Part III
Macroeconomic performance

Recent macroeconomic developments

7

In 1997 economic growth is returning to the region as a whole. Fewer countries – largely those where structural reforms have been lagging – have experienced economic decline and more countries, 11 altogether, are experiencing GDP growth in excess of 4 per cent. The turnaround is primarily due to the end of economic contraction in Russia, the region's largest economy, which is expected to show cautious but positive growth this year. Performance has not improved consistently across the region. There have been some major setbacks that demonstrate the fragile nature of the recovery. Nevertheless, with a combined GDP of around US$ 1 trillion or 3 per cent of the world economy, the region is rapidly establishing itself as a major "emerging" market.[1]

With regard to inflation, developments have been similarly mixed. While average inflation in the CIS is likely to be cut in half this year, the average for eastern Europe is set to increase, primarily because of reversals in Bulgaria and Romania.

As output has recovered and foreign investor interest has risen, external balances have deteriorated rapidly. This is largely due to the fact that the recovery is increasingly driven by private consumption and investment demand, which demonstrates the growing confidence of consumers and investors in these countries as well as the existence of profitable investment opportunities. Large inflows of mostly private capital have both financed and contributed to these external imbalances. As the transition economies grow increasingly strongly over the coming years, current account deficits and the external funding that they imply are to some extent an inevitable and in principle a positive phenomenon. They allow countries to exploit their growing integration into the world economy by supplementing domestic savings with external savings in the growth process. Nevertheless, these flows create claims that will have to be serviced in the future, and runaway consumption as well as the inefficient use of external funds by governments are potential problems. The sustainability of current account positions is a matter that should receive increasing attention from policy makers in the region. In some economies external debt is growing at a rate which will have to be handled carefully.

Apart from developments in growth, inflation and external accounts, this chapter provides a discussion of trends in the external competitiveness of the transition economies. Productivity growth has continued at very high levels. At the same time, wages are beginning to catch up, compensating at least partly for the hardship of the early transition years. The evidence does not yet suggest that increasing real wages and unit labour costs have seriously undermined competitiveness in general, but they do call for keeping up the pace of productivity growth by deepening restructuring and for wage growth moderation.

7.1 Output recovery: Revival of domestic demand

After seven years of continuous decline, the region as a whole is witnessing the resumption of economic growth in 1997, but the rate projected for the year is still fragile, at less than 1 per cent. Compared with 1996, average growth is likely to slow somewhat in eastern Europe but accelerate in the Baltics, while economic contraction seems finally to have come to an end in the CIS. This turnaround is largely due to the improving performance of Russia and Ukraine, with Russia likely to register its first year of (mildly) positive growth. Eleven economies in the region, out of 26 (including Bosnia and Herzegovina), are expected to grow at rates of 4 per cent or more in 1997, and only seven are in decline.[2] This compares with five and 13, respectively, just three years ago.

Cumulative growth rates suggest that in 1996 the level of real GDP in the region as a whole may have reached 70 per cent of the level in 1989 (and marginally more in 1997), but these estimates are fraught with conceptual and measurement problems. As discussed in Chapter 4, a substantial proportion of economic activity remains undeclared or underdeclared, whereas the earlier regime was characterised by over-reporting. In addition, relative prices have changed drastically following the introduction of market forces, and GDP in 1989 was simply not the same as it is now in its ability to satisfy consumer preferences, nor in terms of instant availability as opposed to the need to queue.

Nevertheless, in the absence of better data or methods, it is interesting to note that the indexes of GDP, thus estimated, differ enormously across countries (see Table 7.1). On average, weighted by the relative size of the economies, eastern Europe and the Baltics are expected in 1997 to achieve 95 per cent of the level of GDP in 1989, but even within this group there are stark differences, with Poland now easily surpassing the 100 per cent mark and Lithuania far behind at only 44 per cent. The CIS is, on average, only at 56 per cent of the 1989 level, ranging from 34 per cent in Moldova and Georgia to 86 per cent in Uzbekistan.

[1] It has around 7% of the world's population, and thus a GDP per capita a little under half of the world average. The countries are all middle income according to the World Bank classification, except for Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Georgia, Kyrgyzstan and Tajikistan, which are low income (less than US$ 755 per capita in 1995; see *World Development Report 1997*, Table 1, which includes detailed information on these countries for the first time).

[2] Bosnia and Herzegovina is not included in Table 7.1.

Table 7.1

Growth in real GDP in eastern Europe, the Baltics and the CIS

	1990	1991	1992	1993	1994	1995	1996 *Estimate*	1997 *Projection*	Estimated level of real GDP in 1996	Projected level of real GDP in 1997
				(Percentage change)					*(1989=100)*	*(1989=100)*
Albania	-10.0	-27.7	-7.2	9.6	9.4	8.9	8.2	-15.0	*85*	*73*
Bulgaria	-9.1	-11.7	-7.3	-2.4	1.8	2.1	-10.9	-7.0	*67*	*63*
Croatia	-6.9	-19.8	-11.1	-0.9	0.6	1.7	4.2	5.0	*70*	*74*
Czech Republic	-1.2	-11.5	-3.3	0.6	2.7	5.9	4.1	1.0	*89*	*90*
Estonia	-8.1	-7.9	-14.2	-8.5	-1.8	4.3	4.0	7.0	*71*	*76*
FYR Macedonia	-9.9	-12.1	-21.1	-8.4	-4.0	-1.4	1.1	2.0	*55*	*56*
Hungary	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.0	3.0	*86*	*89*
Latvia	2.9	-10.4	-34.9	-14.9	0.6	-0.8	2.8	3.4	*52*	*54*
Lithuania	-5.0	-13.4	-37.7	-24.2	1.0	3.0	3.6	4.5	*42*	*44*
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	6.0	5.5	*104*	*110*
Romania	-5.6	-12.9	-8.7	1.5	3.9	7.1	4.1	-1.5	*88*	*87*
Slovak Republic	-2.5	-14.6	-6.5	-3.7	4.9	6.8	6.9	4.5	*90*	*94*
Slovenia	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.1	4.0	*95*	*99*
Eastern Europe and the Baltic States [1]	*-6.8*	*-10.6*	*-4.2*	*0.4*	*3.7*	*5.3*	*4.1*	*3.1*	*92*	*95*
Armenia	-7.4	-17.1	-52.6	-14.8	5.4	6.9	5.8	5.8	*37*	*39*
Azerbaijan	-11.7	-0.7	-22.6	-23.1	-18.1	-11.0	1.3	5.2	*39*	*41*
Belarus	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.6	3.0	*64*	*66*
Georgia	-12.4	-13.8	-44.8	-25.4	-11.4	2.4	10.5	10.5	*31*	*34*
Kazakhstan	-0.4	-13.0	-2.9	-10.4	-17.8	-8.9	1.1	2.0	*57*	*58*
Kyrgyzstan	3.0	-5.0	-19.0	-16.0	-20.0	1.3	5.6	6.0	*57*	*60*
Moldova	-2.4	-17.5	-29.0	-1.0	-31.2	-3.0	-8.0	-2.0	*35*	*34*
Russia	-4.0	-5.0	-14.5	-8.7	-12.6	-4.0	-5.0	1.0	*57*	*57*
Tajikistan	-1.6	-7.1	-29.0	-11.1	-21.5	-12.5	-7.0	-3.0	*37*	*36*
Turkmenistan	2.0	-4.7	-5.3	-10.0	-19.0	-8.2	-3.0	-15.0	*60*	*51*
Ukraine	-3.4	-11.6	-13.7	-14.2	-23.0	-11.8	-10.1	-3.0	*39*	*37*
Uzbekistan	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	1.0	*85*	*86*
The Commonwealth of Independent States [2]	*-3.7*	*-5.8*	*-14.3*	*-9.3*	*-13.5*	*-4.9*	*-4.6*	*0.8*	*56*	*56*
Eastern Europe, the Baltics and the CIS	**-4.9**	**-7.7**	**-10.3**	**-5.4**	**-6.6**	**-0.8**	**-1.1**	**1.7**	*70*	*72*

Notes:

Data for 1990-95 represent the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1996 are preliminary actuals, mostly official government estimates. Data for 1997 represent EBRD projections.

[1] Estimates for real GDP represent weighted averages for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The weights used were EBRD estimates of nominal dollar-GDP for 1996.

[2] Here taken to include all countries of the former Soviet Union, except Estonia, Latvia and Lithuania. Estimates for real GDP represent weighted averages. The weights used were EBRD estimates of nominal dollar-GDP for 1996.

If local currency GDP is converted into US dollars, the region has been growing for several years, driven by the rapid process of real appreciation of currencies in the CIS and the Baltics and, to a somewhat more moderate extent, in eastern Europe.[3] In 1996 the total dollar (official) GDP of the region is estimated at US$ 945 billion, an increase of more than 50 per cent compared with 1994. Real appreciation has continued at a slower pace in 1997, but there are reasons to expect that it will continue for several years to come (see Box 7.2).

There are some interesting patterns in the growth performance (see Table 7.1). In eastern Europe and the Baltics, eight countries out of 14 grew at rates of 4 per cent or more in 1996, but three of these (Albania, the Czech Republic and Romania) are experiencing sharply lower or negative growth in 1997.[4] In Albania, economic contraction is the result of financial and social turmoil in the wake of the collapse of vast deposit pyramid schemes, while in Romania it is linked to the reining in of fiscal and monetary accounts (loosened in 1996) and accelerated restructuring of the economy. Growth in the Czech Republic has slowed down as the result of an austerity programme aimed at scaling back external imbalances

[3] Real appreciation means that the purchasing power of domestic incomes in acquiring dollar-denominated goods and services from trading partners increases even though it may be flat in real (local currency) terms.

[4] The other countries in this group are Bosnia and Herzegovina, Croatia, Estonia, Poland and the Slovak Republic.

following the crisis on the currency markets during the spring. Otherwise, countries in this group are continuing to grow at a healthy rate, though a slowdown from high growth is expected in Poland and the Slovak Republic. It should be noted that *all* countries of eastern Europe and the Baltics that grew at 4 per cent or more in 1996 experienced a deterioration in their trade balances, in some cases very significantly (in Estonia, Croatia and the Slovak Republic the shift was equivalent to more than 6 per cent of GDP; see Chart 7.5).

A second group of countries, which includes FYR Macedonia, Hungary, Latvia, Lithuania and Slovenia, grew at more moderate rates in 1996. Three of these countries had driven a course of cautious demand management since 1995, Hungary to counter a growing current account deficit and Latvia and Lithuania to re-establish confidence in their financial sectors after a series of bank failures. In all of these countries, growth is poised to accelerate in 1997. Lastly, there is Bulgaria, the only country in eastern Europe that experienced economic decline in 1996. That decline was the result of a collapse of confidence in the financial system and the currency after years of delayed and half-hearted reforms. An ambitious programme of structural reforms and macroeconomic management adopted since the second quarter of 1997 has arrested further declines in production, but GDP for the full year will nevertheless fall markedly.

In the CIS, growth in 1996 was above 4 per cent in three countries where GDP had declined particularly sharply earlier in the decade, namely Armenia (where growth had been high since 1994), Georgia (where it accelerated to "tiger" levels) and Kyrgyzstan. Each of these countries continues to grow at a brisk pace in 1997, but all have very large current account deficits and increasing external debt, which may call for cautious demand policies (see Section 7.3 below). A group growing more moderately includes Azerbaijan, Belarus, Kazakhstan and Uzbekistan. An acceleration of growth is expected in 1997 for Azerbaijan and Kazakhstan, the two oil economies where substantial production is beginning to come on stream, while growth rates in Belarus and Uzbekistan, two economies with a substantial reform backlog, remain broadly unchanged.

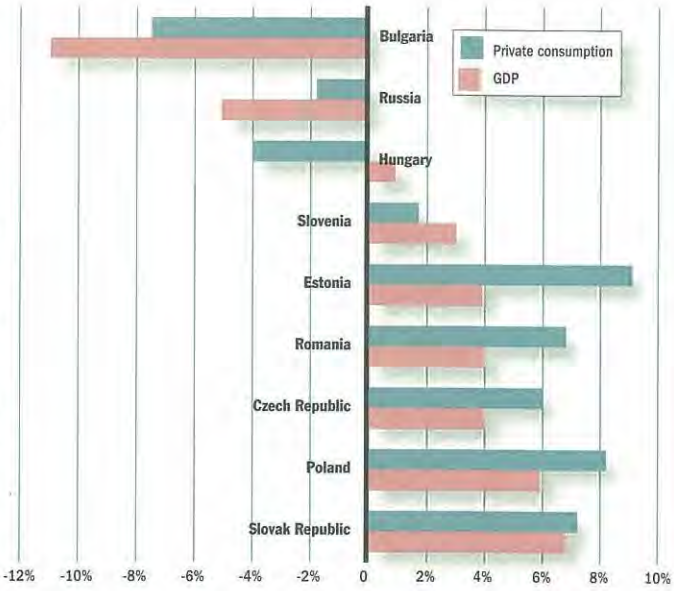
Finally, five countries in the CIS continued to have negative GDP growth in 1996. While continued contraction is expected for 1997 in Moldova, Tajikistan, Turkmenistan and Ukraine, it is Russia's turnaround in 1997 which has attracted the greatest attention. After projections of a recovery in Russia repeatedly proved to be premature, it does appear that 1997 will finally see it happen. GDP has been essentially flat since the middle of 1996 but there are now signs of growth. It is the change in Russia's performance which is largely responsible for the region's overall growth in 1997, both because of its size and because of its importance as a market for other countries in the CIS.

In 1996 and 1997 growth across much of the region has been led by domestic demand. Earlier in the transition, net exports played a greater role in the recovery, especially in eastern Europe, while domestic consumption and investment were depressed by systemic risk and uncertainties. The limited available information on the demand composition of GDP[5] is consistent with a rapid rise in private consumption demand in most of the high-growth countries, and an investment boom in some of them. As shown in Chart 7.1, private consumption has outstripped GDP growth in all five countries growing at more than 4 per cent in 1996 for which data at that level of detail were available. Meanwhile, in the Czech Republic, Poland and the Slovak Republic, investment spending grew at rates of more than 10, 20 and 30 per cent, respectively.[6] Hungary, while growing again, is an exception to these trends, with net exports the more important source of GDP growth in 1996.

Chart 7.1

Growth in private consumption and GDP, 1996

Change over 1995



Source:
National Statistical Yearbooks.

Higher consumer spending reflects brighter expectations about the future – precautionary savings are less necessary when it is perceived that income growth "is here to stay" – and higher real wages. Market growth itself, combined with greater price stability and more efficient financial systems, stimulates investment. Combining information from six advanced transition countries (see Chart 7.10), real wages in industry rose by about 7 per cent in 1996, after a rise of between 4 and 4.5 per cent in 1994-95. Real wage increases continued in the first quarter of 1997. At the same time, growing external imbalances, analysed in greater detail in Section 7.3, indicate that some economies may be in danger of

[5] Comprehensive data on the expenditure side of GDP in transition economies is relatively scarce as most countries tend to produce and/or publish only supply-side GDP series. Up-to-date direct estimates of final demand components of GDP in constant prices are available for relatively few countries, mostly advanced transition economies.

[6] In the Slovak Republic, this was partly caused by one-off, large investments related to the completion of the Mochovce nuclear power plant.

overheating. This highlights the need for careful macroeconomic management.

With growth, the production structure is changing. Services, neglected under central planning, are rapidly expanding their share of GDP, while industrial production is stabilising at a far lower share than before the transition.[7] The pattern for agriculture is less clear. The expansion of services and the rise in their relative price (see Section 7.2) forces the manufacturing and other tradable sectors to generate rapid productivity gains in order to maintain margins and growth. Such productivity gains are intimately linked to the pace of, and thus the conditions for, enterprise restructuring discussed in Part II of this Report.

7.2 Stabilisation: Lower inflation but fragile fiscal positions

Inflation has been brought further under control in most of the region. End-year inflation in 1997 is expected to be 40 per cent or less in 20 out of 26 countries. Median inflation fell from 32 per cent in 1995 to a projected 14 per cent in 1997. There is now single-digit inflation (on an end-year 1997 basis) in nine countries (see Table 7.2).[8] Most cases of improvement have been in the CIS. However, inflation performance has not been uniform. There have been slippages both in the CIS and in some countries of eastern Europe.

In Albania the achievement of reducing inflation to a single digit in 1995 was compromised in 1996 in the run-up to elections. The situation in 1997 is clearly worse, and it is in fact remarkable, given the social chaos during the first half of the year and continuing difficulties for the new administration to re-establish control, that there is no evidence of more extreme inflation. Inflation is expected to move into the range of 40 per cent for the full year 1997.

In Bulgaria the loss of macroeconomic control during 1996 and early 1997 drove the economy back into extreme inflation. Year-end inflation of 311 per cent was recorded in 1996, and is projected to be nearly 600 per cent in 1997. Since March, however, there has been a rapid process of disinflation, which was reinforced by the introduction of a currency board system in July.

In Romania the monetisation of fiscal deficits in the context of elections led to the build-up of inflationary pressures during the second half of 1996. Despite significant monetary tightening in 1997, inflation is expected to accelerate to just over 100 per cent by the year-end, following the removal of administrative price controls.

In the CIS reversals in previous stabilisation efforts have occurred in Armenia, Belarus and Tajikistan, while only a gradual improvement at relatively high levels of inflation is expected for Uzbekistan. In all these cases, a resumption of expansionary monetary policies, typically in support of ailing state enterprises, lies behind inflation in 1997.

Countries that were more consistent in their stabilisation commitments have nevertheless had difficulties reducing inflation to levels typical (at present) of Western market economies. Similar to experiences in some developing countries, it has been far easier to bring inflation down from annual triple-digit rates to rates between 10 and 20 per cent a year, than to move beyond that success. Early disinflation has relied on strict monetary policy combined with the stabilisation of exchange rates by design and/or as a result of inflows of foreign capital. However, an important factor in explaining the persistence of double-digit inflation in the transition economies is the continuing adjustment of relative prices. While the prices of most goods and services quickly found equilibrium levels after the initial liberalisation, the adjustment of administered prices, in particular for utilities and social services (e.g. housing, medicine and health care) has proceeded far more gradually in a process likely to last several more years in most countries (see Chart 7.2). These services have substantial weight in the consumer price index, and for the most part the increase in their prices has not been offset by reductions in the prices of other goods. The result is continuing upward pressure on the general price level.[9]

Disinflation over the past two years in the CIS has been helped by the development of a domestic securities market which has allowed governments to limit the monetary financing of fiscal deficits. In some countries, most prominently Russia, international portfolio investment has contributed to this process. Partly as a result of substantial capital inflows, the yield on Russian treasury bills (GKOs) fell from 200 per cent in mid-1996 to 20 per cent by July 1997.

However, public finances in much of the region remain fragile. Measured at the level of general government,[10] fiscal deficits in excess of 3 per cent of GDP were recorded in more than half of the transition economies in 1996 (see Table 7.3).[11] In general, fiscal deficits are higher in the countries of the CIS than in eastern Europe and the Baltics (except for Bulgaria and Albania, where deficits have been extraordinarily high). Fiscal balances are expected to improve further in eastern Europe in 1997. However, fiscal expansion is expected in some countries (such as the Slovak Republic) in a move that may be ill-timed at the current stage of the economic cycle.

[7] See Chapter 4.

[8] Bosnia and Herzegovina is not included in Table 7.2.

[9] In addition, there may be statistical problems of measurement. In particular, the upgrading of product and service quality that has been associated with the opening of borders and the growing private sector tends to be difficult to reflect in price surveys. Higher product prices may, in some cases, simply indicate quality improvements.

[10] This definition includes the state, municipalities and extrabudgetary funds, such as social insurance.

[11] In some countries in Table 7.3 whose fiscal deficits appear to be low, such as Belarus and Turkmenistan, the general government accounts hide substantial quasi-fiscal deficits, such as subsidised directed credit by state-owned banks.

