.4
Indonesia	Jakarta Composite	-13.2	-37.1
Malaysia	KLSE Composite	-11.1	-44.4
Singapore	SES All	-10.0	-26.0
South Korea	Korea Comp. Ex	-20.0	-34.9
Thailand	Bangkok SET	-10.0	-42.6

Source: *Financial Times*, various issues.

TABLE 1.1.3

Exports from the ECE region and Japan to East and South-east Asia, 1990 and 1996
(Percentage shares in total exports)

	Destination			
Origin	*ASEAN-4[a]*	*NIEs[b]*	*China*	*Total*
Western Europe				
1990	0.9	2.2	0.5	3.6
1996	1.6	3.4	0.9	5.9
United States				
1990	2.8	10.4	1.3	14.5
1996	4.2	11.9	2.0	18.1
Transition countries[c]				
1996	0.6	1.0	0.3	1.9
Japan				
1990	7.7	19.7	2.1	29.5
1996	12.4	24.7	5.3	42.4

Source: United Nations COMTRADE Database.

a Indonesia, Malaysia, Thailand and the Philippines.

b Hong Kong, Republic of Korea, Singapore and Taiwan Province of China.

c Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, Slovakia, Slovenia, and Lithuania (1995).

TABLE 1.1.4

Imports of the ECE region and Japan from East and South-east Asia, 1990 and 1996
(Percentage shares in total imports)

	Origin			
Destination	*ASEAN-4[a]*	*NIEs[b]*	*China*	*Total*
Western Europe				
1990	1.0	2.4	0.7	4.0
1996	1.8	3.1	1.8	6.7
United States				
1990	3.6	12.2	3.1	18.9
1996	5.8	10.4	6.7	22.9
Transition countries[c]				
1996	0.7	2.6	1.2	4.6
Japan				
1990	10.4	11.1	5.1	26.6
1996	11.9	11.7	11.6	35.2

Source: United Nations COMTRADE Database.

a Indonesia, Malaysia, Thailand and the Philippines.

b Hong Kong, Republic of Korea, Singapore and Taiwan Province of China.

c Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, Slovakia, Slovenia, and Lithuania (1995).

TABLE 1.2.1

Quarterly changes in real GDP in western Europe and North America, 1996-1997
(Percentage change over previous quarter)

	1996				1997		
	QI	*QII*	*QIII*	*QIV*	*QI*	*QII*	*QIII*
France	1.3	-0.2	0.8	0.2	0.3	1.0	..
Germany	-0.2	1.6	0.5	0.2	0.3	1.0	..
Italy	0.6	-0.8	0.7	-0.2	-0.3	1.6	..
United Kingdom	0.6	0.6	0.6	1.1	0.9	1.0	1.0
Canada	0.3	0.4	0.8	0.7	0.9	1.2	..
United States	0.4	1.5	0.3	1.1	1.2	0.8	0.9
Western Europe[a]	0.5	0.4	0.7	0.4	0.3	1.1	..
North America	0.4	1.4	0.3	1.0	1.2	0.8	..
Total above	0.5	0.8	0.5	0.7	0.8	1.0	..
Japan	2.0	-0.3	0.3	0.9	1.4	-2.8	..
Total, *including Japan*	0.7	0.7	0.4	0.8	0.9	0.3	..

Source: National statistics.

Note: Data are seasonally adjusted.

[a] Twelve countries: Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom.

TABLE 1.2.2

Annual changes in real GDP in the ECE market economies, 1995-1997
(Percentage change over previous year)

	1995	*1996*	*1997*[a]
Western Europe	2.7	2.0	2.6
4 major countries	2.3	1.5	2.3
France	2.1	1.5	2.3
Germany	1.8	1.4	2.4
Italy	2.9	0.7	1.0
United Kingdom	2.7	2.3	3.5
18 smaller countries	3.3	3.0	3.2
Austria	1.5	1.3	1.6
Belgium	2.1	1.5	2.2
Cyprus	6.0	1.9	3.5
Denmark	2.6	2.7	3.3
Finland	5.1	3.3	4.5
Greece	2.0	2.6	3.0
Iceland	1.2	5.7	4.5
Ireland	10.4	7.7	7.5
Israel	7.1	4.4	2.5
Luxembourg	3.2	3.9	3.5
Malta	7.3	4.2	4.0
Netherlands	2.3	3.3	3.3
Norway	3.6	5.3	3.9
Portugal	1.9	3.0	3.3
Spain	2.7	2.3	3.2
Sweden	3.6	1.1	2.1
Switzerland	0.8	-0.7	0.8
Turkey	7.2	7.2	5.2
North America	2.0	2.7	3.7
Canada	2.3	1.5	3.7
United States	2.0	2.8	3.7
Total above	2.4	2.3	3.1
Memorandum item:			
Japan	1.4	3.6	1.0
Total above, *including Japan*	2.2	2.5	2.8

Source: National statistics and national economic reports; *OECD Economic Outlook* (Paris), June 1997.

[a] Forecasts.

TABLE 1.2.3

Contribution of major expenditure components to changes in real GDP, 1997
(Percentage points)

	Western Europe[a]		*United States*	
	QI 1997	*QII 1997*	*QI 1997*	*QII 1997*
Private consumption	0.3	0.5	0.9	0.2
Government consumption	–	–	–	0.1
Fixed investment	-0.1	0.2	0.1	0.5
Stockbuilding	0.1	0.2	0.4	0.2
Total domestic demand	0.2	0.9	1.4	0.9
Exports	0.2	1.4	0.3	0.6
Imports	0.1	1.1	0.6	0.7
Net exports	0.1	0.2	-0.3	-0.1
GDP[b]	0.3	1.1	1.2	0.8

Source: National statistics.

Note: Data are seasonally adjusted.

a Ten countries: Denmark, Finland, France, Germany, Italy, Norway, Spain, Sweden, Switzerland and the United Kingdom.

b Percentage change over preceding quarter.