Table 7.2

Inflation in eastern Europe, the Baltics and the CIS

(change in the year-end retail/consumer price level, in per cent)

	1991	1992	1993	1994	1995	1996 *Estimate*	1997 *Projection*
Albania	104	237	31	16	6	17	42
Bulgaria	339	79	64	122	33	311	592
Croatia	250	938	1,149	-3	4	3	4
Czech Republic	52	13	18	10	8	9	9
Estonia	304	954	36	42	29	15	12
FYR Macedonia	230	1,925	230	55	9	0	8
Hungary	32	22	21	21	28	20	17
Latvia	262	959	35	26	23	13	8
Lithuania	345	1,161	189	45	36	13	10
Poland	60	44	38	29	22	19	15
Romania	223	199	296	62	28	57	116
Slovak Republic	58	9	25	12	7	5	7
Slovenia	247	93	23	18	9	9	9
Eastern Europe and the Baltic states [1]	*193*	*510*	*166*	*35*	*19*	*38*	*65*
Armenia	25	1,341	10,896	1,885	32	6	19
Azerbaijan	126	1,395	1,294	1,788	85	7	7
Belarus	93	1,558	1,994	1,900	243	40	99
Georgia	131	1,177	7,488	6,473	57	14	9
Kazakhstan	137	2,984	2,169	1,160	60	29	12
Kyrgyzstan	170	1,259	1,363	96	32	35	24
Moldova	151	2,198	837	116	24	15	11
Russia	144	2,501	837	217	132	22	14
Tajikistan	204	1,364	7,344	1	2,132	41	105
Turkmenistan	155	644	9,750	1,328	1,262	446	44
Ukraine	161	2,730	10,155	401	182	40	15
Uzbekistan	169	910	885	1,281	117	64	40
The Commonwealth of Independent States [2]	*139*	*1,672*	*4,584*	*1,387*	*363*	*63*	*33*

Notes:
Data for 1990-95 represent the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1996 are preliminary actuals, mostly official government estimates. Data for 1997 represent EBRD projections. Figure for Albania for 1997 is based on the information from parts of the country where data collection was possible.

[1] Unweighted average for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

[2] Unweighted average for all countries of the former Soviet Union, except Estonia, Latvia and Lithuania.

In many countries, in fact in most of those that experienced a deterioration in their fiscal positions during 1996, poor revenue performance rather than a lack of expenditure control was the main source of budgetary difficulties. Compared with 1995, the share of general government expenditure in GDP was reduced in all countries of the region with the exception of Georgia and Moldova. However, in many cases revenues fell even faster, often with striking speed. Chart 7.3 shows that, over the two-year period 1994-96, the share of government revenues in GDP declined in 20 countries, with the decline exceeding 10 per cent of GDP in ten cases.

The development of fiscal revenues reflects various factors. On the one hand, government in many countries, especially in central Europe, is rather large and there have been efforts to reduce the tax pressure. Furthermore, revenues have fallen for cyclical reasons – economies have shrunk, and parts of the tax base (such as profit and income taxes) have moved disproportionately as a result. However, arguably the most important factors explaining the rapidly worsening performance in recent years have been structural and institutional. These problems stem from the challenges of creating effective tax systems in the new market-oriented environment with a much higher degree of decentralisation.[12]

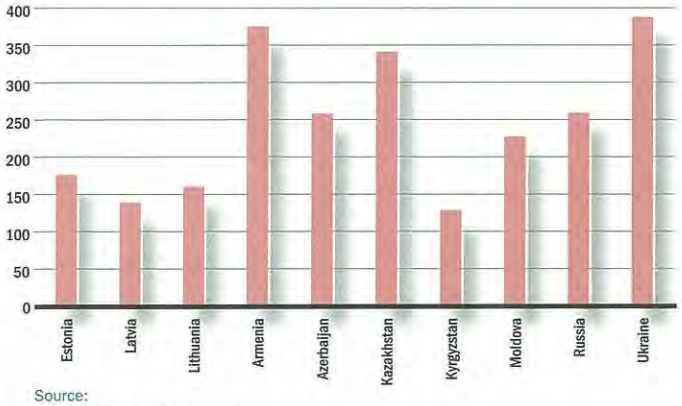
Poor tax collection often has its roots in the poor design and administration of taxes. The definitions of tax bases remain problematic throughout the CIS, often including items that would, by any reasonable standard, be treated as costs (such as standard bank provisioning for bad loans or parts of the wage bill). Taxes also tend to change frequently without due notification, and have

[12] For further discussion see *Transition Report* 1994, Chapter 6, Taxation and transition. It must be remembered that in the old regime profits and turnover were the primary base for taxation and could be assessed and manipulated fairly directly by governments. Competition has in many cases lowered profits and undermined this base.

Chart 7.2

Change in relative prices in selected transition economies

Change in the CPI for services relative to the general consumer basket (=100) 1994-96

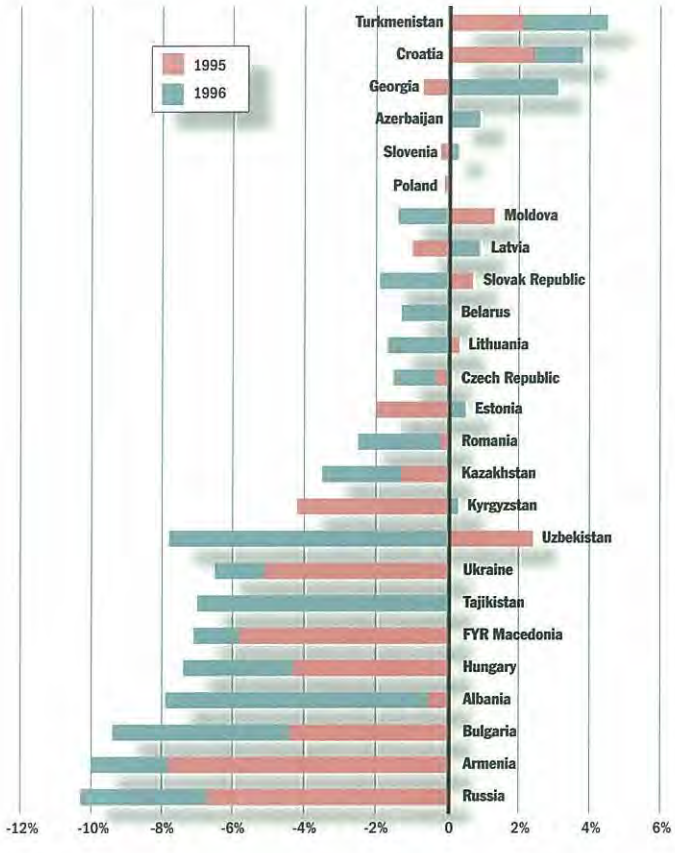


Source:
National Statistical Institute.

Chart 7.3

Change in government revenues, 1995-96

As a share of GDP



Note:
Consolidated general government balances are not available for Poland, in 1996, and for Azerbaijan, Belarus and Tajikistan, in 1995.

Source:
Calculated on the basis of the selected economic indicators at the back of this Report.

sometimes been applied retroactively. In addition, there is often a dizzying array of taxes whose relation to each other is unclear. The result is widespread discretion by tax administrators, a plethora of special deals that undermine the revenue base, and a lot of management time dedicated to the avoidance or evasion of taxes. Continued use of barter, payments in kind and accumulation of arrears (whereby a large share of transactions and income effectively escapes taxation) are partly associated with tax evasion and are major causes of poor tax revenues, particularly in the CIS.[13]

Box 7.1 provides greater detail on the problems of raising government revenue in Russia. In Russia and in other countries tax reform, and in particular the reform of tax administration, has been high on the agenda but, as the numbers suggest, it may take time before these measures are effective.

In the longer term, the ability of all the transition economies to raise sufficient government revenue and implement expenditure controls would be difficult to sustain without fundamental public sector reforms. Taxes raised to finance social security, in particular pensions systems, are already disproportionately large and, given current demographic trends, the pension burden will increase further in the coming years. Health and education systems, as well as public spending on infrastructure, have suffered under the transition process. There are additional and growing claims on budgetary resources to finance restructuring and environmental clean-up. These are issues that are likely to be of particular importance in countries that have applied for membership in the EU. Some steps towards the reform of public expenditures have already been taken. Far-reaching pension reforms have been initiated in a number of countries. Generally speaking, if only for budgetary reasons, governments across the region will have to rely to a growing extent on private sector involvement in some of their traditional responsibilities. Public-private partnerships, which may offer a solution, are discussed in Chapter 1.

7.3 External trends: Growing imbalances

Most countries in the region – Russia being the main exception – are experiencing growing trade deficits and a continued deterioration of their current account positions. Almost half of the transition economies recorded current account deficits in excess of 7 per cent of GDP in 1996. In 10 countries the deterioration in the current account balance in 1996 was equivalent to at least 4 per cent of GDP (see Table 7.4). These developments have been driven above all by booming domestic demand assisted, and partly stimulated, by growing private capital inflows. While overall, this is a welcome sign of growing confidence in the region, the current account deficits may raise questions of sustainability, in particular in view of the rapid build-up of foreign debt. In some countries, they have already contributed to currency volatility, and careful demand management through fiscal adjustment is advisable to ward off the potential for balance-of-payments crises.

[13] See Box 2.2 (Chapter 2) for a discussion of barter in Russia.

Table 7.3

General government balances in eastern Europe, the Baltics and the CIS

(in per cent of GDP)

	1990	1991	1992	1993	1994	1995	1996 Estimate	Change 1995-96
Albania	-15.0	-31.0	-22.0	-15.0	-12.0	-10.0	-12.0	**-2.0**
Bulgaria	na	na	-5.2	-10.9	-5.8	-6.4	-13.4	**-7.0**
Croatia	na	na	-4.0	-0.8	1.7	-0.9	-0.5	**0.4**
Czech Republic	na	na	na	2.7	0.8	0.4	-0.2	**-0.6**
Estonia	na	5.2	-0.3	-0.7	1.3	-1.2	-1.5	**-0.3**
FYR Macedonia	na	n.a.	-9.6	-13.6	-3.2	-1.3	-0.4	**0.9**
Hungary	0.4	-2.2	-5.5	-6.8	-8.2	-6.5	-3.5	**3.0**
Latvia	na	na	-0.8	0.6	-4.1	-3.5	-1.4	**2.1**
Lithuania	-5.4	2.7	0.8	-3.1	-4.2	-3.3	-3.6	**-0.3**
Poland	3.1	-6.7	-6.6	-3.4	-2.8	-3.6	-3.1	**0.5**
Romania	1.0	3.3	-4.6	-0.4	-1.9	-2.6	-3.9	**-1.3**
Slovak Republic	na	na	na	-7.0	-1.3	0.1	-1.2	**-1.3**
Slovenia	-0.3	2.6	0.2	0.3	-0.2	0.0	0.3	**0.3**
Eastern Europe and the Baltic states [1]	–	–	–	*-4.5*	*-3.1*	*-3.0*	*-3.4*	***-0.4***
Armenia	na	-1.8	-8.1	-56.1	-16.5	-11.1	-9.3	**1.8**
Azerbaijan	na	na	2.8	-12.7	-11.4	-4.2	-2.6	**1.6**
Belarus	na	na	na	-1.9	-2.6	-1.9	-1.6	**0.3**
Georgia	na	-3.0	-25.4	-26.2	-7.4	-4.5	-4.4	**0.1**
Kazakhstan	1.4	-7.9	-7.3	-1.3	-7.2	-2.0	-2.5	**-0.5**
Kyrgyzstan	0.3	4.6	-17.4	-14.2	-7.7	-13.5	-6.4	**7.1**
Moldova	na	0.0	-26.2	-7.4	-8.7	-5.7	-6.7	**-1.0**
Russia	na	na	-21.6	-7.2	-10.4	-5.5	-8.3	**-2.8**
Tajikistan	na	-16.4	-31.2	-25.0	-10.5	-11.2	-5.3	**5.9**
Turkmenistan	1.2	2.5	13.2	-0.5	-1.4	-1.6	-0.2	**1.4**
Ukraine	na	na	-25.4	-16.2	-7.8	-4.9	-3.2	**1.7**
Uzbekistan	-1.1	-3.6	-18.4	-10.4	-6.1	-4.1	-7.3	**-3.2**
The Commonwealth of Independent States [2]	–	–	–	*-11.2*	*-7.4*	*-5.4*	*-4.4*	***1.0***

Notes:

Data for 1990-95 represent the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1996 are preliminary actuals, mostly IMF estimates. Change in fiscal balances in 1995-96 represents the difference between the ratios of fiscal balances to GDP in the respective years. General government includes the state, municipalities and extrabudgetary funds. Balances reported on cash basis except for Albania and Poland. 1996 figure for Albania refers to the first half of 1996. Data for Armenia refer to the consolidated state government, for Croatia refer to the consolidated central government and for Uzbekistan refer to the state and extrabudgetary funds.

[1] Unweighted average for Albania, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

[2] Unweighted average for all countries of the former Soviet Union, except Estonia, Latvia and Lithuania.

Foreign trade

Current accounts have largely followed developments in external trade (see Chart 7.4). The growth in the dollar value of both merchandise exports and imports fell sharply during 1996 (however, note the data problems discussed below). After registering increases of 26 per cent and 34 per cent respectively in 1995, growth of only 6 per cent for exports and 12 per cent for imports was recorded in 1996. At the level of individual countries, the performance was mixed, with most of the decline recorded in eastern Europe and some countries of the CIS actually increasing exports. Taking into account the real appreciation of exchange rates over the period, which increased the dollar value of GDP, the share of exports in GDP in the region excluding Russia fell by more than 10 per cent in 1996 (3.3 percentage points), while that of imports remained broadly constant (see Chart 7.5).

The sharply lower measured growth in both export and import values in most countries of the region is surprising and appears in fact to have been associated with valuation problems and one-off events in 1995.[14] When valuation problems are considered, it

[14] Examples of the kinds of problems that arise are as follows. The balances of payments, from which the data discussed above were taken, are partly at odds with customs and national accounts statistics. Trade statistics were adjusted in the Czech Republic in 1995. Without that statistical break, imports would have grown at around half the registered 69% increase. In Hungary balance-of-payments statistics are recorded on a cash basis, and currency substitution accompanying the progressive liberalisation of capital account transactions made it difficult to keep trade-related and other capital flows apart. In 1994 and 1995 Hungarian customs recorded import growth of 16% and 7% respectively compared with -0.9% and 37% registered in the balance of payments. National accounts statistics measuring the growth in volume terms of trade in both goods and non-factor services also paint a very different picture for 1996, with a modest decrease in export growth rates in the Czech Republic, Hungary and Poland, a deceleration of import growth in the Czech Republic and a relatively sharp *increase* for Hungary and Poland. Unfortunately, reliable national accounts are not available for a wider range of countries. Finally, if trade figures are converted into Deutschmarks at annual average DM/dollar cross rates, export values for the region as a whole – but excluding again Russia – grew 17.3% in 1995 and 9.5% in 1996, and import growth *increased* slightly from 19.7% in 1995 to 21.5% in 1996.

Box 7.1

Tax regime and tax revenues in Russia

Tax collection has been one of the weakest elements of Russia's macroeconomic performance throughout the transition process. At the same time, the structure and operation of the tax regime has been the single most important flaw in the Russian business climate. Since late 1991 there has been no comprehensive overhaul of the tax regime. Changes have been mainly of an ad hoc nature, driven by the short-term imperatives of fiscal crisis, resulting in slow and inconsistent tax reforms, and deep tensions in the fiscal relationships between the centre and Russia's 89 regions. A new Tax Code, which would represent a significant advance over the present system, was approved by the Duma in its first reading and is scheduled to be finally adopted by the end of the year. It is expected to enter into force on 1 January 1998.

Characteristics of the current tax regime

With a nominal (statutory) tax burden of around 35 per cent of GDP (for local, regional and federal taxes and contributions to extrabudgetary funds combined), the Russian tax effort is not high by international standards. However, a range of structural characteristics of the tax system can make taxation extremely onerous for businesses. Compared with other countries, a much larger part of the tax burden falls on businesses than on individuals. Enterprises have faced a variety of taxes which are based on the companies' revenue as opposed to profits. The outdated Russian accounting system has artificially increased the profit tax liability for companies due to non-deductibility of many legitimate business expenses, the lack of inflation accounting and low depreciation rates.

A further and no less severe problem has been the basic instability and the lack of transparency of the tax regime. Currently, the tax system is governed by around 2,000 legislative acts, leaving wide scope for contradictory interpretation by various tax authorities. There is a proliferation of federal, regional and local taxes, with the total number exceeding 200. Frequent changes in taxation, in some cases applied retroactively, as well as arbitrary enforcement of the taxation rules, have made the effective tax burden largely unpredictable.

The reaction of the authorities to the adverse impact of the tax regime on the real economy and on tax compliance has magnified these problems. A web of tax exemptions, tax deferrals and other tax privileges has developed over the years granted by various levels of government to mitigate the adverse impact of the nominal tax burden on businesses or out of political considerations. Taxation has increasingly become a matter of bargaining between the tax authorities and the tax payers.

Faced with decreasing tax compliance and growing outright tax evasion, the authorities resorted to different measures, which until very recently proved to be largely ineffective. Initially they introduced a draconian tax penalty system and created a special tax police, who tended to be more interested in collecting tax penalties or kickbacks than in revenue-raising. There have been recurring attempts to reform the tax administration. However, progress in this area has been very slow. In late 1996 an Emergency Tax Commission was created to deal with the largest tax-delinquent enterprises, using the threat of bankruptcy to force these companies to pay off their tax arrears.

Decline in tax revenues

Tax revenues have declined sharply throughout the transition period. According to official data, the actual tax revenues of Russia's enlarged budget (including the consolidated revenues of the federal and the regional budgets and those of the extrabudgetary funds) fell from over 44 per cent of GDP in 1992 to less than 30 per cent in 1996, with the decline accelerating in the 1994-96 period. This trend continued in the first quarter of 1997 when tax collection ran at a mere 64 per cent of the budgetary targets, compared with 80 per cent in 1996. Tax collection improved significantly during the second quarter as a result of major one-off payments of tax arrears by a number of large enterprises, most importantly by Gazprom.

The key factors underlying the deteriorating revenue performance, in addition to the decline of output and profits, have been the following: (i) There is a shrinking tax base caused by the impact of exemptions, tax deferrals and other tax concessions. At the end of 1996 total tax concessions amounted to an estimated Rb 163 trillion (7.2 per cent of GDP). (ii) Reductions have been made in the statutory rates under the profit tax and VAT reform steps, such as the elimination of the excess wage tax and the phasing out of export tariffs. Although these were inevitable and positive changes in themselves, they also contributed to the revenue decline as they have not led to the hoped for improvements in tax compliance. (iii) There has been a deterioration in tax discipline. The level of tax arrears has increased sharply in recent years. In 1996 the stock of identified arrears to the consolidated budget were estimated at close to Rb 128 trillion (5.7 per cent of GDP) while arrears to the extrabudgetary funds were close to Rb 100 trillion (4.3 per cent of GDP). Tax evasion, reflecting both the growth of the informal economy and weaker tax compliance in the formal economy, has increased. Under-reporting of production, barter transactions, capital flight and non-wage forms of remuneration of employees have been the main avenues for tax avoidance. According to the State Tax Service, at the beginning of 1997 about one-third of enterprises did not pay any taxes and only 16.6 per cent of the enterprises (or a quarter of the functioning taxpayers) are regularly paying the taxes that are due. (iv) The budgetary revenue performance is further complicated by the fact that, since 1994, the Government has received an increasing share of revenue in various non-monetary forms or as offsets against public expenditure, with adverse implications for the flexibility of fiscal policy.

The budgetary revenue crisis has acquired a self-reinforcing character in recent years. The Government has increasingly resorted to the sequestration of budget expenditures and has been prevented from complying with its own obligations, including the payment of pensions and public wages. As a result, the Government itself contributed to the deterioration of tax discipline and the deepening of the general payment crisis. A lasting turnaround in the current budgetary crisis can be expected only if the Government regains its credibility (which has recently received a major boost with the paying off of pension arrears) and the Russian tax system is comprehensively reformed.

Table 7.4

Current account and trade balances in eastern Europe, the Baltics and the CIS

	Current account balance 1996	Merchandise trade balance 1996	Current account balance 1996	Merchandise trade balance 1996	Change in current account balance 1995-96	Change in merchandise trade balance 1995-96
	(In million US dollars)		*(In per cent of GDP)*		*(Change in GDP-share in per cent)*	
Albania	-123	-692	-4.7	-26.7	2.7	-7.1
Bulgaria	117	209	1.3	2.4	1.8	1.5
Croatia	-1,452	-3,276	-7.6	-17.2	1.8	-1.2
Czech Republic	-4,476	-5,972	-8.1	-10.9	-5.3	-3.4
Estonia	-448	-1,058	-10.3	-24.2	-5.6	-6.2
FYR Macedonia	-288	-317	-7.8	-8.6	-1.7	-2.4
Hungary	-1,700	-2,600	-3.8	-5.9	1.9	-0.4
Latvia	-361	-929	-7.2	-18.5	-3.5	-7.0
Lithuania	-440	-631	-4.4	-6.3	0.0	0.0
Poland	-1,352	-8,154	-1.0	-6.1	-5.7	-4.6
Romania	-2,336	-2,130	-5.9	-4.6	-1.0	-0.1
Slovak Republic	-1,941	-2,106	-10.2	-11.1	-8.0	-9.8
Slovenia	47	-853	0.3	-4.6	0.5	-0.1
Eastern Europe and the Baltic states [1]	–	–	*-5.3*	*-10.9*	*-1.7*	*-3.1*
Armenia [2]	-424	-436	-26.6	-27.4	10.9	3.9
Azerbaijan	-811	-549	-23.6	-8.0	-12.1	1.9
Belarus	-909	-1,335	-6.7	-9.9	-4.3	-4.8
Georgia	-222	-295	-4.9	-6.5	3.4	5.2
Kazakhstan	-700	-300	-3.4	-1.4	0.6	-0.3
Kyrgyzstan	-414	-373	-23.7	-21.4	-4.4	-3.7
Moldova	-250	-234	-13.1	-12.2	-4.5	-9.0
Russia	9,600	23,100	2.2	5.2	0.9	0.3
Tajikistan	-110	-50	-10.9	-5.0	-11.1	-9.5
Turkmenistan	43	159	1.7	6.1	1.4	1.6
Ukraine	-1,184	-4,296	-2.7	-9.8	1.5	-3.5
Uzbekistan	-1,075	-931	-7.9	-6.8	-7.4	-8.9
The Commonwealth of Independent States [3]	–	–	*-10.0*	*-8.1*	*-2.1*	*-2.2*

Notes:

Data are the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Change in current account and merchandise trade balances in 1995-96 represents the difference between the ratios of current account and merchandise trade balances to GDP in respective years.

1 Unweighted average for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

2 The current account balance for Armenia excludes transfers.

3 Unweighted average for all countries of the former Soviet Union, except Armenia, Estonia, Latvia and Lithuania.

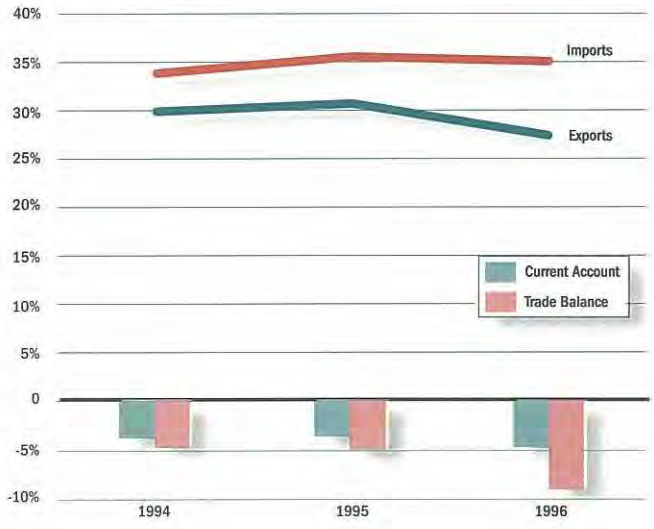
appears in fact that imports may have continued to grow at previous rates, while export growth decelerated and trade deficits increased. This is consistent with the view that external accounts have been driven, above all, by the boom in domestic demand that the region is experiencing (see Section 7.1). The rapid increase in consumption and investment spending has stimulated imports and diverted potential export goods to the domestic market. However, other factors are also likely to have played a role in determining recent trade patterns. Among them is the sluggish demand in western Europe, the destination for between one-third and two-thirds of exports of most transition economies and where total import growth dropped from 7 per cent in 1995 to 2.5 per cent in 1996. It is interesting to note that intra-regional trade, which had all but collapsed in the early 1990s, showed growth which far outpaced that of trade with developed and developing market economies in 1996. The importance of western European and in particular German demand for eastern Europe's export performance is confirmed by preliminary information for 1997, which has seen improvements in the pace of export growth and a narrowing of the gap between import and export growth in the Czech Republic, Hungary and Poland that are hard to explain by domestic events, but are consistent with growing demand from Germany.

A microeconomic factor contributing to the external trade performance may be the slow pace of restructuring in industry. On the basis of a product-level analysis, the United Nations Economic

Chart 7.4

External trade and balances,

Whole region excluding Russia (in per cent of GDP)

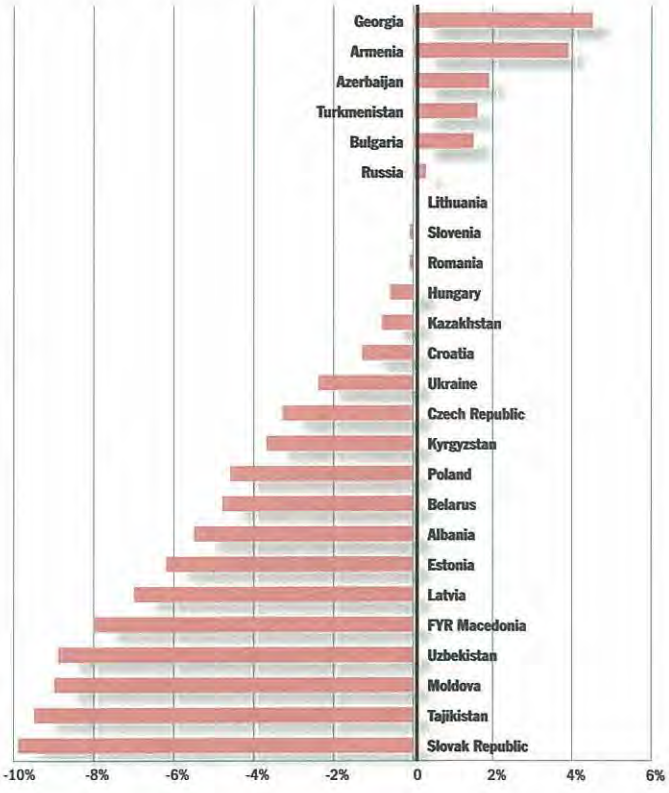


Source:
Calculated on the basis of the selected economic indicators at the back of this Report.

Chart 7.5

Deterioration in trade balances, 1996

Change over 1995 (in per cent of GDP)



Source:
Selected economic indicators at the back of this Report.

Commission for Europe[15] concludes that eastern European producers have often been unable to capitalise on rising domestic demand. While there is still unused capacity in many companies, there seem to be difficulties in supplying higher-quality consumer and investment goods and in responding quickly to changing demand patterns (see also Chapter 4). Similar considerations apply to export markets. Hungary, which is often viewed as having the best record in enterprise restructuring, was incidentally one of the very few countries to record export-driven growth in 1996. Finally, it is possible that increasing competitiveness problems are associated with rising dollar wages in manufacturing, especially for exports of weaker companies. Nevertheless, the country-level evidence in this regard is inconclusive (see Section 7.4).

Capital flows

Capital inflows may have contributed to domestic demand and thus external imbalances as much as they helped finance them. There has been a significant shift of financing away from official to private sources of funds. Private capital flows are notoriously difficult to estimate, but all available information points to a rapid increase in inflows over the past few years. According to one source, the Institute for International Finance, net private flows (covering direct investments, portfolio investments in debt and equity securities, commercial bank lending and trade finance) into the seven main recipient countries of the region[16] increased from US$ 13.9 billion in 1993 to US$ 33.7 billion in 1996 and is projected to rise further to a striking US$ 52 billion in 1997. Over the same period, net official flows decreased from US$ 9.5 billion (1993) to US$ 7.3 billion (1996), and are not expected to pick up in the near future.

Charts 7.6 and 7.7 provide a graphic representation of developments in commercial bank lending and bond issues by sub-region. The share of the former Soviet Union in the total, large in 1990 and 1991 before its break-up, remained low from 1992 to 1996 but has been rising strongly in 1997. The more advanced countries of eastern Europe attracted growing amounts of funding over the same period.[17] While sovereign and sovereign-backed issuers have been particularly prominent on the international bond markets – with Kazakhstan, Lithuania, Moldova, Russia, Ukraine and the cities of Moscow and St Petersburg making debut public offerings since late 1996 – significant issues have also been made by "blue chip" commercial entities and banks, especially in the advanced countries of central Europe. A large number of Russian regional authorities, municipalities and enterprises are expected to launch bonds during the remainder of 1997. Since 1995, private borrowers have dominated the commercial loan market, the vast

[15] UNECE (1997).

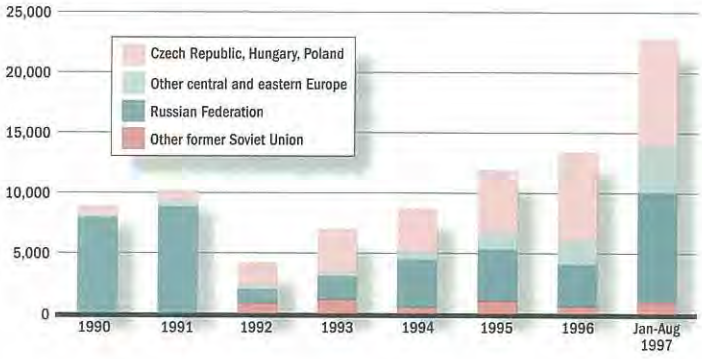
[16] Bulgaria, Czech Republic, Hungary, Poland, Romania, Russia and the Slovak Republic.

[17] The "blip" in bond issues to eastern Europe in 1993 is due to the Bank of Hungary's issuing 21 bonds to finance growing current account deficits.

Chart 7.6

Syndicated lending by commercial banks, by sub-region

In millions of US$

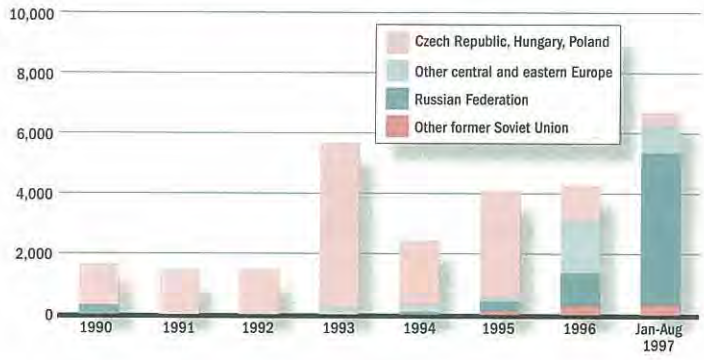


Source:
Euromoney: Loanware

Chart 7.7

International bond issues, by sub-region

In millions of US$



Source:
Euromoney: Bondware

Note:
For 1990 and 1991, Russian data refer to the whole USSR. For 1990 to 1992, Czech data refer to the whole of Czechoslovakia.

majority in the form of bank-to-bank loans and project financing. Again, borrowers in Russia have been particularly active on this market recently. Syndicated loans to 21 Russian banks for a total value of US$ 1.2 billion have been recorded during the first half of 1997 alone.[18]

Along with rising volumes, terms have generally improved, but there are cases of rapid reversal which demonstrate the fragility of these markets and the information problem still faced by investors.[19] Issue spreads of 375, 325, 100 and 80 basis points over US Treasuries were recorded in recent bond issues by Russia (June 1997, 10 year maturity), Ukraine (August, one-year), Poland (June, 20-year) and Croatia (February, five-year) respectively. As of mid-September, effective spreads were 312, 283, 120 and 152 basis points, suggesting improved confidence in the former two countries and slightly deteriorating confidence in the latter. In the syndicated loan market, spreads over LIBOR declined by 133 (to 323), 75 (to 47) and 70 basis points (to 20) for Russia, the Slovak Republic and Hungary respectively during the first quarter of 1997.

Over recent years, eastern European and Russian corporates and banks have increasingly taken the direct route to overseas equity markets, although this still represents a small share of aggregate flows. Issues have generally taken the form of American Depository Receipts[20] and private placements, but there have also been direct listings on western Stock Exchanges. International equity issues, primarily in conjunction with privatisation, were initially dominated by Hungary, which issued US$ 837 million in shares abroad over the period 1994-96. Poland had issues of US$ 218 million in 1995, but it is in 1996 that this form of finance "took off", with a total of US$ 1.3 billion in share issues from seven countries. Russia (US$ 800 million) again dominated this segment.[21] Overseas issues are viewed increasingly as an attractive option by large companies in the region because of the lack of depth and liquidity of domestic equity markets. Some 15 Russian corporates had launched ADR programmes by the spring of 1997, and at least as many others were preparing such issues.

Inflows into local money markets are a similarly recent phenomenon, have made an equally spectacular start, and are again dominated by Russia. Inflows into the Russian treasury bill (GKO and OFZ) market have been prompted by the gradual relaxation of restrictions on purchases by non-residents since early 1996, which has been partly motivated by the authorities' desire to lower the cost of public debt. Non-residents purchased US$ 5.6 billion in treasury bills through "S" accounts[22] in 1996, and US$ 5.4 billion in January-April of 1997 alone. By April, they held approximately one-quarter of outstanding issues through these official channels, and probably more through "grey market" operations with Russian intermediaries. Since mid-1997, with yields on GKOs having declined significantly, foreigners have been entering the more "exotic" Russian regional and municipal bond markets in search of higher yields (e.g. Orenburg treasury bills yielded 600 basis points over GKOs in August 1997). Unhedged positions are now being taken in roubles.

[18] However, these loans tend to carry short maturities of one year or less.

[19] Information on terms is drawn from the Euromoney Loanware and Bondware databases.

[20] American (and Global) Depository Receipts spare non-resident investors the settlement and custody problems of what are still weak institutional infrastructures for capital markets in the region. They are securities issued on the US market by reputable financial institutions, regulated by the US Securities and Exchange Commission, but backed by the cash flow of shares or debt securities held in other countries.

[21] The largest single issue by a company in a transition economy was Gazprom (US$ 430 million ADR). Lukoil plans to raise US$ 1 billion in New York this year. In central Europe, MATAV will likely be largest issue so far, perhaps US$ 0.5 billion.

[22] Since early 1996, non-residents are allowed to open so-called rouble "S" accounts at designated Russian banks to buy government paper, but profits have to be repatriated through contracts involving a cap on dollar yields. This requirement is gradually being phased out and markets are set to be fully liberalised by early 1998. "Grey" market purchases involving Russian intermediaries have played on the large arbitrage margins between resident and non-resident markets.

The experience of Ukraine and Bulgaria demonstrates how rapidly market conditions have adapted to changed expectations (see Chart 7.8). In both countries, foreign investors were all but absent from the domestic securities markets until late 1996. Foreign hedge funds and proprietary traders of various investment banks began to enter the Hryvna treasury bill market in January 1997 and contributed to driving down annualised yields by about 25 percentage points within a matter of two weeks and by a further 10 percentage points (to 20 per cent on six-month paper) by mid-July. In Bulgaria, yields on four-week treasury bills fell from 600 per cent to 100 per cent within the first three weeks of April after the Government had signed an IMF programme. They declined further to less than 6 per cent in July. Foreigners accounted for 20 per cent (or DM 171 million) of the outstanding stock of treasury bills at end-August, after accounting for virtually nil in March. In addition, over the same period US$ 225 million was invested in Bulgarian bank recapitalisation bonds with a 25-year maturity (indexed to the US dollar but payable in leva), helping to drive the market price up from around 40 per cent to 75 per cent of nominal value at a time when the liquidity of Bulgarian buyers was severely weakened.

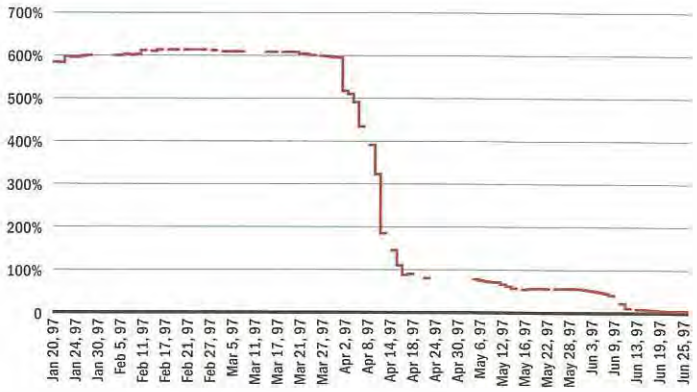
Recent low yields on transition economy debt are partly explained by excess liquidity in the international capital markets and not only by falling risk perceptions – or the reality of risk. Indeed, in some cases the yields may look unrealistically low in relation to the risks involved. Similar phenomena have been observed in other emerging markets, and one should be cautious in projecting these conditions too far into the future. The markets can be unforgiving when debt servicing problems surface and risk perceptions are sharply adjusted, possibly across the board even for borrowers who show little sign of trouble.

Foreign direct investment (FDI) has continued to flow into the region at a rapid pace, covering an increasingly broad range of countries (see Table 7.5). What would appear to be a slight pause in 1996 for the aggregate flow into the region (down by approximately US$ 500 million compared with 1995) masks an underlying growth trend. Several large infrastructure privatisations in Hungary, (power sector) and the Czech Republic (telecoms) took place in December 1995 and distort the annual comparison. Poland was the region's leading recipient of FDI in 1996, replacing Hungary which had held that position since 1989. In both Russia and Poland, FDI has accelerated further in 1997. Azerbaijan, Kazakhstan and Ukraine have begun to attract an increasing share of the regional total, and Latvia and Lithuania have both caught up with Estonia as investment locations. Generally speaking, FDI continues to follow natural resources – where these are abundant – and progress in transition. Its broader distribution is primarily witness to the progress that countries outside the core group of advanced reformers have made in establishing environments worth investing in. Over the coming years, FDI into the region is likely to increase further, with some projections reaching around US$ 18 billion in 1997 and more than

Chart 7.8

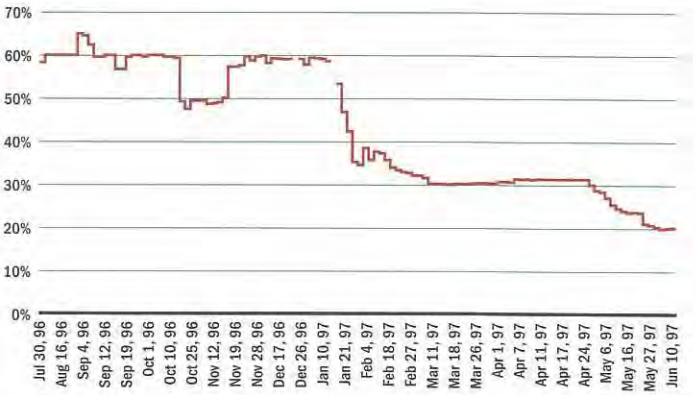
Bulgaria: yield on four-week treasury bills, January-June 1997

On annual basis



Ukraine: yield on six-month treasury bills, July 1996-June 1997

On annual basis



Source:
Salomon Brothers International.

US$ 20 billion in 1998. In 1997, Poland and Russia are each expected to attract about one-quarter of the total. Large-scale privatisations through direct sales, especially in the infrastructure sector, are likely to be a key driving force along with a consolidation of investments in the automotive industry (see Chapter 2).