TABLE 1.2.4

Standardized unemployment rates[a] in the ECE market economies, 1995-1997
(Per cent of civilian labour force)

			1996	*1997*	
	1995	*1996*	*QIV*	*QI*	*QII*
Western Europe	10.1	10.1	10.0	10.0	10.0
4 major countries	9.8	10.1	10.1	10.2	10.2
France	11.7	12.4	12.6	12.5	12.6
Germany	8.2	8.9	9.1	9.5	9.6
Italy	11.9	12.0	12.0	12.2	12.5
United Kingdom	8.8	8.2	7.8	7.5	7.2
17 smaller countries	10.4	10.0	9.9	9.8	9.7
Austria	3.9	4.4	4.3	4.4	4.4
Belgium	9.9	9.8	9.5	9.5	9.6
Cyprus[b]	2.6	3.0	3.4	3.5	3.5*
Denmark	7.2	6.9	6.4	6.5	6.2
Finland	16.2	15.3	14.8	15.2	15.3
Greece	10.0	10.4	10.4[c]	10.4[d]	10.4[d]
Iceland	5.0	4.4	4.2	3.7	4.2
Ireland	12.3	11.8	11.4	11.1	10.8
Israel	6.9	6.7	7.1	7.4	7.6
Luxembourg	2.9	3.3	3.5	3.6	3.7
Malta[b]	3.6	3.7	4.3	4.5	4.5*
Netherlands	6.9	6.3	6.1	5.7	5.5
Norway	5.0	4.9	4.7	4.1	4.4
Portugal	7.3	7.3	7.1	7.0	6.5
Spain	22.9	22.1	21.6	21.2	20.7
Sweden	9.2	10.0	10.3	10.7	10.8
Switzerland	4.2	4.7	5.1	5.4	5.3
Turkey	7.5	6.5	6.5[c]	6.6[d]	6.6[d]
North America	6.0	5.8	7.5	7.6	7.1
Canada	9.5	9.7	9.9	9.6	9.4
United States	5.6	5.4	5.3	5.3	4.9
Total above	8.3	8.3	8.2	8.2	8.0
Memorandum item:					
Japan	3.1	3.4	3.3	3.3	3.4
Total above, *including Japan*	7.5	7.5	7.4	7.4	7.2

Source: National statistics; OECD, *Quarterly Labour Force Statistics*, No. 3, 1997, *Main Economic Indicators*, various issues, *OECD Economic Outlook*, June 1997 (Paris); UN/ECE secretariat estimates.

Note: All aggregates exclude Israel. Quarterly data are seasonally adjusted. Comparisons with previous years are limited by changes in methodology in the United States (1997).

a Adjusted to achieve comparability between countries except Cyprus, Greece, Iceland, Israel, Malta, Switzerland and Turkey.

b End of period.

c Average annual unemployment rate.

d Average annual unemployment rate forecast by OECD.

TABLE 1.2.5

Consumer prices in the ECE market economies, 1996-1997
(Percentage change)

	Annual average 1996	1997[a] QI-QIII	Quarter over preceding quarter 1996 QIV	1997 QI	1997 QII	1997 QIII
Western Europe	2.3	1.9	0.4	0.6	0.5	0.5
4 major countries	2.4	1.9	0.3	0.6	0.5	0.5
France	2.0	1.2	0.4	0.5	0.2	0.1
Germany	1.5	1.7	-0.1	0.9	0.4	0.7
Italy	3.9	1.9	0.5	0.4	0.4	0.2
United Kingdom	2.4	2.9	0.6	0.6	1.3	1.0
16 smaller countries	2.3	1.8	0.5	0.4	0.5	0.4
Austria	1.9	1.4	0.5	0.4	0.3	–
Belgium	2.0	1.7	0.4	0.6	-0.2	1.0
Cyprus	2.9	..	1.7	–	1.8	..
Denmark	2.0	2.2	0.6	0.3	0.9	0.5
Finland	0.5	1.0	0.1	0.1	1.0	0.4
Greece	8.5	5.8	2.7	0.8	2.7	-0.9
Iceland	2.3	1.8	0.3	0.1	0.7	0.6
Ireland	1.6	1.4	0.5	-0.1	0.6	0.2
Israel	11.3	9.3	1.9	2.3	2.5	2.1
Luxembourg	1.4	1.4	0.5	0.4	0.1	0.5
Malta	2.5	2.9	1.0	0.7	1.2	0.2
Netherlands	2.1	2.2	0.8	0.5	0.5	0.7
Norway	1.3	2.7	0.6	1.0	0.4	0.2
Portugal	3.0	2.3	0.2	0.6	0.6	0.6
Spain	3.6	2.0	0.5	0.5	0.1	0.7
Sweden	0.5	0.2	–	-0.3	1.0	0.4
Switzerland	0.8	0.6	0.2	0.4	-0.1	–
Turkey	79.8	81.2	17.6	16.3	17.0	17.3
North America	2.8	2.4	0.7	0.7	0.4	0.4
Canada	1.6	1.8	0.6	0.5	0.3	0.2
United States	3.0	2.5	0.7	0.7	0.4	0.4
Total above	2.6	2.1	0.5	0.6	0.5	0.4
Memorandum item:						
Japan	0.1	2.3	0.3	-0.2	2.1	–
Total above, *Including Japan*	2.1	2.2	0.5	0.5	0.7	0.4

Source: National statistics.

Note: All aggregates exclude Israel and Turkey. Quarterly data are seasonally adjusted.

a Percentage change over the same period of the previous year.