Sustainability of current account deficits

Private and official capital flows over the past few years have easily exceeded current account deficits and contributed to the replenishment of foreign exchange reserves. They reflect above all rising confidence of foreign investors and creditors, deriving from the economic recovery and the growing track record of reforms, combined with attractive investment opportunities. As discussed in Chapters 3 and 6, the potential productivity (and profitability) of new capital in the transition economies is likely to be higher than in more settled market environments. At the same time, domestic financial systems are still unable to offer much support to

Table 7.5

Foreign direct investment
(net inflows recorded in the balance of payments)

	1994	1995	1996 (revised)	Cumulative FDI-inflows 1989-96	Cumulative FDI-inflows 1989-96 per capita	FDI-inflows per capita in 1996	FDI-inflows as a share of GDP in 1996
		(In millions of US dollars)		(In millions of US dollars)		(In US dollars)	(In per cent)
Albania	53	70	90	298	93	28	3
Bulgaria	105	82	100	425	51	12	1
Croatia	98	81	349	615	129	73	2
Czech Republic	1,024	2,720	1,264	7,120	692	123	2
Estonia	212	199	110	735	477	71	3
Hungary	1,097	4,410	1,986	13,260	1,300	195	4
Latvia	155	165	230	644	258	92	5
Lithuania [1]	31	72	152	285	76	41	2
FYR Macedonia	24	13	39	76	38	20	1
Poland	542	1,134	2,741	5,398	140	71	2
Romania	347	404	210	1,186	52	9	1
Slovak Republic	178	134	177	623	117	33	1
Slovenia	131	170	180	743	372	90	1
Eastern Europe and the Baltic states	*3,997*	*9,654*	*7,628*	*31,408*	*273*	*66*	*2*
Armenia	3	19	22	44	12	6	1
Azerbaijan	22	284	661	987	130	87	19
Belarus	10	7	75	167	16	7	1
Georgia	8	6	25	39	7	5	1
Kazakhstan	635	859	1,100	3,067	187	67	5
Kyrgyzstan	45	61	31	147	33	7	2
Moldova	18	73	56	161	37	13	3
Russia	584	2,021	2,040	5,843	40	14	0
Tajikistan	12	13	13	55	10	2	1
Turkmenistan	103	233	129	544	118	28	5
Ukraine	100	300	500	1,270	25	10	1
Uzbekistan	73	-24	50	156	7	2	0
The Commonwealth of Independent States	*1,613*	*3,852*	*4,702*	*12,480*	*44*	*17*	*1*
Total	***5,610***	***13,506***	***12,330***	***43,888***	***110***	***31***	***1***

Sources:
IMF, central banks and EBRD estimates.

[1] FDI figures for Lithuania are only available from 1993. For 1993 and 1994, figures cover only investment in equity capital. For 1995 and 1996, equity capital and reinvested earnings are covered but inter-company debt transactions are not covered.

investors and savings are limited, especially during the recovery from the transition-related recession when future earnings expectations stimulate consumption. Foreign financing can help the transition economies realise their growth potential and cope with the demands of consumption. Current account deficits may thus merely represent the other side of the growth coin.

However, foreign financing also creates obligations that will have to be serviced in the future, and growing current account deficits introduce, therefore, an element of vulnerability and instability into a country's economic framework. Shifts in perceptions can lead to quick revisions in credit assessments by foreign sources of finance, possibly inducing rapid reversals in capital flows and currency crises. Market perceptions as to the sustainability of a current account deficit are notoriously hard to predict. However, they tend to focus on the way in which the economy generates the means for repaying external claims in the future and, more specifically, on whether the government, the main obligor in most countries, continues to be able and willing to pay. The rate at which an economy invests rather than consumes foreign funds, the soundness of fiscal and monetary policy, the structural reforms and political stability that help underpin prudent macroeconomic policy in a lasting way and the size of existing foreign debt all enter this assessment. The perceived ability to address short-term refinancing needs on external debt, and thus the term structure of existing obligations, can be an important additional consideration.

As mentioned above, during the past year international markets overall have clearly passed a favourable judgement on most transition economies despite the worsening current account situation.

But events in the Czech Republic and Bulgaria have, in very different ways, also demonstrated how things can go wrong.

In early 1997 the Czech Republic combined relatively low external debt and a near-balanced budget with a large and growing current account deficit. While a private consumption boom – partly induced by substantial real wage increases – contributed to the external imbalances, this was matched by a strong investment performance and thus, in principle, favourable prospects for future earnings. Nevertheless, confidence in the efficiency and transparency of the financial system declined during 1996 following a series of bank failures. In addition, the fixed exchange rate of the koruna had contributed to loss of competitiveness and was the subject of political debate[23] – a debate which, incidentally, exposed the vulnerability of the Czech banking sector, which had large foreign liabilities, to devaluation. The koruna regime became the focal point of speculation about the sustainability of the country's external accounts. In April 1997 the koruna was subject to attack as doubts grew about the Government's willingness and ability to take corrective action. The "small package" of economic reforms announced in April 1997 was deemed insufficient to stave off the growing external imbalance. In addition, it reinforced the perception that the Government itself had doubts about sustainability and caused large amounts of short-term external funds (portfolio investments and bank deposits) to be withdrawn. The Czech Republic spent about 2 billion dollars in foreign exchange reserves before letting the exchange rate depreciate and switching to a managed float system. The markets reacted favourably to further government policy announcements in May. In addition, there was an improvement in the current account in the second quarter. By August, the koruna had reversed about one quarter of its initial 12 per cent decline against its central parity, though the crisis left a legacy of interest rates which remain 200-300 basis points above pre-crisis levels.

Bulgaria in early 1996 faced a very different set of conditions. Its external and internal debt stood at about 80 per cent and 35 per cent of GDP respectively, making them among the highest in the region. The same applied to the fiscal and quasi-fiscal deficits (with estimates for the sum of these in 1995 and 1996 in the range of 15-18 per cent of GDP), while the current account was broadly in balance. Two factors contributed directly to a currency crisis, which lasted from January 1996 to March 1997. First, for several years the banking system had refinanced the losses of the essentially unreformed state enterprise sector. When liquidity problems developed towards the end of 1995 (and problem banks were increasingly propped up with uncollateralised National Bank deposits), confidence in the banking sector was quickly eroded. Second, money creation spilled over into a loss of international reserves (which were at US$ 1.2 billion at end-1995). Given external debt servicing needs of around US$ 1 billion during 1996 and deep disagreements between the Government and the international financial institutions on economic policy-making, doubts grew about the country's ability to refinance obligations as they came due. These developments led to the withdrawal of US$ 900 million (10 per cent of GDP) in foreign currency deposits from the banking system, despite restrictions, and increasingly a generalised run on banks and on the lev. As of February 1997, broad money was at less than a quarter of its real value in late 1995, the lev had depreciated by about 4,500 per cent, and international reserves were at critically low levels. After a change in government, cross-party agreement was reached on an ambitious programme of stabilisation and structural reform. The foreign exchange market reacted almost instantly. The exchange rate stabilised and appreciated by about 100 per cent, foreign capital was attracted into domestic securities as early as March and by the time of the introduction of a currency board on 1 July international reserves were exceeding their end-1995 level. However, vast amounts of savings had been destroyed and economic activity suffered severely.

Table 7.6 provides a grouping of countries around some standard indicators for analyses of sustainability, the size of the current account and fiscal deficits and the ratio of external debt to exports.[24] It also displays groupings around debt-to-GDP ratios, but these ratios should be viewed with some caution as, in the transition economies, they have often changed rapidly in response to real exchange rate appreciation. In such a broad-brush categorisation, the cut-off points for "low", "medium" and "high" are necessarily somewhat arbitrary. Also, the fiscal deficit criteria should ideally be expanded to cover "quasi-fiscal deficits" resulting from the state's influence over the activity of banks and enterprises. The accounts of Belarus and Turkmenistan, for instance, would then look far worse. Nevertheless, Table 7.6 offers some useful insights. With very few exceptions, the external debt burden is not high by international standards. For instance, the Latin American average for the debt-to-exports ratio (including goods and non-factor services in the denominator) was 203 per cent in 1996[25], a level surpassed among transition economies only by Armenia, Bulgaria and Georgia. The average for all developing countries was 146 per cent, compared with 121 per cent for the transition economies.[26] However, while external debt is not (yet) high, it has been growing very rapidly. The large number of countries with significant current account deficits provides one indication of this.[27] While, as mentioned above, in the more advanced transition economies a growing share of external finance has taken the form of equity, debt-creating flows continue to be prevalent in many CIS countries.

[23] In fact, following earlier debates on the impact of capital inflows on the exchange rate regime the National Bank had widened the fluctuation band of the koruna from ± 0.5% to 7.5% in February 1996.

[24] Where the data were available, "exports" here include revenue from goods and non-factor services.

[25] *World Debt Tables 1997*, World Bank.

[26] The ratio was almost the same in eastern Europe and the Baltics (123%) and in the CIS (118%).

[27] Note that developing countries have, on average, maintained current account deficits within 2% of GDP over the past few years. This is the cut-off point between "low" and "medium" deficits in Table 7.6.

Table 7.6

Debt indicators and deficits in 1996

	Current account balance [1]	Fiscal balance [2, 3]	Gross external debt/ Current account revenues [4, 5]	Net external debt/GDP [6, 7]
	(In per cent of GDP)		*(In per cent)*	
Low	Russia (2.2)	Belarus (-1.6)	Albania (82.1)	Albania (20)
	Bulgaria (1.3)	Croatia (-0.5)	Azerbaijan (66.4)	Armenia (28)
	Poland (-1)	Czech Republic (-0.7)	Belarus (16.3)	Azerbaijan (10)
	Slovenia (0.3)	Estonia (-1.5)	Croatia (58.9)	Belarus (4)
	Turkmenistan (-0.7)	FYR Macedonia (-0.4)	Czech Republic (67.3)	Croatia (13)
		Latvia (-1.4)	Estonia (11.8)	Czech Republic (15)
		Slovak Republic (-1.2)	Kazakhstan (69.3)	Estonia (-7)
		Slovenia (0.3)	Latvia (29.4)	FYR Macedonia (25)
		Turkmenistan (-0.2)	Lithuania (34.8)	Georgia (27)
			Slovak Republic (70.2)	Kazakhstan (9)
			Slovenia (36.9)	Latvia (-4)
			Turkmenistan (36.0)	Lithuania (4)
			Ukraine (45.5)	Moldova (27)
			Uzbekistan (61.7)	Poland (17)
				Romania (16)
				Russia (26)
				Slovak Republic (24)
				Slovenia (9)
				Turkmenistan (-19)
				Ukraine (17)
				Uzbekistan (1)
Medium	Albania (-4.7)	Azerbaijan (-2.6)	FYR Macedonia (128.9)	Hungary (40)
	Belarus (-6.7)	Georgia (-4.4)	Hungary (143.7)	Kyrgyzstan (35)
	Georgia (-4.9)	Hungary (-3.5)	Kyrgyzstan (141.0)	
	Hungary (-3.8)	Kazakhstan (-3.1)	Moldova (100.2)	
	Kazakhstan (-3.8)	Lithuania (-3.6)	Poland (145.3)	
	Lithuania (-4.4)	Poland (-3.1)	Romania (110.5)	
	Romania (-5.9)	Romania (-3.9)	Russia (125.9)	
	Ukraine (-2.7)	Ukraine (-3.2)	Tajikistan (186.0)	
High	Armenia (-26.6)	Albania (-12.0)	Armenia (211.4)	Bulgaria (105)
	Azerbaijan (-23.6)	Armenia (-9.3)	Bulgaria (204.0)	Tajikistan (90)
	Croatia (-7.6)	Bulgaria (-13.4)	Georgia (331.0)	
	Czech Republic (-8.1)	Kyrgyzstan (-6.4)		
	Estonia (-10.3)	Moldova (-6.7)		
	FYR Macedonia (-7.8)	Russia (-8.3)		
	Kyrgyzstan (-23.7)	Tajikistan (-5.3)		
	Latvia (-7.2)	Uzbekistan (-7.3)		
	Moldova (-13.1)			
	Slovak Republic (-10.2)			
	Tajikistan (-10.9)			
	Uzbekistan (-7.9)			

[1] Categories: "Low": current account deficit smaller than or equal to -2% of GDP. "Medium": current account deficit between -2% and -7% of GDP. "High": current account deficit greater than -7% of GDP.

[2] Data refer to the general government.

[3] Categories: "Low": fiscal deficit smaller than or equal to -2% of GDP. "Medium": fiscal deficit between -2% and 5% of GDP. "High": fiscal deficit greater than -5% of GDP.

[4] Categories: "Low": ratio of gross external debt to current account revenues smaller than or equal to 100%. "Medium": ratio of gross external debt to current account revenues between 100% and 200%. "High": ratio of gross external debt to current account revenues greater than 200%.

[5] Current account revenues include merchandise exports and exports of non-factor services. In the case of Armenia, Azerbaijan, Belarus, Bulgaria, FYR Macedonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Romania, Tajikistan and Uzbekistan, the gross external debt is divided only by merchandise exports.

[6] Categories: "Low": ratio of gross external debt to GDP smaller than or equal to 30%. "Medium": ratio of gross external debt to GDP between 30% and 50%. "High": ratio of gross external debt to GDP greater than 50%.

[7] Net external debt equals gross external debt net of gross reserves of the monetary authorities.

Sources:
Calculations on the basis of the selected economic indicators at the back of this Report.

A further cause for concern is the association of high current account deficits with significant budgetary imbalances in several CIS countries, notably Armenia, Kyrgyzstan, Moldova, Tajikistan and Uzbekistan. Together with evidence of low public investment activity,[28] this suggests that a large proportion of foreign funding may serve to meet current outlays that do not improve those countries' future repayment capacity. Foreign borrowing was in some cases explicitly earmarked to reduce budgetary pensions and wage arrears (e.g. a recent Russian bond issue and a planned Kazakh issue).[29] The association between budgetary and external imbalances is particularly worrying if viewed against the background of the weak fiscal revenue performance across much of the CIS (see Section 7.2). The vast majority of CIS debt is owed by sovereign or sovereign-backed borrowers. Problems of fiscal sustainability are perhaps the most likely source of external instability in the future.

The sources of the external imbalances in the region, in particular the rapid growth in consumption and, in the CIS, the precarious fiscal positions, suggest that governments should drive a course of cautious demand management in order to pre-empt instability in the future. As indicated in Section 7.2, this requires above all a strengthening of the fiscal revenue base, public expenditure reforms, especially in the area of social expenditures, and – as illustrated by the Bulgarian crisis – a strong commitment to press ahead with restructuring in the enterprise and banking sectors. The need for reforms would appear to be particularly urgent in countries that perform poorly on several of the indicators in Table 7.6. Armenia, Bulgaria, Kyrgyzstan, Moldova, Tajikistan and Uzbekistan all score badly on two or more of the indicators. Georgia has also had problems in managing its debt, but debt indicators seem to be improving as the dollar value of GDP is rising fast. Over time, sustainability is likely to be enhanced by a rising share of foreign direct investment in total capital flows on the one hand, and by increasing domestic savings rates on the other (see Chapter 6 of the 1996 *Transition Report*). The ability to attract such investment and raise savings depends, however, on many of the same policies outlined above.

Finally, the past year has also demonstrated the need for ensuring a careful mix of policies. One factor that may have contributed to current account deficits in several countries, including the Czech and Slovak Republics, Croatia and Estonia, was the combination of tight monetary policies, fixed or pegged exchange rates, and moderately slackening fiscal policies. This resulted in sizeable differentials of domestic over foreign interest rates and thus profit opportunities for short-term foreign capital, which contributed to demand pressures. Apart from the impact this may have had on the size of current account deficits, short-term financing of external deficits also makes a country particularly vulnerable to changes in risk perceptions leading to sudden reversals of capital flows. While foreign direct investment was strong in the Czech Republic in 1996 and the term structure of debt generally quite favourable, during the last two quarters of 1996 the ratio of short-term debt rose to 28 per cent, while portfolio inflows also accumulated rapidly. This led to a more volatile structure of foreign capital and added to the pressures which arose in the spring of 1997. In the case of Estonia and the Slovak Republic, short-term capital inflows increased dramatically to over 50 per cent of the total in 1996, attracted primarily by high interest rate differentials. A reassessment of the mix of monetary and fiscal policies in these two countries would seem prudent.

7.4 Productivity, real exchange rates and competitiveness

International competitiveness in manufacturing declined somewhat during 1996 and 1997 in several countries of the region. In the advanced countries of eastern Europe, the average increase in unit labour costs in Deutschmark terms was 9 per cent in 1996.[30] During the same period, unit labour costs in Germany fell by 1 per cent. This development reflects partly the delayed adjustment of wages to productivity growth in earlier years and the continuing upward adjustment of real exchange rates after the sharp depreciation at the start of the transition.

Specifically, the change in Deutschmark unit labour costs can be attributed to three factors, which are analysed for 12 countries for which the full range of data was available (see Table 7.7): (i) Labour productivity growth in manufacturing continued to average around 8 per cent in 1996 and was growing at double-digit rates in Croatia, Latvia and Romania (see Chart 7.9). (ii) For the first time in 1996, real wage growth in terms of domestic producer prices outpaced the growth of labour productivity in six out of 12 countries, which resulted in a squeeze on profit margins. At the same time, real wage growth in terms of consumer prices continued to lag behind productivity growth, as consumer prices increased considerably faster than producer prices (see Chart 7.10).[31] (iii) Except for Bulgaria and Romania, currencies continued to appreciate strongly against the Deutschmark (and other hard currencies), with the median rate of appreciation among the 12 countries surpassing 10 per cent during 1996 (see Chart 7.11). As discussed in Box 7.2, there is reason to believe that real appreciation will continue for some time to come.

The result was a considerable increase in unit labour costs in terms of Deutschmarks during 1996 in seven of the 12 countries. This trend has continued into 1997, except in Estonia, where productivity growth has accelerated, and Russia, where real wages

[28] See Kapur and van der Mensbrugghe (1997).

[29] And, in fact, certain state-owned enterprises are said to have borrowed abroad to meet their tax liabilities. This is a reflection of the liquidity crisis in the enterprise sector of the CIS (see the discussion of barter in Russia in Chapter 2, Box 2.3).

[30] The growth rate refers to an employment-weighted average of Croatia, the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia.

[31] This phenomenon has characterised relative price adjustments in the region for some time. Its origins may be traced to the larger weight of prices of non-tradable goods, such as public utility prices and other services (most importantly rents) in the CPI, and the moderating effects of real exchange rate appreciation on the PPI, which is dominated by tradable goods. Therefore, generally speaking, reduced manufacturing profits and reduced purchasing power of wages have financed increased transfers to public utilities and providers of services.

Table 7.7

Indicators of competitiveness

(change, in per cent)

	1994	1995	1996	1997-Q1
Bulgaria [1]				
Industrial gross output	8.5	4.9	0.2	na
Productivity in industry	12.6	7.3	3.3	na
Real wage in industry (PPI-based)	-12.1	3.3	-17.9	na
Real D-Mark exchange rate (CPI-based)	-4.5	13.6	-18.7	na
D-Mark unit labour costs	-31.7	4.9	-30.1	na
Croatia [2]				
Industrial gross output	-2.7	0.3	3.1	3.0
Productivity in industry	1.6	5.8	11.4	10.8
Real wage in industry (PPI-based)	29.8	30.8	11.0	6.0
Real D-Mark exchange rate (CPI-based)	13.0	1.3	3.1	6.3
D-Mark unit labour costs	33.3	26.0	2.1	1.5
Czech Republic [3]				
Manufacturing gross output	0.1	8.2	5.5	-3.0
Productivity in manufacturing	4.9	11.1	9.6	1.1
Real wage in manufacturing (PPI-based)	11.2	9.5	12.0	9.6
Real D-Mark exchange rate (CPI-based)	6.4	2.6	10.1	14.0
D-Mark unit labour costs	11.0	1.5	10.0	22.3
Estonia [4]				
Manufacturing gross output	-3.2	2.9	4.8	17.8
Productivity in manufacturing	6.7	0.4	6.3	20.8
Real wage in manufacturing (PPI-based)	26.9	14.1	7.8	11.1
Real D-Mark exchange rate (CPI-based)	43.7	26.6	21.3	8.6
D-Mark unit labour costs	61.4	35.2	16.3	-2.1
Hungary [5]				
Manufacturing gross output	9.3	5.3	3.5	8.9
Productivity in manufacturing	7.3	11.2	9.1	9.8
Real wage in manufacturing (PPI-based)	9.2	-5.9	-0.2	-0.8
Real D-Mark exchange rate (CPI-based)	-0.8	-7.0	5.4	10.6
D-Mark unit labour costs	-2.8	-19.4	-3.6	5.4
Latvia [6]				
Industrial gross output	-9.4	-6.7	0.9	-4.4
Productivity in industry	9.4	-1.1	12.6	-3.1
Real wage in industry (PPI-based)	39.6	15.2	4.6	22.5
Real D-Mark exchange rate (CPI-based)	56.8	14.7	16.6	16.1
D-Mark unit labour costs	76.7	21.9	6.3	43.0
Lithuania [7]				
Manufacturing gross output	-29.7	0.9	1.3	-4.8
Productivity in manufacturing	-12.1	11.9	4.9	-9.0
Real wage in manufacturing (PPI-based)	16.4	11.3	21.6	10.9
Real D-Mark exchange rate (CPI-based)	76.9	21.1	29.0	8.7
D-Mark unit labour costs	102.2	12.7	42.7	34.0
Poland [8]				
Manufacturing gross output	13.6	11.6	10.5	10.4
Productivity in manufacturing	13.9	7.0	9.9	9.8
Real wage in manufacturing (PPI-based)	5.1	5.4	18.3	12.4
Real D-Mark exchange rate (CPI-based)	1.6	3.8	11.6	9.9
D-Mark unit labour costs	-5.9	2.6	12.5	7.0
Romania [9]				
Manufacturing gross output	3.7	12.1	12.6	16.2
Productivity in manufacturing	13.3	19.2	16.7	19.6
Real wage in manufacturing (PPI-based)	-7.3	16.7	3.6	-14.2
Real D-Mark exchange rate (CPI-based)	3.9	-6.6	-5.3	2.5
D-Mark unit labour costs	-3.6	-5.0	-7.9	-24.3
Russia [10]				
Manufacturing gross output	-24.0	-3.9	-6.8	3.3
Productivity in manufacturing	-17.7	4.8	1.3	6.4
Real wage in manufacturing (PPI-based)	-17.5	-31.3	6.0	-13.0
Real D-Mark exchange rate (CPI-based)	76.2	23.9	35.9	10.5
D-Mark unit labour costs	94.7	-6.4	47.5	-5.4
Slovak Republic [11]				
Industrial gross output	4.7	8.3	2.5	1.7
Productivity in industry	6.8	4.0	2.5	2.5
Real wage in industry (PPI-based)	7.0	5.7	10.1	7.2
Real D-Mark exchange rate (CPI-based)	4.0	2.8	6.1	7.8
D-Mark unit labour costs	3.8	5.5	13.8	13.9
Slovenia [12]				
Industrial gross output	6.4	2.0	1.0	0.2
Productivity in industry	11.4	7.2	6.6	5.8
Real wage in industry (PPI-based)	8.1	3.9	7.0	7.8
Real D-Mark exchange rate (CPI-based)	1.6	6.9	-0.5	4.7
D-Mark unit labour costs	-1.5	4.9	-1.5	5.7

Notes:

Numbers in the first three columns represent the percentage change in annual averages. Numbers in the last column represent the change in the average of 1997 Q1 from the average of 1996 Q1.

Productivity is calculated as the ratio of manufacturing production to manufacturing employment.

The real D-Mark exchange rate is calculated as the domestic CPI divided by the product of the German CPI and the exchange rate. A positive sign represents a real appreciation.

D-Mark unit labour costs are calculated as D-Mark wages divided by productivity.

Data on the exchange rate to the D-Mark, on CPI and PPI are based on National Sources, the International Financial Statistics and EBRD estimates.

[1] Data on industrial production, employment and wages are taken from the *Statistical Yearbook*, various issues, and annual reports by the National Bank of Bulgaria. Real wages are calculated as average gross monthly wages in industry, deflated by the PPI in industry.

[2] Data on industrial production, employment and wages are taken from the 1996 *Statistical Yearbook* and various issues of *Monthly Statistical Report*, published by the Central Bureau of Statistics. Real wages are calculated as average monthly wages in industry, deflated by the PPI in industry. The 1994 growth rate refers to net wages, subsequent growth rates refer to gross wages.

[3] Data on production, employment and wages are taken from annual and monthly publications of the Czech Statistical Office. Real wages are calculated as average monthly gross wages in manufacturing, deflated by the PPI in industry.

[4] Data on production, employment and wages are taken from annual and monthly reports by the Estonian Statistical Office. Real wages are calculated as average gross monthly wages in manufacturing deflated by the PPI in manufacturing.

[5] Data on production, employment and wages are taken from the *Monthly Bulletin of Statistics* of the Hungarian Statistical Office. Real wages are calculated as average monthly gross wages in manufacturing deflated by the PPI in industry.

[6] Data on production, employment and wages are taken from the OECD Short-term Economic Indicators, various issues. Real wages are calculated as average monthly gross wages in industry deflated by the PPI in industry.

[7] Data on employment and wages are taken from OECD *Short-term Economic Indicators*, various issues. Output includes mining and is taken from the *International Financial Statistics*, various issues. Real wages are calculated as average monthly gross wages in manufacturing deflated by the PPI in industry.

[8] Data on production, employment and wages are taken from monthly and quarterly reports of the Polish Statistical Office. Real wages are calculated as average monthly gross wages in manufacturing deflated by the PPI in manufacturing.

[9] Data on production, employment and wages are taken from OECD *Short-term Economic Indicators*, various issues. Real wages are caculated as average net wages in manufacturing deflated by the PPI in industry.

[10] Data on production, employment and wages are taken from OECD *Short-term Economic Indicators*, various issues. Output and employment figures for 1996 and 1997 Q1 refer to industry rather than manufacturing. Wages for 1997 Q1 are taken from *Russian Economic Trends*. Real wages are calculated as average gross monthly wages in manufacturing deflated by the PPI in industry.

[11] Data on production, employment and wages are taken from OECD *Short-term Economic Indicators*, various issues and from annual and monthly publications by the Slovak Statistical Office Real wages are calculated as average gross monthly wages in industry deflated by the PPI in industry.

[12] Data on production, employment and wages are taken from the Slovenian Institute for Macroeconomic Analysis and Development. Real wages are calculated as average gross monthly wages in industry deflated by the PPI in industry.

appear to have declined recently. The sources of the increase in unit labour costs differ somewhat among countries, with real wages the key element in central Europe and real appreciation of exchange rates relatively more important in Russia and the Baltics. Hungary has been an exception to the trend in that real wages declined in 1996. At the same time, real appreciation against the Deutschmark was relatively moderate, so that labour cost competitiveness in manufacturing improved substantially. In 1997, however, Hungary has moved back towards the pattern observed in the other advanced countries.

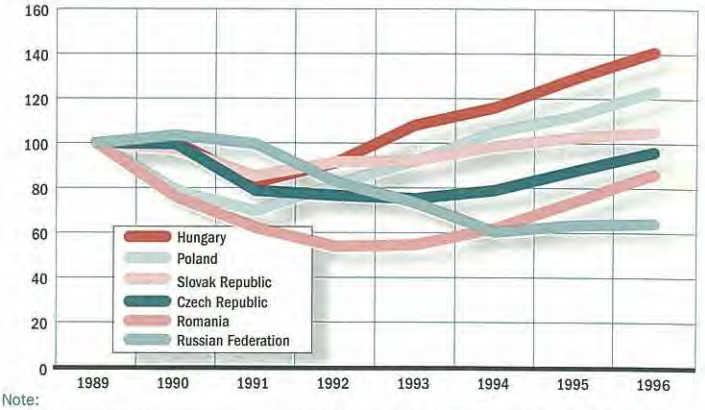
As the transition progresses, certain patterns are emerging in productivity growth. Labour productivity is the ratio between the value of output, measured in constant prices, and the level of employment. In the early stages of transition developments in productivity throughout the region were dominated by the decline in output. The initial decline in measured productivity began to be reversed in most countries as surplus labour was shed, but with a delay. Since many enterprises were maintaining excess labour under central planning, and labour forces as a share of the population were very high compared with those in market economies, the effect of redundancies could, in proportional terms, easily surpass that of the initial decline in output and generate very high rates of measured productivity growth over and above the "starting level". Finally, in a third phase which the more advanced transition economies have entered and which partly overlaps with the second, productivity begins to be driven by fresh capital investment, improved technologies and modern management methods – the "deep restructuring" discussed in more detail in Chapters 4 and 5.

In summary, most countries lost some of their labour cost advantage *vis-à-vis* more developed market economies. However, in hard currency terms wages remain low compared with western Europe (see Chart 7.12) while education levels and other important assets are substantial in comparison with developing countries of the same income category. There is little evidence that the increase in unit labour costs has damaged exports in general so far. Export performance across the region does not appear to be strongly correlated with the growth in unit labour costs (the simple correlation co-efficient for 1996 was -0.25).[32] Nevertheless, for some firms, especially if they underwent little restructuring, competitive pressures have begun to intensify compared with the early years of the transition. There may also be some impact on international investor confidence. The rapid rise in real wages was a factor in the debates surrounding the Czech currency crisis. In the context of stagnant industrial productivity, it contributed to the growing pressure on the Czech currency during the first five months of 1997. The Slovak Republic has similarly recorded sluggish labour productivity growth coupled with a substantial real wage increase during the first half of 1997.

Chart 7.9

Labour productivity in manufacturing

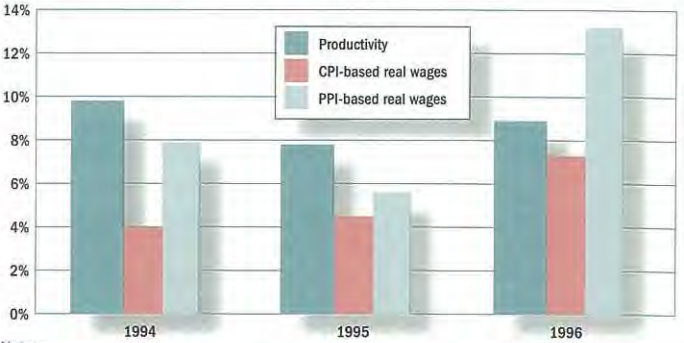
Index: 1989=100



Note:
Data were taken from the sources described in the footnotes on Table 7.7. In the Slovak Republic, productivity refers to industry.

Chart 7.10

Annual average growth in productivity and real wages in six advanced transition economies

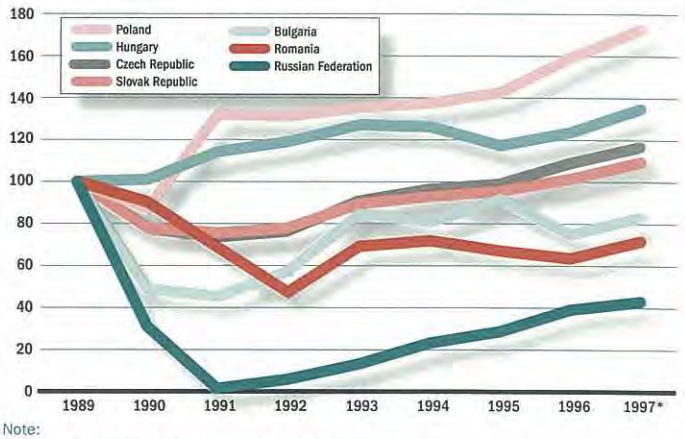


Note:
Data are based on the sources described in the footnotes on Table 7.7. Growth rates shown are the averages for Croatia, Czech Republic, Hungary, Poland, Slovak Republic and Slovenia, weighted by manufacturing employment.

Chart 7.11

Real exchange rates against the Deutschmark

CPI-based, 1989=100



Note:
An increase in the index represents a real appreciation.
* Data for 1997 are extrapolated from first-half 1997 figures.

Box 7.2

Sources of real exchange rate appreciation

Real exchanges rates are one of the most important determinants of international competitiveness.[1] Real appreciation was rapid in countries of the former Soviet Union where the exchange rate depreciated most dramatically at the beginning of transition. This suggests that the trend of real appreciation may have been the result of a continued correction process after an initial under-valuation. Comparisons of actual and purchasing power parity (PPP) exchange rates indicate that most currencies in the region were substantially below their PPP values in the early transition and have since then rapidly moved to reduce that gap.

However, the concept of under-valuation is problematic in that it presumes the existence of a "correct" value of an exchange rate. There is no general theoretical reason why nominal exchange rates should ever equal their PPP values.[2] The initial "under-valuation" was, in fact, the result of rational behaviour of financial markets as domestic and foreign holders of local currencies required large risk premia to be compensated for the uncertainty arising from the short track record of the new governments and central banks, indeed the process of transition itself.

A decrease in the perceived country risk, as evidenced by recent "investment grade" ratings for a number of countries, provides the most convincing explanation for the initial real appreciation. This boost in confidence induced domestic savers to hold domestic currency rather than to convert earnings into "safe" currencies and it makes domestic firms more willing to invest locally. At the same time, lower risk has also improved the confidence of foreign investors, making them more willing to provide loans and make investments. Taken together, these responses to lower risk contributed to net inflows of capital and thus the general trend in real appreciation.

Real appreciation is also a function of the exchange rate regime. Many currencies are officially or unofficially pegged against a foreign anchor currency. At the same time, consumer prices continue to rise driven by the upward adjustment of utility and housing prices which is a continuing process in many transition economies, as discussed in Section 7.3. Given the large weight that these services have in the CPI – which is used as the deflator in many calculations of the real exchange rate – this combination has been an important contributing factor to real appreciation. Given the remaining gap between cost-recovery prices and retail prices for these services in most countries of the region, it may well remain a source of real appreciation for some time to come.

A further explanation for real appreciation is based on the observation that the "law of one price" does not necessarily hold in the transition economies. That "law" posits that a given tradable good would, in the absence of obstacles to imports and exports, carry the same price in all countries (assuming similar transport and distribution costs). However, severe deficiencies in domestic distribution systems in most transition economies effectively led to a segmentation of markets and, given the initial overcapacity in many industrial sectors, to prices for domestically produced tradable goods that could be far lower than world market levels (even adjusted for quality). In many countries, reducing transaction costs in trade is still largely an unfinished task. Over time, as more efficient logistics and marketing techniques are developed and wholesale and retail trade mature (and excess capacity in industry is reduced), this price differential for tradables declines, leading to real appreciation.

Real appreciation should in theory also be related to productivity differentials across sectors.[3] If productivity rises faster in the tradable sectors (most manufacturing goods) than in the non-tradable sectors (construction and many services), growing demand for limited factors, such as labour and land, will push up costs for both sectors. This in turn would increase prices in the non-tradable sector (which does not face foreign price competition and is therefore able to pass costs through into prices) and thus cause real appreciation.

Comparing manufacturing productivity growth with productivity growth in GDP shows that in the early transition, the decline in productivity was more pronounced in manufacturing than in other sectors (driven by sharply falling output and only slowly falling employment levels). In most countries, the recovery of productivity growth occurred earlier in sectors other than manufacturing. In recent years, however, productivity growth in manufacturing has outpaced productivity growth in GDP as a whole, suggesting a pattern of productivity growth that is more common for industrialised countries. However, real exchange rate appreciation generally started earlier, implying that productivity differentials were not, or at least not the dominant, driving force for real appreciation in the early transition. Also, comparisons of productivity growth across sectors are notoriously difficult since it is hard to adjust for quality changes and since deflators for services are problematic.

However, real appreciation may not have been as large as the data suggest. Measurement errors can exaggerate inflationary measures when quality improvements are not fully taken into account in price statistics. Thus, if the rate of quality improvements is more rapid in eastern European countries than in the Western market economies (as is likely to be the case), the inflation rate differential between these regions and thus real appreciation would tend to be overstated.

[1] There is no unique definition for the real exchange rate. A real exchange rate change generally measures the change of domestic prices converted into international currency relative to the change in foreign prices. These prices can be consumer prices, producers prices, wholesale prices, the GDP deflator, or unit labour costs. Real appreciation was strongest when based on unit labour costs and weaker when based on producer prices. Real exchange rate appreciation based on the CPI was in between the other two measures.

[2] Non-tradable inputs (e.g. human capital, land) vary across countries, implying productivity differentials. Countries with higher productivity in the tradable sector should usually be the more "expensive" ones in equilibrium. Also, if one government has a more credible policy of maintaining a low variance in inflation, then this currency should be more expensive than in a country with a higher projected inflationary risk.

[3] This is commonly referred to as the "Balassa-Samuelson" effect.

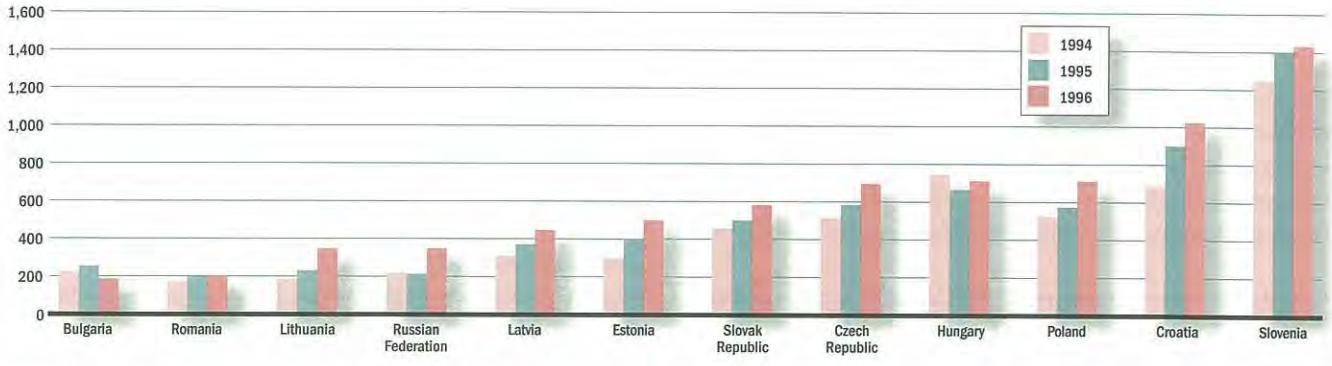
7.5 Conclusion

The past year has seen the resumption of growth in the region as a whole, a surge in inflows of private capital and a deterioration of government revenues in the CIS and of external accounts in a wide range of countries. These developments are explained, to some extent, by a revival of domestic demand and, partly related to this, by growing confidence in the region. The combination of growth and current account deficits is not surprising, given the region's significant investment opportunities but relatively low savings rates. Foreign capital can help the transition economies realise their growth potential. Nevertheless, to ensure a stable recovery, increasing attention will need to be paid to sources of internal and external imbalances, in particular since some of the foreign capital is of a relatively short-term nature and the very large inflows may not be a sustainable phenomenon. Subject to continued advance in the transition, foreign sources of funds will be looking particularly closely at fiscal policies. It is probably fair to say that monetary policies have led the way in restoring macroeconomic stability with, at times, extraordinarily high real rates of interest. To secure the macroeconomic performance, fiscal positions must be put on a

Chart 7.12

Average gross monthly wage costs in manufacturing

In D-Mark



Note:

Data were taken from the sources described in the footnotes on Table 7.7. Average monthly wage costs are average gross monthly wages including pay-roll taxes paid by employees and employers. Employers' pay-roll contributions were estimated from pay-roll tax rates. Wage rates apply to industry in Bulgaria, Croatia, Latvia, Slovak Republic and Slovenia.

sound long-term basis. In many countries there are still difficult adjustments to make on both the revenue and expenditure sides. As a broad generalisation one can say that in the western part of the region the challenges will be particularly severe in controlling expenditure, and to the east in raising revenue. These macroeconomic issues cannot be separated from the general process of reforms. As elsewhere in the transition, improving policy on the fiscal front requires not only careful attention to building institutions, but also promoting and enforcing responsible behaviour both inside and outside government.