TABLE 1.2.6

Changes in the volume of merchandise trade in the ECE market economies, 1996-1997
(Percentage change over same period of previous year)

	Exports 1996	Exports 1st half 1997	Imports 1996	Imports 1st half 1997
Western Europe	4.9	7.7	3.2	4.7
4 major countries	4.2	7.3	2.5	4.2
France	4.1	8.8	2.7	5.9
Germany	6.7	12.4	3.0	6.6
Italy	-1.5	-1.6[a]	-4.0	-2.4[a]
United Kingdom	6.7	7.5	8.6	5.8
9 smaller countries	7.4	9.1	5.4	6.4
Belgium-Luxembourg	2.4	6.4	5.4	4.4
Denmark	1.3	2.0[a]	–	1.5[a]
Finland	4.8	14.1	7.9	9.4
Ireland	9.0	7.3[b]	9.7	7.6[a]
Netherlands	5.0	..	6.7	..
Norway	10.5	5.9	10.0	8.4
Spain	11.9	14.1	7.1	7.9
Sweden	6.0	4.0[a]	2.0	5.0[a]
Switzerland	2.1	3.3	1.5	4.6
North America	9.1	14.6	9.5	15.0
Canada	4.5	5.9	5.6	16.8
United States	9.5	15.3	9.9	14.9
Total above	7.2	11.4	6.6	10.2
Memorandum item:				
Japan	-0.7	10.6	2.3	3.1
Total above, *including Japan*	5.9	11.2	5.9	9.0

Source: National statistics; OECD, *Monthly Statistics of Foreign Trade, Series A* (Paris), various issues.

a First quarter-1997.

b January-April 1997.

TABLE 1.2.7

Current account balances in the seven major economies, 1996-1997
(Billion dollars)

	Merchandise trade 1996 1st half	Merchandise trade 1996 2nd half	Merchandise trade 1997 1st half	Total 1996 1st half	Total 1996 2nd half	Total 1997 1st half
France	6.9	8.1	13.7	9.5	11.0	20.7
Germany	29.5	35.7	35.7	-4.3	-9.7	-2.7
Italy	27.1	33.7	22.0	17.0	24.1	15.8
United Kingdom	-11.4	-8.1	-10.2	-3.1	2.6	1.4
Canada	15.0	15.1	8.8	-0.4	3.2	-5.7
United States	-90.5	-100.7	-96.9	-60.0	-88.1	-69.6
Japan	40.6	43.0	43.0	33.8	32.1	42.0

Source: OECD, *Main Economic Indicators* (Paris), various issues.

TABLE 1.3.1

GDP expectations and outcomes in the transition economies, 1995-1998
(Percentage change over same period of preceding year)

			1997				
	1995	*1996*	*Ex ante forecasts*	*January-March*	*January-June*	*October forecast*	*1998 forecasts*
Eastern Europe	5.6	4.0	5.1	3.7	3.6	3.2	4.6
Albania	8.0	9.1	6.0	..	..	-8	12
Bosnia and Herzegovina	..	..		..	..	..	..
Bulgaria	2.1	-10.9	3.0	-11.7	-9.8	-8	4
Croatia	2.6	5.1	6-8	3.2	4.0*	7+	7+
Czech Republic	5.9	4.1	4.8	1.5	1.3	1.8	2.5-3.1
Hungary	1.5	1.0	2.0	2.1	3.2	4	4
Poland	7.0	6.0	5-6	7.3	7.4	6.3-6.4	5.6
Romania	7.1	4.1	4.5	..	..	-3	2.3
Slovakia	6.8	6.9	5-6	5.8	6.0	5.8-6.1	5
Slovenia	4.1	3.1	5.0	2.0	2.9	3.5-4	4.5-4.8
The former Yugoslav Republic of Macedonia	-1.2	0.7	2.0	..	..	..	..
Yugoslavia[a]	4.0	4.3	12.5	..	..	6.5	..
Baltic states	2.1	3.7	..	5.2	6.0	5.3	5.9
Estonia	4.3	4.0	..	10.8	11.7	6-8	5.5
Latvia	-0.8	2.8	0-3	2.6	4.6	4	5
Lithuania	3.0	4.2	4.2	3.0	2.5	5	7
CIS	-5.6	-4.9	..	-1.2	-0.5	0.6	2.2
Armenia	6.9	5.8	..	1.4	1.4	3.3	5-6
Azerbaijan	-11.8	1.3	..	3.5	5.2	..	..
Belarus	-10.4	2.6	..	9.0	11.0	5	7-8
Georgia	3.3	11.2	..	8.9	14.7	10	..
Kazakhstan	-8.2	0.5	..	0.5	1.6	0.9	3
Kyrgyzstan	-5.4	5.6	..	0.1	6.8	..	7
Republic of Moldova	-1.9	-8.0	7.7	-5.5	..	..	..
Russian Federation	-4.1	-5.6	0/-3	0.3	-0.2	0-0.5	2
Tajikistan	-12.4	-16.7	..	4.8	5.5	..	..
Turkmenistan	-10.0	0.1	..	..	-29	..	..
Ukraine	-12.2	-10.0	-0.5	-7.9	-7.5	-3	0.5
Uzbekistan	-1.2	1.6	..	1.7	3.9	5.2	..
Total above	-1.4	-1.4	..	1.3	1.1	1.7	3.1
Memorandum items:							
CETE-5	5.9	5.0	..	4.9	5.6	5.2	5.0
SETE-7	5.0	1.8	..	..	..	-1.2	4.1
Ex-GDR *Länder*	5.3	2.0	4-6	5.0	..	..	..

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

Note: Forecasts are generally those of national conjunctural institutes or, if these are not available, government forecasts associated with the central budget formulation. Aggregates shown are: *Eastern Europe* (the 12 countries below that line), with sub-aggregates *CETE-5* (central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and *SETE-7* (south European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and Yugoslavia); *Baltic states* (Estonia, Latvia, Lithuania); *CIS* (12 member countries of the Commonwealth of Independent States); and *total transition countries*.

[a] Gross material product (value added of the material sphere including depreciation).

TABLE 1.3.2

Gross industrial output in the transition economies, 1995-1997
(Percentage change over same period of preceding year)

	1995	1996	1997 Jan.-Mar.	1997 Jan.-June	1997 Jan.-Sept.
Eastern Europe	6.6	6.9	5.2	6.0	5.3
Albania[a]	-7.2	10.6	..	..	..
Bosnia and Herzegovina	..	87.0	52.9	44.8	36.9
Bulgaria	5.0	-1.0	-12.7	-12.3	-11.0*
Croatia	0.3	3.1	2.8	4.8	4.8[b]
Czech Republic	8.7	6.4	-4.2	0.5	0.2
Hungary	4.6	3.4	5.4	7.9	8.4[b]
Poland	9.7	8.7	7.6	10.7	11.1
Romania	9.4	9.9	12.5	2.8	-3.5
Slovakia	8.2	2.5	1.7	3.5	3.2[b]
Slovenia	2.0	1.1	0.1	1.0	0.8[c]
The former Yugoslav Republic of Macedonia	-10.8	3.1	4.3	2.0	3.0[c]
Yugoslavia	3.8	7.5	6.6	7.7	7.9[c]
Baltic states	0.4	2.9	-1.5	3.6	3.6
Estonia[d]	1.9	1.1	9.3	12.7	12.0
Latvia	-6.3	1.4	-4.3	1.0	3.0
Lithuania	5.2	5.1	-6.2	-0.1	-1.2
CIS	-5.9	-3.3	–	0.6	1.9
Armenia	2.4	1.2	-2.8	-2.9	0.1
Azerbaijan	-17.2	-6.7	0.4	0.2	0.2
Belarus	-11.7	3.5	9.8	13.9	15.8
Georgia	-9.8	7.7	10.9	11.8	11.9
Kazakhstan	-8.2	0.3	1.2	2.8	3.6
Kyrgyzstan	-17.8	8.8	6.9	28.8	45.9
Republic of Moldova	-3.9	-6.5	-14.9	-11.7	-5.5
Russian Federation	-3.3	-5.0	0.7	0.8	1.5
Tajikistan	-13.6	-19.8	-14.5	-9.9	-8.0
Turkmenistan	-6.4	17.9	-14.7	-35.2	..
Ukraine	-12.0	-5.1	-6.0	-4.5	-2.4
Uzbekistan	0.1	6.0	4.2	5.4	..
Total above	-2.0	–	1.6	2.5	3.1
Memorandum items:					..
CETE-5	8.5	7.0	4.9	8.0	8.3
SETE-7	2.1	6.6	5.9	0.9	-2.3
Ex-GDR *Länder*	5.8	4.3	..	..	..

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

Note: On regional aggregates, see the note to table 1.3.1.

a 1996 refers to public sector only.
b January-August.
c January-July.
d Industrial sales.

TABLE 1.3.3

Retail trade in the transition economies, 1994-1997
(Percentage change over same period of preceding year)

	1994	1995	1996	1997 Jan.-Mar.	1997 Jan.-Jun.	1997 Jan.-Sept.
Eastern Europe						
Albania	..	..	..	..	..	..
Bulgaria	2.8	2.6	-9.3	-49.6	-47.4[a]	-45.4[b]
Croatia	14.5	16.5	3.4	28.8	5.9	5.6
Czech Republic	5.5	4.8	9.6	0.8	1.0	..
Hungary	-6.1	-8.1	-5.0	-8.8	-4.9	-3.7[b]
Poland	3.0	2.3	4.5	10.6	11.0	10.8[b]
Romania	8.4	29.0	7.9	-24.8	-30.8	-30.9[c]
Slovakia	1.6	2.0	7.0	6.8	4.3	4.6
Slovenia	6.0	4.3	-2.9	..	7.5[a]	..
The former Yugoslav Republic of Macedonia	-10.3	-1.8	-10.2	37.1*	43.7*	48.4*[c]
Yugoslavia	67.8	4.5	7.0	10.0	2.0	4.0[c]
Baltic states						
Estonia	27.5	10.5	2.0	34.9	39.8	41.9[b]
Latvia	25.0	-0.2	-9.0	6.6	9.1	13.6[b]
Lithuania	20.7	8.7	5.0	..	16.7	15.3
CIS						
Armenia	-1.4	54.0	12.5	4.0	4.0	5.0
Azerbaijan	-15.7	2.3	14.1	25.0	21.0	18.0
Belarus	-9.5	-23.0	30.5	26.0	20.0	19.0
Georgia	-25.0	155.0	22.5	58.0	24.0	29.0
Kazakhstan	-53.0	-14.4	33.3	31.0	30.0	26.0
Kyrgyzstan	-4.4	-6.0	1.8	7.0	4.0	8.0
Republic of Moldova	-41.7	-3.3	-5.0	-4.0	-6.0	-6.0
Russian Federation	0.1	-7.2	-4.0	1.0	1.0	0.7
Tajikistan	-28.4	-80.2	-0.9	69.0	90.0	38.0
Turkmenistan	-56.6	-57.6	-8.5	..	..	..
Ukraine	-13.6	-13.9	-5.1	-0.2	3.0	5.0
Uzbekistan	-9.6	-4.3	22.2	2.0	14.0	10.0

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

Note: Retail trade covers goods and catering in Hungary and the CIS countries; goods mainly in Bulgaria, Croatia, the Czech Republic, Poland, Romania, Slovakia, Slovenia, The former Yugoslav Republic of Macedonia, Yugoslavia and the Baltic states. The coverage in 1997, which is based on current reporting, may differ from the coverage in the annual statistics.

a January-May.
b January-August.
c January-July.

TABLE 1.3.4

Trade balances in selected transition economies, 1994-1997
(Per cent of GDP)

	1994	*1995*	*1996*	*Jan.-Jun. 1997*
Eastern Europe				
Albania	-23.3	-18.3	-34.7	..
Bulgaria	-3.5	-2.3	1.0	5.6
Croatia	-6.8	-15.9	-17.2	-21.3
Czech Republic	-1.8	-7.2	-10.5	-8.9
Hungary	-9.3	-5.9	-6.9	-4.8
Poland	-4.7	-5.2	-9.6	-10.7
Romania	-3.2	-6.6	-9.4	-6.5
Slovakia	0.1	-1.8	-12.8	-10.6
Slovenia	-3.3	-6.3	-5.9	-7.0
The former Yugoslav Republic of Macedonia	-14.4	-13.6	-13.0	-16.0
Baltic states				
Estonia	-15.2	-19.5	-25.9	-31.0
Latvia	-6.9	-11.5	-17.4	-15.9
Lithuania	-7.5	-15.8	-15.5	-18.2
CIS				
Belarus	1.3	-1.1	-4.1	-5.4
Republic of Moldova	-1.6	0.4	-10.1	-18.8
Russian Federation	8.3	9.1	9.1	6.6
Ukraine	4.6	1.9	1.3	2.6

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

Note: The balance refers to merchandise trade only; for the CIS countries it does not cover intra-CIS trade. GDP is converted at current market exchange rates.