References

I. Kapur and E. van der Mensbrugghe (1997), "External Borrowing by the Baltics, Russia and other countries of the Former Soviet Union: Developments and Policy Issues", IMF Working Paper, WP/97/72, IMF, Washington DC, June.

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Forecasts and prospects

8

This chapter presents projections of the growth of output and inflation for the region according to the latest estimates (up to the beginning of September 1997) from a number of institutions. The main aim is to provide a summary of forecasters' views of the trends in output and inflation for the period up to the end of 1998.[1]

Growth in eastern Europe and the Baltic states is projected at a little over 3 per cent in 1997. This is below the earlier expectations of many forecasters owing to the sharp contractions in output in both Albania and Bulgaria as well as slower growth in the Czech Republic following the government's deflationary package, intended to narrow the large trade deficit. Growth is expected to strengthen to 4 per cent in 1998. In some countries, however, growth is projected to slow from the high rates achieved in earlier years, partly because forecasters expect that governments will slow the growth of domestic demand as trade and current account deficits have widened. The (unweighted) average inflation rate for the region in 1997 is affected by the high rate for Bulgaria; it is projected to fall from 103 per cent to some 15 per cent in 1998.

In the CIS growth is projected at 0.4 per cent in 1997. However, there is still no consensus among the forecasters as to whether 1997 will represent the first year of recovery for the Russian economy. The forecasters agree that Russia, as well as several other countries in the CIS where output has fallen since the reforms began, will record positive growth in 1998, resulting in growth in the CIS of 2.8 per cent. The success of the stabilisation policies in most countries is reflected in projections of a further decline in the (unweighted) average inflation rate for the CIS from 37 per cent to 34 per cent by the end of 1998.

There is a growing number of institutions making projections of developments in the region, a reflection of the increasing interest in some of these countries as emerging markets for investors as well as the opportunity for greater trade and investment as reform progresses. It has not been possible to include all such institutions. The approach has been to include a number of projections from different types of organisations, including international institutions, consultants, research institutes and banks that are active in the region. The international organisations included are the European Union (EU), the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD), the United Nations Economic Commission for Europe and the EBRD. The two consultants are the Economist Intelligence Unit (EIU) and PlanEcon. The three research institutes are the Institute for Economic Research (IWH), Halle, Germany; Kopint-Datorg in Hungary; and the Vienna Institute for Comparative Economic Studies. The banks are Credit Suisse First Boston (CSFB), JP Morgan and the Union Bank of Switzerland (UBS).[2]

As noted in the 1996 *Transition Report*, all these projections are subject to considerable uncertainty. This reflects several factors, including the absence of reliable time series for many variables in some countries so that the estimates tend to be based on informal techniques rather than being derived from econometric models. Differences between some of the projections will also reflect differences in timing. The case of the Czech Republic is an example where most forecasters who completed their projections after the depreciation of the currency in May lowered their estimates of GDP growth for 1997. Those who completed their projections after the end of July will also have had to make a judgement on the effects of the severe floods in both the Czech Republic and Poland.

Almost all of these projections are "baseline" cases and assume the absence of significant shocks. The extent to which such shocks can invalidate short-term projections can be shown by comparing some of the projections for 1997 included in the 1996 *Transition Report* with the latest estimates shown here. For example, both Albania and the Czech Republic were projected to record a further year of strong growth in 1997 (of over 7 per cent and 5 per cent respectively), according to the "average" of growth estimates included in the 1996 *Transition Report*. The latest estimates show that the Albanian economy will contract strongly this year while the Czech economy is likely to grow by just 2 per cent. Several countries in the region have experienced banking crises or sharp falls in the value of their currencies in recent years, all of which have necessitated remedial measures which have had their effect on economic activity. Box 8.1 provides an illustration of how one such shock – a banking crisis – can adversely affect the prospects for growth and price stability.

8.1 Projections of growth and inflation for 1997 and 1998 for eastern Europe and the Baltic states

Economic growth in eastern Europe and the Baltic states is projected to slow to 3.2 per cent in 1997 (weighted average), which is below the 4.4 per cent attained by this group of countries in 1996 and also below the EBRD's projection of 3.9 per cent growth published in the *Transition Report Update* in April 1997 (see Table 8.1). However, much of the deterioration in near-term prospects is due to slower growth in the Czech Republic and the steeper than expected decline in two of the smaller economies, Albania and Bulgaria, as a result of earlier economic crises.

[1] This chapter does not contain a discussion of forecasts for Bosnia and Herzegovina, since there are very few (although EBRD estimates of growth and inflation for this country in 1997 are contained in the Selected Economic Indicators at the end of this Report).

[2] In the tables estimates from some institutions have been rounded to the nearest whole number or to one decimal place.

Table 8.1

GDP growth forecasts for 1997

(in per cent) [1]

Eastern Europe and the Baltic states	Average [2]	Range [3]	EBRD (Aug 97)	European Union (Mar 97)	IMF (Sept 97)	OECD (June 97)	United Nations ECE [5] (May 97)	Economist Intelligence Unit (July 97)	PlanEcon (July/ (Aug 97)	IWH [6] (Aug 97)	Kopint-Datorg [7] (July 97)	Vienna Institute (July 97)	CSFB [8] (Aug 97)	JP Morgan (July 97)	UBS [9] (June 97)
Albania	-13.7	19.8	-15.0	–	-10.0	–	–	-5.0	-24.8	–	–	–	–	–	–
Bulgaria	-6.3	7.0	-7.0	-6.7	-7.4	-6.0	-3.0	-5.0	-5.1	-6.0	-10.0	-7.0	-5.0	-6.8	-7.5
Croatia	5.1	2.0	5.0	–	5.5	–	5.5	5.0	4.8	–	4.0	5.0	6.0	–	5.0
Czech Republic	2.0	4.6	1.0	4.6	2.0	2.6	4.5	1.5	2.6	3.0	1.0	1.5	0.0	1.3	1.0
Estonia	5.3	4.0	7.0	3.0	5.0	–	4.5	5.2	6.3	5.0	–	–	–	–	6.0
FYR Macedonia	3.9	3.0	2.0	–	5.0	–	–	4.0	4.6	–	–	–	–	–	–
Hungary	2.8	2.4	3.0	1.5	3.0	2.4	2.0	3.0	3.9	2.5	2.5	3.0	3.0	2.8	3.5
Latvia	3.5	2.0	3.4	2.8	4.0	–	3.5	4.0	3.9	2.0	–	–	–	–	4.0
Lithuania	4.3	2.0	4.5	4.0	4.5	–	5.0	3.8	4.4	3.0	–	–	–	–	5.0
Poland	5.7	2.0	5.5	6.5	5.5	5.0	5.5	6.0	5.8	6.0	5.5	6.0	6.0	5.7	4.5
Romania	-1.9	4.9	-1.5	-3.6	-1.5	-1.0	-2.0	-1.0	1.3	-3.0	-1.0	-3.0	-3.0	–	-3.0
Slovak Republic	4.7	2.6	4.5	5.9	4.5	5.0	6.0	4.0	3.4	4.5	4.0	5.0	4.0	–	5.0
Slovenia	3.6	1.2	4.0	4.2	4.0	3.5	4.0	3.3	3.4	3.5	3.0	3.5	3.0	–	3.5
Average	**1.4**	**2.5**	**1.3**	**2.2**	**1.9**	**1.6**	**3.2**	**2.2**	**1.1**	**2.1**	**1.1**	**1.8**	**1.8**	**0.8**	**2.5**
Weighted average [4]	**3.2**	**–**	**3.1**	**–**	**3.3**	**–**	**–**	**3.4**	**–**	**3.7**	**–**	**–**	**–**	**–**	**–**
Commonwealth of Independent States															
Armenia	4.4	2.8	5.8	–	5.8	–	–	3.0	3.0	–	–	–	–	–	–
Azerbaijan	5.1	1.1	5.2	–	5.7	–	–	5.0	4.6	–	–	–	–	–	–
Belarus	5.0	3.8	3.0	–	5.0	–	5.0	5.0	6.8	5.0	–	–	–	–	–
Georgia	10.1	0.7	10.5	–	10.0	–	–	10.0	9.8	–	–	–	–	–	–
Kazakhstan	2.2	1.9	2.0	–	1.5	–	2.0	1.5	3.4	–	–	–	–	–	2.5
Kyrgyzstan	5.8	1.9	6.0	–	6.9	–	–	5.0	5.2	–	–	–	–	–	–
Moldova	0.3	8.0	-2.0	–	1.4	–	6.0	-2.0	-1.8	–	–	–	–	–	–
Russia	0.4	4.0	1.0	–	1.5	2.0	1.0	0.0	0.3	-2.0	-1.0	0.0	1.0	-1.0	1.5
Tajikistan	-0.5	10.3	-3.0	–	-5.3	–	–	5.0	1.3	–	–	–	–	–	–
Turkmenistan	-14.5	8.5	-15.0	–	-18.5	–	–	-10.0	-14.5	–	–	–	–	–	–
Ukraine	-4.1	8.0	-3.0	–	-3.0	–	–	-5.0	-2.5	-6.0	-8.0	0.0	-4.0	–	-5.0
Uzbekistan	1.4	4.9	1.0	–	2.2	–	–	-1.5	3.4	–	–	–	–	–	2.0
Average	**1.3**	**8.0**	**1.0**	**–**	**1.1**	**2.0**	**3.5**	**1.3**	**1.6**	**-1.0**	**-4.5**	**0.0**	**-1.5**	**-1.0**	**0.3**
Weighted average [4]	**0.4**	**–**	**0.8**	**–**	**1.3**	**–**	**–**	**-0.1**	**0.6**	**–**	**–**	**–**	**–**	**–**	**–**

Notes:

[1] All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

[2] The number at the bottom of this column refers to the mean of all the average forecasts shown in this table.

[3] This column shows the difference between the highest and the lowest of the forecasts.

[4] Weighted average based on EBRD estimates of size of GDP in each country in 1996. Several institutions calculate their own weighted average. For 1997 IWH estimates GDP growth for eastern Europe and the Baltic states at 3.4% and for the CIS at -2.2%. The comparable data for 1998 are 3.6% and 1.6%.

The EU estimates the weighted average growth rate for 10 countries in eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 3.6% in 1997 and 5.2% in 1998. In their *Review and Outlook for Eastern Europe*, PlanEcon gives an aggregate growth rate for this part of the region of 3.6% in 1997 and 4.4% in 1998. However, the country coverage differs from that shown here. PlanEcon excludes the Baltic states and includes Serbia.

[5] United Nations Economic Commission for Europe.

[6] Institute for Economic Research, Halle, Federal Republic of Germany.

[7] Kopint-Datorg is the Institute for Economic and Market Research, Hungary.

[8] Credit Suisse First Boston.

[9] Union Bank of Switzerland.

Table 8.2

GDP growth forecasts for 1998

(in per cent) [1]

Eastern Europe and the Baltic states	Average [2]	Range [3]	EBRD (Aug 97)	European Union (Mar 97)	OECD (June 97)	Economist Intelligence Unit (July 97)	PlanEcon (July/ (Aug 97)	IWH [5] (Aug 97)	Kopint-Datorg [6] (July 97)	Vienna Institute (July 97)	CSFB [7] (Aug 97)	JP Morgan (July 97)	UBS [8] (June 97)
Albania	8.9	10.7	10.0	–	–	3.0	13.7	–	–	–	–	–	–
Bulgaria	2.2	10.5	2.5	2.9	2.0	5.5	3.6	2.0	-5.0	3.0	–	2.3	3.0
Croatia	5.2	1.5	5.0	–	–	6.0	4.9	–	4.5	5.0	5.6	–	5.5
Czech Republic	2.5	4.0	2.5	5.0	2.0	3.0	3.6	2.5	2.0	2.0	1.0	2.5	1.5
Estonia	4.4	3.0	5.0	3.0	–	4.0	4.6	4.0	–	–	–	–	6.0
FYR Macedonia	5.1	0.4	5.0	–	–	5.0	5.4	–	–	–	–	–	–
Hungary	4.0	2.2	4.0	3.0	3.5	4.4	5.2	3.5	3.5	4.0	4.0	3.5	5.0
Latvia	4.6	2.9	5.0	3.2	–	5.0	5.9	3.0	–	–	–	–	5.5
Lithuania	4.3	2.5	5.5	4.5	–	4.0	3.4	3.0	–	–	–	–	5.5
Poland	5.0	3.0	5.0	7.0	4.9	5.3	4.9	5.0	4.0	6.0	4.0	4.7	4.0
Romania	1.9	4.0	1.5	0.9	3.0	4.0	3.3	0.0	0.0	2.0	–	–	2.3
Slovak Republic	3.7	3.8	3.0	5.4	5.0	3.0	1.6	3.5	2.5	5.0	–	–	4.0
Slovenia	4.3	2.3	4.5	4.8	4.0	3.9	5.3	4.0	3.0	4.0	–	–	5.0
Average	**4.3**	**3.2**	**4.5**	**4.0**	**3.5**	**4.3**	**5.0**	**3.1**	**1.8**	**3.9**	**3.7**	**3.3**	**4.3**
Weighted average [4]	**4.0**	**0.5**	**4.0**	**–**	**–**	**4.5**	**4.4**	**–**	**–**	**–**	**–**	**–**	**–**
Commonwealth of Independent States													
Armenia	5.1	0.2	5.0	–	–	5.0	5.2	–	–	–	–	–	–
Azerbaijan	6.9	2.5	8.5	–	–	6.0	6.3	–	–	–	–	–	–
Belarus	0.6	10.0	2.5	–	–	4.0	-6.0	2.0	–	–	–	–	–
Georgia	9.5	2.4	10.0	–	–	8.0	10.4	–	–	–	–	–	–
Kazakhstan	3.7	1.0	3.5	–	–	4.0	4.2	–	–	–	–	–	3.2
Kyrgyzstan	4.8	0.6	5.0	–	–	5.0	4.4	–	–	–	–	–	–
Moldova	4.0	6.9	3.0	–	–	1.0	7.9	–	–	–	–	–	–
Russia	2.8	4.0	3.0	–	5.0	2.0	3.2	2.0	1.0	2.0	3.0	3.0	4.0
Tajikistan	2.6	5.0	0.0	–	–	5.0	2.9	–	–	–	–	–	–
Turkmenistan	3.7	8.0	8.0	–	–	0.0	3.0	–	–	–	–	–	–
Ukraine	1.1	5.0	2.0	–	–	1.0	1.5	-2.0	0.0	3.0	3.0	–	0.0
Uzbekistan	2.7	4.0	2.5	–	–	1.0	5.0	–	–	–	–	–	2.2
Average	**4.0**	**4.5**	**4.4**	**–**	**5.0**	**3.5**	**4.0**	**0.7**	**0.5**	**2.5**	**3.0**	**3.0**	**2.4**
Weighted average [4]	**2.8**	**–**	**3.1**	**–**	**–**	**2.2**	**3.2**	**–**	**–**	**–**	**–**	**–**	**–**

Notes:

[1] All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

[2] The number at the bottom of this column refers to the mean of all the average forecasts shown in this table.

[3] This column shows the difference between the highest and the lowest of the forecasts.

[4] Weighted average based on EBRD estimates of size of GDP in each country in 1996. Several institutions calculate their own weighted average. For 1997 IWH estimates GDP growth for eastern Europe and the Baltic states at 3.4% and for the CIS at -2.2%. The comparable data for 1998 are 3.6% and 1.6%. The EU estimates the weighted average growth rate for 10 countries in eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 3.6% in 1997 and 5.2% in 1998. In their *Review and Outlook for Eastern Europe*, PlanEcon gives an aggregate growth rate for this part of the region as 3.6% in 1997 and 4.4% in 1998. However, the country coverage differs from that shown here. PlanEcon excludes the Baltic states and includes Serbia.

[5] Institute for Economic Research, Halle, Federal Republic of Germany.

[6] Kopint-Datorg is the Institute for Economic and Market Research, Hungary.

[7] Credit Suisse First Boston.

[8] Union Bank of Switzerland.

The economic problems in Albania, Bulgaria and Romania have resulted in a substantial increase in the (unweighted) annual average inflation rate for all countries in the group to over 100 per cent in 1997 (see Table 8.3).[3] Most of the forecasters expect that the stabilisation programmes currently being implemented by the authorities in both Bulgaria and Romania will be successful, and most also appear to have assumed that Albania's economy will gradually return to normality. Thus in 1998 this group of countries is projected to record growth of 4 per cent combined with a further decline in inflation (an average of some 15 per cent – see Table 8.4).[4]

Growth forecasts for the economies of eastern Europe and the Baltic states compare favourably with growth prospects in western Europe. In their latest *Economic Outlook* (June 1997), the OECD projects GDP growth in the EU at 2.3 per cent in 1997, rising to 2.7 per cent in 1998. However, the success in lowering inflation in most of the industrial countries has resulted in an OECD projection of EU inflation (measured by changes in the GDP deflator) of 1.8 per cent in 1997 and 1.9 per cent in 1998 (and in Germany, the main Western market for a number of countries in this group, inflation is projected at a little over 1 per cent per annum in both years). Thus most of these transition economies are likely to continue to experience some further real appreciation of their exchange rates, especially those that are linked to the Deutschmark.

The impact of shocks to these economies provides one way of distinguishing between them. The Czech Republic, Hungary, Latvia and Lithuania have all experienced economic shocks and have implemented or are implementing measures to ensure a return to steady growth. A second group of countries (Croatia, Estonia, FYR Macedonia, Poland, the Slovak Republic and Slovenia) have to date all achieved steady or, in the cases of Poland and the Slovak Republic, strong rates of economic growth. With the exception of Slovenia, however, they have all experienced large or increasing current account deficits (discussed in more detail in Chapter 7). In 1996 the current account deficits were 10 per cent or more of GDP in Estonia and the Slovak Republic, and 7 per cent of GDP in Croatia and FYR Macedonia. Poland recorded only a small current account deficit in 1996, but it has increased in 1997. Thus one of the main issues facing these countries is their need to be prepared to restrain the growth of domestic demand to lower the trade and current account deficits to more sustainable levels. It is this factor which lies behind some of the projections for 1998 of either slower growth or growth maintained at a similar level to that expected for 1997. The third group of countries, comprising Albania, Bulgaria and Romania, have all been subject to severe structural problems resulting in negative growth in 1997 and a sharp increase in inflation.

Among the first group of countries, a number of the forecasters, including the EBRD, believe that the stabilisation and reform package introduced by the Hungarian government in 1995 has been successful and will lead to a period of steady growth. After a period of modest GDP growth in both 1995 and 1996 (of 1.5 per cent and 1 per cent respectively), growth is projected to strengthen to 4 per cent in 1998, with both PlanEcon and UBS projecting even stronger growth. Most forecasters project a further gradual decline in inflation to an annual average of 14 per cent in 1998 and to below this level by the end of 1998.

The effects of the 1995 banking crisis and the associated recession in Latvia are now being overcome, and forecasters project a strengthening of GDP growth from an average of 3.5 per cent in 1997 to 4.6 per cent in 1998. The EBRD and several other forecasters expect the economy to grow by 5 per cent or more in 1998. Lithuania, which experienced the largest cumulative decline of GDP among the three Baltic states, is projected to grow by a little over 4 per cent per annum in both years. There is broad agreement among the forecasters that inflation in both countries will fall quite sharply in 1997, and then more gradually to around 8 per cent in 1998. The range surrounding the inflation estimates for 1998 is greater in the case of Lithuania, which may reflect some uncertainty in the forecasters' minds about the future exchange rate regime. The Lithuanian government has recently indicated that it is considering abolishing the currency board (established in 1994), although it has stated that it will retain the exchange rate peg which has been in operation since 1993.