TABLE 1.3.5

Consumer and industrial producer prices in the transition economies, 1996-1997
(Percentage change over the previous December)

	Consumer prices						*Producer prices*		
	Total								
	1996		*1997*	*1997 August*			*1996*		*1997*
	December	*September*	*September*	*Food*	*Goods*[a]	*Services*	*December*	*September*	*September*
Albania	17.4	12.6[b]	27.2[b]	29.1	..	..	..	..	..
Bosnia and Herzegovina	3.2	0.6	10.2	5.2	3.2	24.5	-4.6	-5.5	0.7
Bulgaria	311.1	153.0	561.6	584.8	452.6	557.8	338.1	128.3[b]	410.5[b]
Croatia[c]	3.5	2.3[b]	2.3[b]	1.3	1.8	4.6	1.5	-0.4	1.3
Czech Republic	8.7	7.1	8.6	3.0	..	..	4.6	3.7	4.9
Hungary	20.0	16.3	14.5	12.0	10.1	16.4	20.6	16.2	15.7
Poland	18.7	14.1	9.6	3.2	8.3	14.5	10.7	8.2	10.1
Romania	56.8	30.0	116.8	198.3[d]	100.5[d]	125.9[d]	60.5	44.6[b]	130.7[b]
Slovakia	5.5	4.1	4.5	1.6	3.9	6.9	4.8	3.3	3.0
Slovenia[c]	8.8	6.7	8.0	11.0	6.6	8.1	5.9	3.1	3.9
The former Yugoslav Republic of Macedonia[c]	0.3	-3.2[b]	1.4[b]	2.6	-3.3	8.0	-0.6	-1.6[b]	5.1[b]
Yugoslavia	59.9	43.1[b]	4.3[b]	1.1	6.5	5.3	51.3	37.2[b]	5.3[b]
Estonia	14.9	12.8	9.6	4.7	8.4	12.4	9.8	8.0	7.7
Latvia[c]	13.2	10.3	5.4	–	5.6	14.6	7.9	7.9	3.0
Lithuania	13.1	10.7	6.4	1.8	..	..	12.4	9.5	0.8
Armenia	5.6	1.3	17.4	12.5	3.8	32.7	17.2	13.7[b]	19.1[b]
Azerbaijan	6.8	4.3	-1.1	-3.1	0.1	9.4	20.9	11.0	1.3
Belarus	39.1	23.1	52.1	47.8	32.3	40.6	32.3	20.5	78.8
Georgia	13.6	11.1	3.2	..	..	..	..	..	..
Kazakhstan	28.6	21.1	7.1	2.7	1.5	29.3	18.8	14.2	9.9
Kyrgyzstan	35.0	19.8	10.3	13.2	2.6	9.2	58.9	46.2	9.2
Republic of Moldova	15.1	10.8	7.3	-1.0	3.1	33.1	19.5	17.8	12.1
Russian Federation	21.8	16.5	9.0	9.4	5.1	17.6	25.5	20.1	6.9
Tajikistan	40.6	24.5	139.5	139.0	48.6	99.7	82.8	66.0	136.5
Turkmenistan	..	..	..	..	..	..	..	..	..
Ukraine	39.7	34.8	6.7	6.6	1.8	5.4	26.1	14.8	3.6
Uzbekistan	..	..	..	..	..	..	81.2	46.2[d]	16.3[d]

Source: UN/ECE secretariat estimates, based on national statistics.
a Manufactured goods excluding food.
b August over December.
c Retail price index. For Croatia the food price index is from the cost of living index.
d July over December.

TABLE 1.3.6

Wages and unit labour costs in industry[a] in the transition economies, 1996-1997
(Percentage change over same period of preceding year)

	Producer prices		*Nominal wages[b]*		*Labour productivity[c]*		*Unit labour costs[d]*		*Real unit labour costs[e]*	
	1996	*1997[f]*	*1996*	*1997[f]*	*1996*	*1997[f]*	*1996*	*1997[f]*	*1996*	*1997[f]*
Albania	..	..	..	..	..	..	..	..	..	..
Bosnia and Herzegovina	-4.8	3.8	244.7	90.0	..	..	..	..	..	..
Bulgaria	129.7	1 394.4	..	..	5.2	..	..	..	..	..
Croatia	1.3	2.1	12.4	9.9	17.4	13.4	-4.3	-3.1	-5.5	-5.1
Czech Republic	4.9	4.5	17.7	12.4	7.2	1.8	9.9	10.4	4.7	5.6
Hungary	22.3	21.8	21.4	22.5	4.3	7.5	16.4	13.9	-4.8	-6.5
Poland	13.2	10.3	26.3	21.1	9.6	11.2	15.3	8.9	1.8	-1.2
Romania	50.0	158.0	58.6	100.3	13.3	7.1	40.0	87.0	-6.7	-27.5
Slovakia	4.0	4.6	14.7	12.0	2.5	5.1	11.9	6.6	7.6	1.9
Slovenia	6.7	5.6	14.1	13.7	2.1	6.4	11.7	6.8	4.7	1.1
The former Yugoslav Republic of Macedonia	-0.1	1.4	3.7	4.7	12.6	8.6	-7.9	-3.6	-7.8	-4.9
Yugoslavia	89.1	30.4	93.5	27.5	9.3	11.0	77.0	14.8	-6.4	-11.9
Estonia	14.7	8.7	25.2	21.1	..	14.8	..	5.5	..	-2.9
Latvia	13.8	4.8	20.3	24.8	3.1	1.2	16.7	23.3	2.6	17.7
Lithuania	16.5	8.4	28.9	24.0	9.7	-4.1	17.5	29.3	0.9	19.2
Armenia	36.3	17.9	48.3	12.5	20.3	1.0	23.3	11.5	-9.6	-5.5
Azerbaijan	70.6	13.8	45.4	49.3	-3.5	3.4	50.7	44.5	-11.7	26.9
Belarus	35.7	77.6	60.5	71.3	4.7	20.1	53.3	42.6	13.0	-19.7
Georgia	..	..	..	..	..	..	..	..	..	..
Kazakhstan	24.8	17.6	35.9	29.5	2.9	6.7	32.0	21.4	5.8	3.2
Kyrgyzstan	44.7	52.6	27.1	25.2	21.9	31.9	4.3	-5.1	-27.9	-37.8
Republic of Moldova	30.2	16.0	33.0	14.3	-4.6	-2.0	39.4	16.7	7.1	0.6
Russian Federation	50.7	19.6	49.1	20.1	-0.1	3.0	49.3	16.7	-1.0	-2.5
Tajikistan	342.2	71.2	258.0	90.9	-20.1	-8.4	348.2	108.3	1.4	21.7
Turkmenistan	..	..	763.7	403.7	13.6	-34.6	660.2	670.6	..	..
Ukraine	54.6	17.6	89.4	20.9	3.8	-2.7	82.4	24.3	18.0	5.7
Uzbekistan	128.5	53.9	99.1	73.4	4.6	9.2	90.3	58.9	-16.7	3.2

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

a Industry = mining, manufacturing and utilities.

b Average gross wages in industry except in Croatia, The former Yugoslav Republic of Macedonia: net wages in industry; in Estonia and all the CIS countries: gross wages including social assistance in total economy; in Bosnia and Herzegovina and Yugoslavia: net wages in total economy.

c Gross industrial output deflated by industrial employment. In this table, the change in industrial employment is calculated from the quarterly employment data which have a different coverage than the reported annual average data in some countries.

d Nominal wages deflated by productivity.

e Unit labour costs deflated by producer price index.

f First half.

TABLE 1.3.7

Total employment in the transition economies, 1994-1997
(Percentage change over same period of preceding year)

	1994	1995	1996	January-June 1996	January-June 1997
Eastern Europe[a]	0.1	-0.5	0.3	-0.1	0.5
Albania	11.0	-0.6	-3.3	-1.2	..
Bosnia and Herzegovina	..	..	..	..	..
Bulgaria	0.6	1.3	-0.1	..	..
Croatia	-2.3	-1.3	–	–	-2.9
Czech Republic	0.8	2.6	0.6	0.8	-0.3
Hungary	-2.2	-1.8	-0.5	-0.7	–
Poland	1.0	1.8	1.9	0.2	1.7
Romania[b]	-0.5	-5.2	-1.2	..	2.5
Slovakia	-1.8	2.2	0.8	0.6	-0.2
Slovenia	-2.5	-0.2	-0.5	-0.5	-0.6
The former Yugoslav Republic of Macedonia	-5.3	-9.5	-4.4	-8.3	-5.0
Yugoslavia	-2.0	-1.4	-0.5	-2.0	-3.0
Baltic states	-4.3	-2.3	-0.6	-0.5	-0.4
Estonia	-2.2	-5.3	-1.6	-2.0	-1.7
Latvia	-3.2	-1.3	-1.8	-1.6	-1.3
Lithuania	-5.8	-1.9	0.9	1.0	0.6
CIS[a]	-3.0	-1.3	-0.7	-1.0	-2.5
Armenia	-3.6	-0.8	-2.8	-2.7	-2.3
Azerbaijan	-2.2	-0.5	1.7	-0.4	-0.1
Belarus	-2.6	-6.2	-1.0	-1.0	-2.2
Georgia	-2.4	-1.2	0.2	..	..
Kazakhstan	-5.0	-0.5	-0.5	-0.6	-2.6
Kyrgyzstan	-2.1	-0.2	0.6	-0.4	-0.5
Republic of Moldova	-0.4	-0.5	-0.8	-0.8	-1.5
Russian Federation	-3.3	-3.0	-0.6	-0.7	-0.8
Tajikistan	-0.6	0.5	-0.1	-0.3	1.8
Turkmenistan	1.4	0.5	-0.3	-0.5	-0.4
Ukraine	-3.8	3.0	-2.1	-3.1	-2.0
Uzbekistan	1.5	0.8	1.3	0.4	0.4
Total above[a]	-2.2	-1.1	-0.4	-0.9	-0.8
Memorandum items:					
CETE-5	0.2	1.4	1.3	0.2	1.0
SETE-7	-0.1	-3.1	-1.0	..	..

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

a Half-year regional aggregates exclude Albania, Bulgaria, Romania and Georgia.

b End of year.

TABLE 1.3.8

Registered unemployment in the transition economies, 1996-1997

	Thousands September 1996	Thousands September 1997	Percentage change	Per cent of labour force September 1996	Per cent of labour force September 1997
Eastern Europe	6 011	5 754	-4.3	11.6	11.2
Albania[a]	165	165	–	12.2	12.6
Bosnia and Herzegovina	..	..	..	..	..
Bulgaria	402	521	29.8	10.5	13.6
Croatia	262	277	5.8	15.3	17.0
Czech Republic	169	248	46.7	3.2	4.8
Hungary	501	459	-8.4	11.0	10.3
Poland	2 341	1 854	-20.8	13.5	10.6
Romania	665	721	8.4	6.3	6.9
Slovakia	314	337	7.3	12.2	13.0
Slovenia	118	125	6.3	13.7	14.4
The former Yugoslav Republic of Macedonia[b c]	239	255	6.6	38.9	42.0
Yugoslavia[c]	835	791	-5.3	26.2	25.5
Baltic states	237	219	-7.6	6.4	5.9
Estonia[d]	36	31	-13.9	5.3	4.6
Latvia	89	89	–	7.0	7.1
Lithuania	112	99	-11.6	6.4	5.6
CIS	7 841	7 919	1.0	6.1	6.2
Armenia	153	170	11.1	9.4	10.6
Azerbaijan	31	37	19.0	1.1	1.3
Belarus	185	140	-24.3	4.1	3.0
Georgia	52	53	1.9	2.8	3.0
Kazakhstan	269	265	-1.5	3.9	3.9
Kyrgyzstan	79	55	-30.4	4.7	3.2
Republic of Moldova	26	27	4.7	1.6	1.6
Russian Federation[e]	6 700	6 504	-2.9	9.2	9.1
Tajikistan	54	54	–	2.8	2.8
Turkmenistan	..	..	..	..	..
Ukraine	258	578	124.0	1.1	2.4
Uzbekistan	34	36	5.9	0.4	0.4
Total above	14 089	13 892	-1.4	7.7	7.6
Memorandum items:					
CETE-5	3 443	3 023	-12.2	11.2	9.9
SETE-7	2 568	2 731	6.3	12.1	13.0
Russian Federation[f]	2 470	2 063	-16.5	3.4	2.9

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

a March.

b August.

c The data on employment cover only the social sector in agriculture, hence unemployment rates are biased upwards (see text).