In the Czech Republic the impact of the Government's fiscal measures, as well as higher interest rates – a further legacy of the currency problems in May 1997 – are expected to slow the growth of domestic demand in both 1997 and 1998. This, in turn, should result in an improvement in the trade and current account deficits. Among the projections shown here, there is a marked difference between those prepared before and after the fall of the currency in May: most of the more recent projections anticipate growth of between 1 and 2 per cent in 1997, followed by a gradual recovery in 1998. The impact of the recent floods on economic activity cannot yet be estimated with any precision since some lost output may be restored, while there will also be a boost to construction activity as repairs to the infrastructure are completed. A combination of higher administered prices and the fall in the exchange rate is expected to lead to a small increase in the annual average inflation rate in both years, although inflation is projected to be on a downward trend by the end of 1998. Kopint-Datorg, however, projects a sharp increase in inflation in 1998.

[3] If Bulgaria is excluded, the unweighted average falls to 23%.

[4] The year-end inflation rate of 71% for these countries (see Table 8.5) is an indication that forecasters expect inflation to be steadily reduced during the remainder of the year. However, the fact that the 1998 end-year inflation figure of a little over 12% (see Table 8.6) is not so very different from the annual average rate suggests that some countries may have difficulty in securing further large declines, especially where further increases in administered prices are required.

Table 8.3

Inflation forecasts for 1997

(change in the average consumer price level, in per cent) [1]

Eastern Europe and the Baltic states	Average [2]	Range [3]	EBRD (Aug 97)	European Union (Mar 97)	IMF (Sept 97)	OECD [4] (June 97)	Economist Intelligence Unit (July 97)	PlanEcon (July/ Aug 97)	IWH [5] (Aug 97)	Kopint-Datorg [6] (July 97)	Vienna Institute (July 97)	CSFB [7] (Aug 97)	JP Morgan (July/ Aug 97)	UBS [8] (Aug 97)
Albania	49.1	36.6	33.4	–	52.0	–	70.0	41.1	–	–	–	–	–	–
Bulgaria	1,050.6	1,090.0	1,049.0	1,500.0	1,059.2	–	1,030.0	1,068.0	410.0	1,000.0	1,200.0	–	1,100.0	1,090.0
Croatia	3.9	1.6	3.7	–	3.6	–	4.2	3.9	–	4.6	4.5	4.0	–	3.0
Czech Republic	8.9	5.0	9.5	8.5	9.0	7.8	8.5	9.1	7.0	12.0	9.0	9.0	8.5	8.6
Estonia	11.9	4.5	11.0	15.0	11.8	–	12.0	10.5	12.0	–	–	–	–	11.0
FYR Macedonia	5.6	5.3	6.0	–	2.0	–	7.0	7.3	–	–	–	–	–	–
Hungary	17.8	2.5	18.0	18.0	18.0	17.7	18.5	17.5	16.0	18.5	18.0	17.0	18.2	18.0
Latvia	9.2	3.7	8.0	11.7	10.0	–	9.8	8.2	8.0	–	–	–	–	8.5
Lithuania	8.9	3.5	9.0	10.5	10.0	–	9.3	8.2	7.0	–	–	–	–	8.5
Poland	15.4	2.5	16.0	15.0	15.0	15.3	16.3	14.5	14.0	15.0	16.0	16.5	15.3	16.0
Romania	137.5	62.0	145.0	98.0	108.9	–	150.0	153.2	100.0	160.0	160.0	150.0	–	150.0
Slovak Republic	6.8	2.0	6.5	6.0	6.5	–	7.2	7.1	8.0	8.0	6.5	6.5	–	6.0
Slovenia	8.9	1.1	9.0	8.2	8.6	–	9.3	8.5	9.0	9.0	9.0	9.0	–	8.9
Average	**102.7**	**93.9**	**101.9**	**169.1**	**101.1**	**13.6**	**104.0**	**104.4**	**59.1 (32.8) [9]**	**153.4**	**177.9**	**30.3**	**285.5**	**120.8**
Commonwealth of Independent States														
Armenia	12.0	7.1	15.0	–	7.9	–	14.0	11.1	–	–	–	–	–	–
Azerbaijan	7.1	2.4	7.0	–	7.0	–	6.0	8.4	–	–	–	–	–	–
Belarus	73.6	20.0	78.0	–	76.0	–	80.0	74.1	60.0	–	–	–	–	–
Georgia	9.9	4.0	9.0	–	12.0	–	8.0	10.4	–	–	–	–	–	–
Kazakhstan	19.0	2.4	18.0	–	20.4	–	19.0	18.5	–	–	–	–	–	19.0
Kyrgyzstan	28.3	3.0	27.0	–	27.2	–	30.0	28.9	–	–	–	–	–	–
Moldova	13.0	5.6	12.0	–	11.4	–	17.0	11.4	–	–	–	–	–	–
Russia	16.1	3.5	17.0	–	15.8	–	16.0	16.1	14.5	18.0	16.0	16.0	16.2	15.5
Tajikistan	46.0	28.0	60.0	–	32.0	–	50.0	42.0	–	–	–	–	–	–
Turkmenistan	115.3	125.0	90.0	–	96.0	–	200.0	75.0	–	–	–	–	–	–
Ukraine	20.5	13.5	20.0	–	17.0	–	18.0	18.4	20.0	20.0	30.0	16.5	–	25.0
Uzbekistan	77.0	95.0	65.0	–	70.0	–	140.0	65.2	–	–	–	–	–	45.0
Average	**36.5**	**25.8**	**34.8**	**–**	**32.7**	**–**	**49.8**	**31.6**	**31.5 (16.2) [9]**	**19.0**	**23.0**	**16.3**	**16.2**	**26.1**

Notes:

1 All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

2 The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

3 This column shows the difference between the highest and the lowest of the forecasts.

4 Inflation is based on the private consumption deflator.

5 Institute for Economic Research, Halle, Federal Republic of Germany.

6 Kopint-Datorg is the Institute for Economic and Market Research, Hungary.

7 Credit Suisse First Boston.

8 Union Bank of Switzerland.

9 The figure in brackets is the Institute's own weighted average of inflation in the region.

With respect to the second group of countries, there is a broad consensus among the forecasters that growth in the Polish economy will slow to 5 per cent by 1998, although this remains well above the regional average. There is also a consensus that inflation will continue to fall, reflected in the narrow range between the forecasts. The main issue raised by several forecasters, for example the Vienna Institute, is the increase in the current account deficit during the first half of 1997. It is acknowledged that there are important differences between Poland and the Czech Republic – for example, the crawling peg exchange rate regime in Poland compared with the Czech Republic's former peg to a currency basket,[5] which has resulted in a more modest appreciation of the real exchange rate. Nevertheless the forecasters' views suggest that there may be a need for fiscal measures to supplement the monetary tightening that has already occurred.

Most forecasters expect growth to slow in the Slovak Republic from the 6.9 per cent recorded in 1996 to below 4 per cent in 1998, partly because of the weakening of industrial production. PlanEcon projects a sharp deceleration in growth in 1998 as the government is assumed to implement measures to lower the current account deficit. The EU, the OECD and the Vienna Institute, however, project growth at 5 per cent or more in both 1997 and 1998. The average of the inflation projections indicates a small rise in the average annual rate, with both PlanEcon and Kopint-Datorg projecting faster increases.

Growth in Estonia is also projected to slow (to 4.4 per cent on average) in 1998 by virtually all the forecasters shown – the main exception is UBS, which projects growth remaining at 6 per cent. The currency board has contributed to lower inflation, and most forecasters project further declines to an average of 10.8 per cent in 1998. The main exception is IWH, which projects an increase in inflation to 14 per cent.

The near-term prospects for Croatia and FYR Macedonia are seen as favourable by most forecasters, although the sustainability of their current account deficits is one of the main uncertainties behind the projections. There is a broad consensus among the forecasters that the Croatian economy will grow at 5 per cent per annum in both 1997 and 1998 following the modest recovery in output last year, and that growth will strengthen to an average of 5 per cent in 1998 in FYR Macedonia. In 1996 both countries recorded very low rates of inflation. In Croatia much of this is due to the firm monetary policy of the central bank with a stable nominal exchange rate. All the forecasters project a continuation of low inflation, although the annual average rate is projected to increase to 5 per cent in 1998. There is, however, some difference between the more optimistic projections of both the EBRD and UBS and those of PlanEcon. From the few projections available for FYR Macedonia, inflation is expected to increase from 5.6 per cent in 1997 to 8 per cent in 1998 as the recovery strengthens.

As noted above, Slovenia is the main exception in this group of countries since it recorded a small surplus on its current account in 1996. Virtually all the forecasters anticipate some increase in growth combined with a further fall in inflation in 1998. One reason why Slovenia has run a current account surplus in three of the last four years has been the restrictions on capital inflows, which have limited the scope for financing deficits and have also ensured that the real exchange rate has remained broadly constant in recent years. Although both PlanEcon and UBS project stronger than average growth rates in 1998, they also mention the slow pace of industrial restructuring.

Of the countries in the third group, both Bulgaria and Romania are currently implementing tough stabilisation programmes and accelerating structural reforms, supported by Stand-by Arrangements with the IMF. In the case of Bulgaria, the stabilisation programme is centred on the currency board (established on 1 July), with the currency pegged to the Deutschmark. Most of the forecasters expect the stabilisation programmes to contribute to a return to positive growth in both countries in 1998 (only PlanEcon projects positive growth in Romania in 1997), combined with a reduction in inflation. The range surrounding these estimates for 1998 is, however, inevitably quite wide. Thus in the case of Bulgaria, Kopint-Datorg projects a further decline in output in 1998 (of 5 per cent) with low inflation. This may be compared with the more bullish growth projections from the EIU and PlanEcon. In the case of Romania, although most forecasters project modest growth in 1998, IWH and Kopint-Datorg project zero growth; the large range on the inflation projections for 1998 is mainly because of the high estimate from UBS.

The task of making projections for Albania is particularly difficult owing to the shortage of reliable information and data following the collapse in the authority of the central government earlier in 1997 after the failure of several financial pyramid schemes. There is, nevertheless, some similarity between the relatively few projections that are available in so far as all the forecasters expect a rebound in growth in 1998 following the sharp contraction in economic activity in 1997. In addition, there is broad agreement that the annual average rate of inflation will fall in 1998. These estimates should, however, be treated with caution in view of the uncertainty over the extent of the disruption to the economy and over the terms of the programme that the government is negotiating with the IMF.

8.2 Projections of growth and inflation for 1997 and 1998 for the Commonwealth of Independent States

GDP in the CIS is projected to increase from only 0.4 per cent in 1997 to a little under 3 per cent on a weighted average basis in 1998, with the EBRD marginally more optimistic about growth prospects for the CIS in both years. Most forecasters expect that nearly all the countries in the region will record positive growth by 1998 and, if this were attained, it would mark the first year of

[5] The Czech koruna was pegged to a basket comprising the US dollar and the DM until May 1997. The fluctuation band was very narrow (+/-0.5%) until the end of February 1996 when the band was widened to +/- 7.5%.

Table 8.4

Inflation forecasts for 1998

(change in the average consumer price level, in per cent) [1]

Eastern Europe and the Baltic states	Average [2]	Range [3]	EBRD (Aug 97)	European Union [4] (Mar 97)	OECD [4] (June 97)	Economist Intelligence Unit (July/Aug 97)	PlanEcon (July/Aug 97)	IWH [5] (Aug 97)	Kopint-Datorg [6] (July 97)	Vienna Institute (July 97)	CSFB [7] (Aug 97)	JP Morgan (July/Aug 97)	UBS [8] (Aug 97)
Albania	26.6	15.7	17.0	–	–	30.0	32.7	–	–	–	–	–	–
Bulgaria	33.4	40.0	37.0	50.0	–	25.0	33.0	38.0	10.0	30.0	–	32.4	45.0
Croatia	5.0	3.8	4.0	–	–	4.8	7.3	–	5.0	5.5	5.0	–	3.5
Czech Republic	10.0	10.2	8.5	8.4	8.4	8.5	9.3	9.5	18.0	12.0	9.3	10.0	7.8
Estonia	10.8	4.0	10.0	10.0	–	10.0	10.9	14.0	–	–	–	–	10.0
FYR Macedonia	7.9	2.8	6.5	–	–	8.0	9.3	–	–	–	–	–	–
Hungary	14.0	4.0	14.0	13.0	15.5	16.0	13.5	12.0	14.0	13.0	14.8	15.4	13.0
Latvia	7.7	2.2	7.0	8.4	–	9.2	7.0	7.0	–	–	–	–	7.5
Lithuania	8.2	4.1	9.0	8.0	–	8.5	10.1	6.0	–	–	–	–	7.5
Poland	12.9	3.5	14.0	12.0	11.5	12.5	11.8	12.0	15.0	13.0	13.5	12.9	13.5
Romania	45.2	60.0	40.0	38.0	–	45.0	38.8	25.0	50.0	40.0	–	–	85.0
Slovak Republic	7.6	7.0	6.5	5.5	–	8.0	11.0	6.0	12.0	7.0	–	–	5.0
Slovenia	8.2	2.1	8.0	9.2	–	8.5	7.1	8.0	8.0	9.0	–	–	7.5
Average	**15.2**	**12.3**	**14.0**	**16.3**	**11.8**	**14.9**	**15.5**	**13.8 (12.9) [9]**	**16.5**	**16.2**	**10.7**	**17.7**	**18.7**
Commonwealth of Independent States													
Armenia	16.1	6.0	14.0	–	–	20.0	14.3	–	–	–	–	–	–
Azerbaijan	8.5	3.6	6.5	–	–	9.0	10.1	–	–	–	–	–	–
Belarus	88.7	65.0	105.0	–	–	110.0	94.9	45.0	–	–	–	–	–
Georgia	8.9	2.5	7.5	–	–	10.0	9.1	–	–	–	–	–	–
Kazakhstan	12.8	7.5	11.0	–	–	17.5	12.7	–	–	–	–	–	10.0
Kyrgyzstan	24.5	1.4	25.0	–	–	25.0	23.6	–	–	–	–	–	–
Moldova	11.2	3.5	9.5	–	–	13.0	11.0	–	–	–	–	–	–
Russia	13.8	9.0	13.0	–	–	14.0	13.1	12.5	20.0	15.0	11.0	13.0	12.5
Tajikistan	40.6	9.0	36.0	–	–	45.0	40.8	–	–	–	–	–	–
Turkmenistan	109.0	142.0	58.0	–	–	200.0	69.0	–	–	–	–	–	–
Ukraine	19.1	10.0	18.0	–	–	16.0	16.5	17.0	25.0	25.0	15.0	–	20.0
Uzbekistan	52.7	48.0	32.0	–	–	80.0	63.6	–	–	–	–	–	35.0
Average	**33.8**	**25.6**	**28.0**	**–**	**–**	**46.6**	**31.6**	**24.8 (13.8) [9]**	**22.5**	**20.0**	**13.0**	**13.0**	**19.4**

Notes:

1 All forecasts quoted here were published or reported to the EBRD between March and September 1997.
The dates in brackets indicate the months in which the forecasts were reported or published by each institution.
There may in some instances be substantial lags between preparation and publication of forecasts.

2 The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

3 This column shows the difference between the highest and the lowest of the forecasts.

4 Inflation is based on the private consumption deflator.

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7 Credit Suisse First Boston.

8 Union Bank of Switzerland.

9 The figure in brackets is the Institute's own weighted average of inflation in the region.

growth for both Tajikistan and Ukraine since 1989 and for Turkmenistan since 1990.

The growth prospects for the region are still largely dependent on the performance of Russia since it accounts for some 75 per cent of the region's GDP. Although many CIS countries have diversified their exports so that intra-CIS trade now represents a smaller share of total trade than before, there is little doubt that the resumption of growth in Russia would contribute to the recovery in most of the other CIS countries. Thus the timing of the recovery in Russia is important to these economies. However, it is an issue on which the majority of forecasters have proved over-optimistic in the past. The average of those forecasts included in both the 1995 and 1996 *Transition Reports* projected a recovery in Russia in 1996 (of 1.6 per cent) and then in 1997 (of 2 per cent). In practice, recorded output fell by 6 per cent in 1996 and the latest average estimate is for growth of just 0.4 per cent in 1997. Of those projections of GDP growth in 1996 that were included in the 1995 *Transition Report*, for example, only the Vienna Institute projected a decline in output (of 3 per cent). It is difficult to be precise as to why forecasters have proved over-optimistic about the timing of the economic recovery in Russia. However, one important factor has been the tendency to overestimate the pace of enterprise restructuring (perhaps making insufficient allowance for the pattern of ownership and corporate governance, which are not always conducive to rapid restructuring).

It should be noted, however, that there is also greater uncertainty over the levels of output in many of the other CIS countries compared with eastern Europe and the Baltic states. In Russia and Ukraine, for example, it is probable that there is a significant under-recording of output as current reporting systems fail to capture some of the output from the growing private sector, while some enterprises almost certainly under-record their activity to reduce their tax burden. More generally, a combination of high tax rates and excessive regulation means that much activity is carried out in the informal sector which, by definition, is not reflected in the official data. If governments in the region were to implement measures that could quickly improve the business environment, for example removing many of the regulations and bureaucracy that enterprises have to contend with, it is possible that there could be an initial boost to measured growth as the informal sector became absorbed into the official economy.

The (unweighted) annual average rate of inflation is projected to decline from 37 per cent in 1997 to 34 per cent in 1998, although this average is heavily influenced by the high rates projected for Belarus, Turkmenistan and Uzbekistan. Several countries are expected to record inflation rates below 20 per cent by 1998. Whereas forecasters have been too optimistic about the timing of the recovery in Russia, as noted in the 1996 *Transition Report*, there has also been a tendency to underestimate the sharp decline in inflation in recent years in some countries, especially where inflation was at high levels. Even though inflation is now generally at much lower levels, this tendency has continued. For example, in the 1996 *Transition Report*, the average annual inflation for the CIS in 1997 was projected at 69 per cent. The decline in inflation reflects the success in implementing stabilisation policies in many countries. In both Russia and Ukraine, for example, lower inflation and attractive yields have increased the demand for government securities. With these markets open to foreign purchasers of such paper, the resulting capital inflows have contributed to greater exchange rate stability, thereby also helping to slow inflation. The attainment of lower inflation will, however, depend crucially on maintaining stabilisation policies and dealing with the problem of tax arrears so that the fiscal position is not undermined.

It is possible to identify three main groups of countries across which the path of economic recovery is projected to differ. The first is Russia, where there is still no real consensus among forecasters as to whether 1997 will mark the first year of positive economic growth. The second group comprises Armenia, Azerbaijan, Georgia, Kazakhstan and Kyrgyzstan, where there is a broad consensus among the forecasts shown here that these countries will record positive growth in both 1997 and 1998. The prospects are rather more uncertain for the countries in the third group, generally reflected in the wider ranges surrounding the estimates of growth and inflation. These countries are Belarus, Moldova, Tajikistan, Turkmenistan, Ukraine and Uzbekistan, which tend to be characterised by low or negative growth, reflecting the slow pace of reform, and in certain cases by relatively high rates of inflation.

The range surrounding the growth estimates for Russia is fairly wide, with some forecasters projecting a modest recovery and others zero or negative growth. The uncertainty is primarily over the timing of the recovery. Most forecasters expect growth to strengthen in 1998 (to an average of almost 3 per cent), with the OECD and UBS projecting strong recoveries. They also anticipate further declines in inflation, with average rates declining from 16 per cent in 1997 to below 14 per cent by 1998. The main exception is Kopint-Datorg, which projects higher inflation in 1998. The EBRD expects the Russian economy to grow at 1 per cent in 1997, strengthening to 3 per cent in 1998. This is mainly dependent on the authorities maintaining low inflation, ensuring a stable and predictable exchange rate and some easing of monetary policy, which would result in lower interest rates.