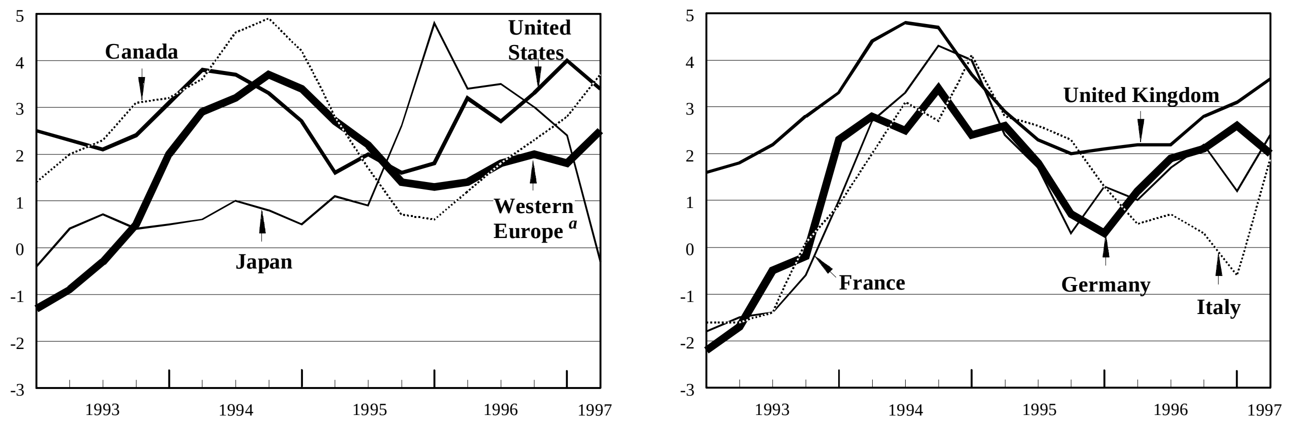
d Job seekers.

e Based on monthly Russian Federation Goskomstat estimates according to the ILO definition, i.e. including all persons not having employment but actively seeking and available for work.

f Registered unemployment.

CHART 1.2.1

Quarterly changes in real GDP in the western market economies, 1993-1997
(Percentage change over same period of preceding year)



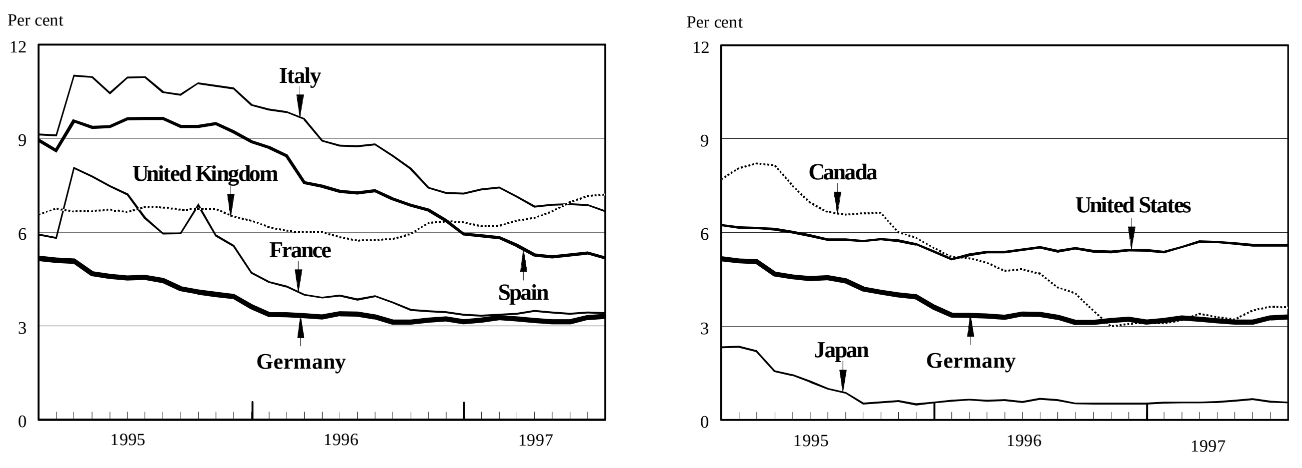
Source: National statistics.

Note: Data are seasonally adjusted.

a Twelve countries: Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom.

CHART 1.2.2

Average monthly nominal short-term interest rates in selected industrial countries, 1995-1997
(Per cent per annum)

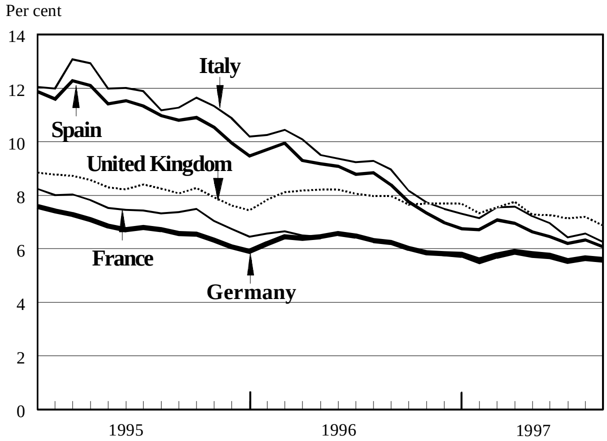


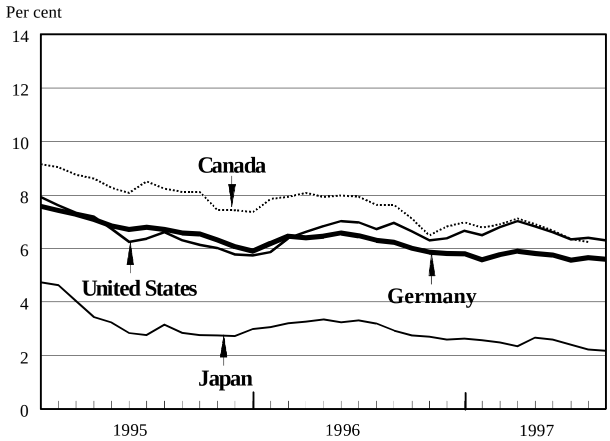
Source: OECD, *Main Economic Indicators* (Paris), various issues.

Note: France, Germany, Italy and the United Kingdom: three-month interbank rates; Canada: 90-day deposit receipts; Japan and the United States: certificates of deposit.

CHART 1.2.3

Average monthly nominal long-term interest rates in selected industrial countries, 1995-1997
(Per cent per annum)

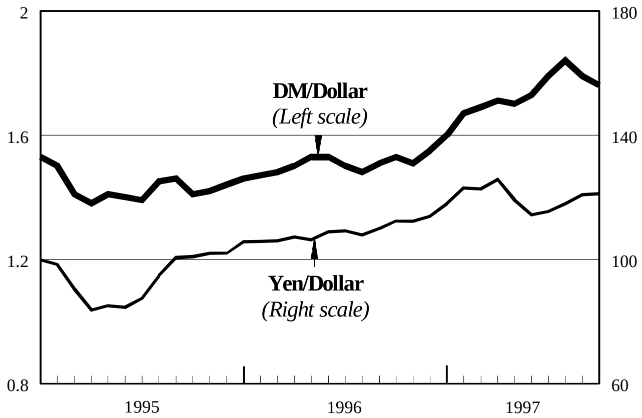


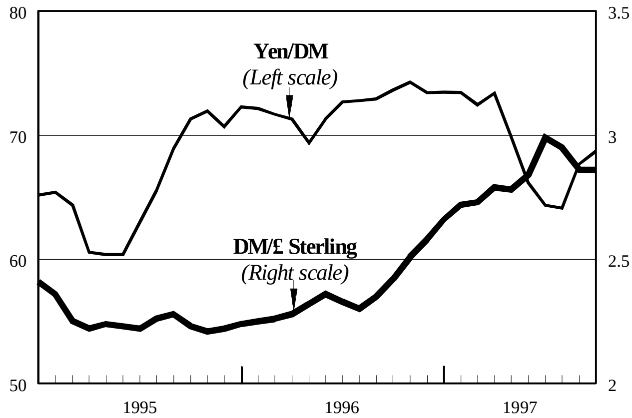


Source: Banque de France, *Bulletin de la Banque de France* (Paris), various issues; direct communications to UN/ECE secretariat.
Note: Average monthly yields on 10-year government bonds; Canada: government bonds with more than 10 years to maturity.

CHART 1.2.4

Average monthly bilateral exchange rates, 1995-1997
(Currency units)



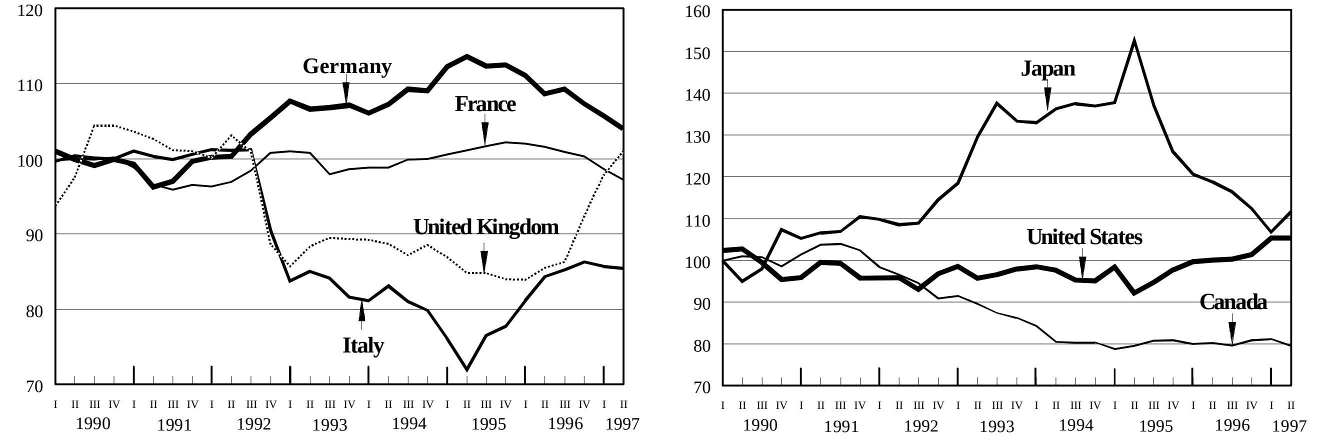


Source: Board of Governors of the Federal Reserve System, Washington, D.C. Data are available on the internet website of the United States Federal Reserve Board of Governors.

Note: Averages of daily spot exchange rates (noon buying rates in New York). Data for October 1997 cover period up to 24 October 1997. The yen/deutsche mark and deutsche mark/pound sterling exchange rates were calculated as cross-rates of the corresponding exchange rates against the dollar.

CHART 1.2.5

Real effective exchange rates in selected industrial countries, 1990-1997
(Indices, 1990=100)



Source: OECD, *Main Economic Indicators* (Paris), various issues.

Note: Calculated by deflating trade-weighted geometric averages of index variations of nominal exchange rates by geometric averages of consumer price index variations.