Several of the countries in the second group have recorded substantial current account deficits – in excess of 20 per cent of GDP in 1996 in both Armenia and Kyrgyzstan and 19 per cent in Azerbaijan, which places some uncertainty on projections. Both Armenia and Georgia were among the first countries in the CIS to move out of recession, and the strong growth rates that have been

Table 8.5

Forecasts of year-end inflation for 1997

(change in the year-end consumer price level, in per cent) [1]

Eastern Europe and the Baltic states	Average [2]	EBRD (Aug 97)	OECD (June 97)	Economist Intelligence Unit (July/Aug 97)	PlanEcon (July/Aug 97)	CSFB [3] (Aug 97)	JP Morgan (July/Aug 97)
Albania	48.2	41.5	-	50.0	53.1	-	-
Bulgaria	653.8	592.0	1,000.0	530.0	561.0	650.0	590.0
Croatia	4.6	4.0	-	5.0	4.9	4.5	-
Czech Republic	9.7	9.0	-	8.4	11.0	10.0	10.2
Estonia	11.4	12.0	-	12.0	10.1	-	-
FYR Macedonia	8.1	8.0	-	8.0	8.4	-	-
Hungary	17.5	17.0	-	18.5	16.6	18.0	17.5
Latvia	8.0	8.0	-	9.4	6.7	-	-
Lithuania	8.7	10.0	-	9.0	7.0	-	-
Poland	14.2	14.5	-	15.0	13.4	14.0	14.3
Romania	129.5	116.0	130.0	130.0	136.7	135.0	-
Slovak Republic	7.7	7.0	6.0	8.8	9.8	7.0	-
Slovenia	8.9	8.8	9.0	9.5	8.2	9.0	-
Average	**71.6**	**65.2**	**286.3**	**62.6**	**65.1**	**105.9**	**158.0**
Commonwealth of Independent States							
Armenia	18.5	19.0	-	22.0	14.5	-	-
Azerbaijan	7.7	6.5	-	6.0	10.7	-	-
Belarus	98.8	99.0	-	100.0	97.5	-	-
Georgia	8.9	8.5	-	10.0	8.1	-	-
Kazakhstan	15.0	12.0	-	18.0	-	-	-
Kyrgyzstan	24.4	24.0	-	25.0	24.3	-	-
Moldova	12.1	11.0	-	15.0	10.3	-	-
Russia	15.0	14.0	15.0	16.0	15.5	14.0	15.2
Tajikistan	68.2	105.0	-	35.0	64.7	-	-
Turkmenistan	96.3	44.0	-	200.0	45.0	-	-
Ukraine	16.8	15.0	-	18.0	17.5	-	-
Uzbekistan	65.9	40.0	-	140.0	67.1	16.5	-
Average	**37.3**	**33.2**	**15.0**	**50.4**	**34.1**	**15.3**	**15.2**

Notes:

[1] All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

[2] The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

[3] Credit Suisse First Boston.

attained reflect partly a rebound from a low base (in 1996, using cumulative reported growth rates, GDP was estimated at 37 per cent and 31 per cent respectively of the level in 1989). The annual average rate of inflation is projected to remain at relatively low levels in Georgia, but to increase in Armenia to 14 per cent according to the EBRD, partly because of an earlier loosening of fiscal and monetary policies. Successful implementation of stabilisation policies has contributed to the steady recovery that Kyrgyzstan has experienced since 1995. There is a broad consensus among the forecasters that growth will be maintained, accompanied by further declines in inflation. Economic prospects will rely heavily on the coming on stream of the Kumtor gold mine, and over the medium term the mine should make a significant contribution to increasing growth and reducing the current account deficit.

The huge energy resource base is the factor that distinguishes both Azerbaijan and Kazakhstan from the other countries in this group. In the short term, successful stabilisation policies have led most forecasters to project stronger growth in 1998 accompanied by a further fall in inflation in Kazakhstan and the maintenance of low inflation in Azerbaijan. Inflation in Azerbaijan is, however, projected at slightly higher rates than those attained at the end of 1996. The EBRD is relatively optimistic about the prospects for inflation, reflecting the impact of capital inflows on the exchange rate. The longer-term prospects for both of these countries will depend on the successful development of their oil and gas reserves. In recent quarters both countries have recorded increases in flows of foreign direct investment, much of which is related to the oil and gas sector, and these flows should provide an important means of financing the current account deficits.

Among the countries in the third group, both Moldova and Ukraine have had success in lowering inflation and are projected to record positive growth in 1998 (the average estimate of positive growth for Moldova in 1997 is heavily influenced by the optimistic "national

source" in the United Nations ECE projection). In the case of Ukraine several forecasters, including the EBRD, expect the rate of decline in the economy to slow in the second half of 1997, leading to positive growth in 1998. The average growth rate in 1998 is, however, projected at only around 1 per cent, and the range surrounding this estimate remains quite wide. The expectation that the economy is beginning to bottom out, with the prospect of an increase in agricultural output, lie behind the EBRD's projection of a gradual recovery in 1998. A period of sustained growth will depend on government measures to remove some of the constraints to private sector activity and investment. There has been a further sharp fall in inflation in 1997 owing to a tight monetary policy and the stability of the exchange rate. Thus inflation is expected to fall to an annual average rate of 20 per cent in 1997. There are good prospects that inflation will fall further during 1998, although this partly depends on strengthening the fiscal position and in particular resolving the problem of the budgetary wage and pension arrears.

Further declines in output are also expected in both Tajikistan and Turkmenistan in 1997, with the prospect of both recording positive growth in 1998. The EBRD is optimistic about the prospects for Turkmenistan, projecting a strong rebound in growth at 8 per cent in 1998, reflecting higher cotton production after the poor harvests of the two previous years and higher gas exports. Inflation has been lowered in both countries, although in Turkmenistan the rate of inflation is projected to experience a temporary increase towards the end of 1997 before falling to 45 per cent at the end of 1998. Both the EBRD and PlanEcon are considerably more optimistic than the EIU on the prospects for stabilisation in this country.

Both Belarus and Uzbekistan are projected to record positive growth by most of the forecasters (although the range of the growth estimates is large in the case of Belarus), but inflation is projected to be at a higher level at the end of 1997 than it was in 1996. In both cases this reflects slippage in stabilisation policies following the suspension of respective IMF programmes, accentuated by the slow pace of structural reforms in the case of Belarus. In both countries there was a marked deterioration in the trade account in 1996, resulting in current account deficits of between 6 and 8 per cent of GDP. The limited availability of official financing in these circumstances suggests some fiscal adjustment will be required during the course of 1998.

8.3 Conclusion

The forecasts surveyed in this chapter provide a mixed view of the region's prospects. The general trend remains one of robust growth in eastern Europe and the Baltic states and a gradual return to growth in the CIS, most importantly in Russia. Several of the leading countries in transition are projected to experience temporary declines in their growth rates as a result of the implementation of policy changes to slow the growth of domestic demand in view of their growing external imbalances. For another group of countries, macroeconomic shocks have been linked to weaknesses in structural reforms. For these countries, including Albania, Bulgaria and Romania in eastern Europe and a number of countries in the CIS, the range of forecasts is large, reflecting the uncertainty over their immediate economic prospects.

Considerable progress has been made with stabilisation throughout the region, and most forecasters expect the rate of inflation throughout the region to continue to decline. There are only a few exceptions where earlier achievements in reducing inflation are projected to be reversed in 1997. These are primarily due to a loosening of monetary and fiscal policies, often combined with a slow pace of structural reform.

Lastly, Box 8.1 addresses one cause of systemic risk linked to deficiencies in structural reforms. Banking crises have contributed to unpredicted reversals in recovery and stabilisation in a number of countries. The box explores the inter-relationships between inher-

Table 8.6

Forecasts of year-end inflation for 1998

(change in the year-end consumer price level, in per cent) [1]

Eastern Europe and the Baltic states	Average [2]	EBRD (Aug 97)	OECD (June 97)	Economist Intelligence Unit (July/ Aug 97)	PlanEcon (July/ Aug 97)	JP Morgan (July/ Aug 97)
Albania	19.3	18.0	-	20.0	19.8	-
Bulgaria	21.2	24.0	30.0	10.0	21.0	21.0
Croatia	5.6	4.0	-	4.0	8.9	-
Czech Republic	7.9	8.0	-	8.5	6.8	8.3
Estonia	10.1	10.0	-	9.5	10.9	-
FYR Macedonia	8.5	6.5	-	10.0	8.9	-
Hungary	13.8	13.0	-	15.0	12.7	14.5
Latvia	7.4	7.0	-	8.5	6.6	-
Lithuania	9.1	9.0	-	8.5	9.8	-
Poland	11.8	13.0	-	12.0	10.2	12.0
Romania	29.2	25.0	30.0	35.0	26.6	-
Slovak Republic	7.9	6.0	6.0	8.0	11.5	-
Slovenia	7.6	8.0	8.0	8.0	6.5	-
Average	**12.3**	**11.7**	**-**	**12.1**	**12.3**	**14.0**
Commonwealth of Independent States						
Armenia	14.2	11.0	-	17.0	14.7	-
Azerbaijan	9.6	6.2	-	13.0	9.6	-
Belarus	104.8	115.0	-	120.0	79.5	-
Georgia	9.1	7.0	-	9.0	11.3	-
Kazakhstan	13.3	10.5	-	16.0	-	-
Kyrgyzstan	21.0	17.0	-	24.0	22.0	-
Moldova	9.8	8.0	-	10.0	11.4	-
Russia	12.2	12.0	12.0	14.0	11.8	11.0
Tajikistan	33.1	27.0	-	40.0	32.4	-
Turkmenistan	98.7	45.0	-	200.0	51.0	-
Ukraine	16.7	20.0	-	14.0	16.0	-
Uzbekistan	47.6	30.0	-	50.0	62.8	-
Average	**32.5**	**25.7**	**12.0**	**43.9**	**29.3**	**11.0**

Notes:

[1] All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

[2] The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

ited weaknesses and remaining deficiencies in regulatory frameworks and macroeconomic discipline in causing banking crises in transition economies, and the effect of bank failures on macroeconomic performance. The analysis underlines the main conclusion emanating from a review of forecasts for the region: the transition process remains fraught with uncertainty and systemic risks.

Box 8.1

Banking failures, banking crises and macroeconomic volatility

Most countries in transition have in recent years experienced the failure of banks, often in large numbers and sometimes, as in Bulgaria and the three Baltic states, with massive consequences for the banking sector and the economy as a whole. In several cases where failures developed into broader crises, this has upset earlier forecasts of economic performance. As stressed in various parts of this Report (see in particular Chapters 2 and 5) banking sectors and the regulation of banks continue to be weak in many transition economies. In addition, the growing stability in the macroeconomic environment poses a challenge to banks since it eliminates sources of easy income. At the same time, remonetisation combined with growing capital inflows is providing banks, weak or strong, with the liquidity to expand loan portfolios at very rapid rates. Together, these factors suggest that there will be pressures on banks in the years ahead as well as opportunities to make mistakes. This adds to the uncertainty over economic forecasts in the region.

Widespread losses in banking sectors and even runs on individual banks – common phenomena throughout the region which are to some extent rooted in the transition process itself – should be carefully distinguished from banking crises. The term "crisis" is associated with significant "contagion effects" and with macroeconomic consequences through linkages with the real economy and impacts on public and international confidence. There are various transmission channels through which liquidity or solvency problems in one or several banks may spread to other parts of the economy. Thus, depositor confidence may be shaken overall, leading to a generalised run on deposits which even essentially healthy banks may not be able to satisfy. Further, the liquidity problems of a bank borrowing on the interbank market may be transmitted to its creditor banks. Banking crises may spread to the foreign exchange markets if depositors look for alternatives to local bank deposits for storing their money. A general loss of confidence in the currency, which may be triggered by a banking crisis, would also tend to fuel inflation, both because of falling money demand and because of exchange rate depreciation. Finally, a liquidity squeeze in the banking sector can reduce the ability of enterprises to borrow and refinance existing obligations. Banking crises involve some degree of financial disintermediation which may depress investment.

The way in which banking crises may upset economic forecasts is well documented by the examples presented in the chart. In the three Baltic states and Bulgaria recent banking crises have caused GDP to perform far worse than projected, albeit to different degrees. Interestingly, with the exception of Bulgaria, the banking crises reviewed here have not led to significant deviations in inflation over the projected level.

Banking crises in transition economies have a number of causes. Three major elements will be distinguished here. The first two of these are particular to the transition process. The third reflects experiences from other parts of the world. Banking crises usually have multiple causes. In any individual episode, the three factors discussed here may be present in different combinations and with varying degrees of intensity.

i) Legacies from the past and continuing lack of restructuring

The transition economies inherited a small number of state-owned banks with regionally and sectorally concentrated portfolios of loans to state-owned enterprises. These loans were often extended at subsidised interest rates and reflected government planning priorities rather than assessments of creditworthiness on the part of the lender. Not surprisingly, many of these loans became effectively non-performing as interest rates were liberalised, and state-owned enterprises suffered the shock of the transition-related recession and simultaneously a hardening of their budget constraints. More stringent regulatory requirements led to a change in loan classifications, exposing the weakness of the inherited portfolios. In many countries government intervention into credit decisions and regulators' connivance in the continuation of unsound lending practices between state-owned banks and enterprises has continued well beyond the start of the transition process. In several countries, governments eventually bailed out insolvent banks at considerable cost to budgets, and sometimes without addressing the underlying causes of the problem, namely bad lending decisions.[1]

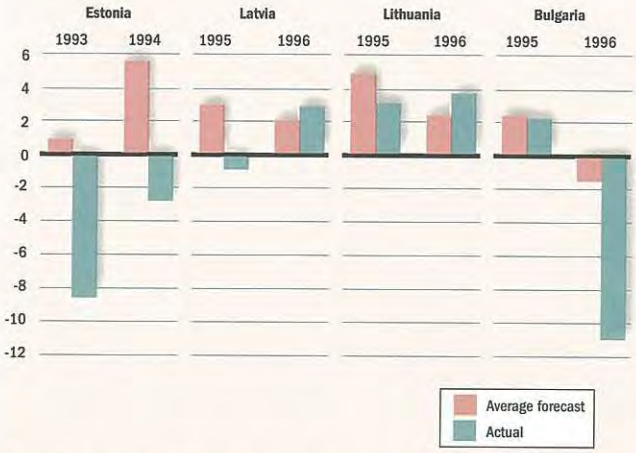
An example of crisis developing from such unsound lending practices is provided by Bulgaria in 1996. Because of continued lending to loss-making state enterprises – with losses amounting to 15 per cent of GDP in 1995 alone – Bulgaria's banking system was essentially insolvent by the end of 1995. The total negative net worth of the sector was estimated at between US$ 1 billion and US$ 2 billion. In autumn 1995 various banks developed liquidity problems and were propped up by increasingly massive central bank refinancing. The money creation spilled over into the foreign exchange markets and, from the beginning of 1996, a growing loss of confidence in the currency and successive runs on banks turned into a vicious circle. By March 1997 banks holding 24 per cent of the sector's total assets were subject to bankruptcy procedures. Deposits in the banking sector fell by 75 per cent in real terms over that period. The macroeconomic costs were huge. The exchange rate dropped from 70 BGL/US$ in December 1995 to 3,200 BGL/US$ in February 1997, inflation over the 14-month period of January 1996 through February 1997 was 1,878 per cent, GDP contracted by 11 per cent in 1996, and a further 7 per cent decline is projected for 1997.

ii) Undisciplined bank entry

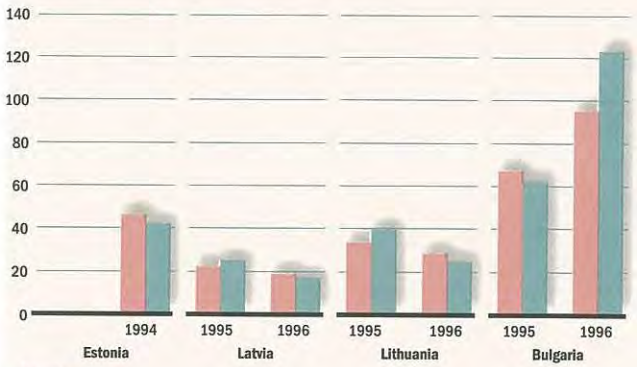
The significance of the inherited bad debt problem was greatly reduced in many transition economies by the very high rates of inflation that characterised the initial transition period. At the same time, lax entry requirements for new banks led to a proliferation of private banks, which were often inadequately capitalised. Some of these had, in fact, been set up by enterprises essentially for their own financial management but were nevertheless permitted to take deposits and participate in the national payments system. With such weak foundations, a process of consolidation has usually followed the period of rapid entry. In many instances, this process has been promoted by the shift to a restrictive monetary policy, such as in the case of Russia, where the tightening of central bank credit precipitated the liquidity crisis of August 1995. As a result, the number of banks declined from a peak of 2,561 in 1995 to 1,887 by June 1997. In the Baltic states the number of banks fell in the aftermath of banking crises from a peak of 43 (1992) to 14 (1996) in Estonia, 61 (1993) to 33 (1996) in Latvia, and 27 (1994) to 12 (1996) in Lithuania. Similar consolidation episodes have occurred throughout the CIS, but generally to a far lesser extent in eastern Europe.

The accuracy of forecasts for GDP growth and average inflation in selected countries affected by banking crises

Growth of GDP, per cent



Consumer price inflation, annual average, per cent



Sources:
EBRD and World Bank.

iii) Rapid remonetisation capital inflows and endemic credit cycles

One potential source of volatility is extremely rapid remonetisation following price stabilisation, a phenomenon that has been observed in several countries of the region. This has led banks to absorb growing liquidity at the very time that previous safe earning opportunities arising from arbitrage on currency markets and high-yielding government securities in the context of price volatility disappeared. In most countries this has so far been achieved successfully. However, it is a lesson of experience, especially from Latin America, that times of rapid liquidity growth are associated with serious information imperfections in the credit market, making client selection (and bank regulation) particularly difficult and increasing the scope for unsound lending.[2] The growing inflow of foreign capital into an increasingly broad spectrum of countries could, as discussed in Chapter 7, exacerbate the dangers of overheating.

In the transition economies there have been no crises so far that were uniquely or even predominantly associated with the rapid expansion of credit portfolios per se. However, rapid remonetisation certainly magnified the problems of a weak regulatory framework in Latvia and Lithuania.[3] In Latvia, the entry of new private banks led to the doubling of the real asset value of the banking sector during 1992-94, and the share of assets in private banks rose from 37 per cent to 85 per cent of total bank assets. This expansion was fuelled by short-term capital inflows for which banks competed fiercely by offering very high interest rates to depositors. A consolidation process set in as profitable opportunities in trade finance gradually receded. When the country's largest private bank, Bank Baltija, failed to provide accounts audited to international accounting standards, this led to doubts over its solvency, deposit withdrawals and the bank's collapse. An investigation revealed flawed lending practices and general management failures, including outright fraud and corruption. In the event, 40 per cent of all bank assets were affected by the crisis, money demand contracted sharply and GDP growth suffered a significant setback compared with earlier expectations.

In Lithuania, as in Latvia, the majority of new private banks entered the market in 1991 and 1992 when licensing requirements were lax and the minimum capital requirement was low. Banks failed to raise their capital in proportionate to the rapid growth of liquidity and loan books during 1993 and 1994. Lack of lending skills and politically motivated and "connected" lending had led to a large number of non-performing loans by 1995. A scandal over the abuse of insider connections eventually led to intervention in the country's second-largest bank, Innovation Bank, with serious repercussions for two further banks. The impact of the crisis is still working its way through the banking sector. Innovation Bank, whose assets in June 1995 had reached US$ 215 million (around 3 per cent of GDP and 21 per cent of domestic assets), was liquidated earlier in 1997, and more liquidations of private banks may follow. The macroeconomic impact of the crisis has, however, been overshadowed by its political ramifications, leading to the resignation of several government ministers, including the prime minister and the governor of the central bank.

Banking crises can greatly accentuate macroeconomic volatility. The weaknesses in banking systems in transition economies stem from a combination of legacies of bad loans, political interference and lack of skills and capital, with large macroeconomic shocks resulting from rapid disinflation and remonetisation. Most countries of the region have not so far been affected by systemic crises on account of the relatively small role of financial intermediation in their economies, although most have experienced a process of bank consolidation as regulatory frameworks have been tightened. However, the establishment of sound banking principles and appropriate bank supervision has far to go. The financial sector weaknesses in the region hold more potential upsets in store for both forecasters and policy makers.

1 In Hungary and Bulgaria this led to repeated "rounds" of bailouts.

2 IDB (1995). See also Honohan (1997).

3 The following account draws on Fleming et al. (1996).

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