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Summary of the *Economic Survey of Europe 2003*

Summary

Economic activity in the Economic Commission for Europe region in 2003 continued to be marked by pronounced differences among the major economies and subregions. In the United States of America, the cyclical recovery gained considerable momentum. The euro area remained the principal “weak spot” of the global economy in 2003, mainly because of sluggish activity in the three largest economies (France, Germany and Italy). Economic activity in Eastern Europe strengthened in 2003, and aggregate gross domestic product growth was again significantly above the European Union average, largely due to the robustness of domestic demand. After some deceleration in 2002, economic activity in the Commonwealth of Independent States region surged in 2003, led by rapid growth in the Russian Federation. In the aggregate gross domestic product in the Commonwealth of Independent States grew by 7.6 per cent, making it one of the fastest growing regions in the world. A combination of favourable external conditions (especially higher export prices for oil and gas) and a continuing strong recovery in domestic demand contributed to this outcome.

The short-term outlook for the Economic Commission for Europe region is for a strengthening of growth in 2004. But the underlying cyclical momentum is expected to differ significantly across the region, with robust growth in North America, Eastern Europe and the Commonwealth of Independent States contrasting with relatively moderate growth expectations for the euro area, where the cyclical recovery, moreover, looks still very fragile. Policy makers are mainly concerned about the risks of a possible faltering of the recovery in the United States, in view of a persistently weak labour market performance and the high current account deficit. In the euro area, there is the risk that a further depreciation of the dollar could choke off the nascent recovery by eroding export growth. In Central and Eastern Europe,

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there are concerns about the size of fiscal and external imbalances in several countries, which may require a tightening of economic policies. In the Commonwealth of Independent States, apart from the uncertainties surrounding world commodity markets, downside risks in some of the countries are also related to the need to tighten economic polices in order to correct domestic and external financial imbalances.

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I. The Economic Commission for Europe economies in 2003

1. A global recovery started in the second half of 2003 after the economic uncertainties created by the conflict in Iraq and the outbreak of the severe acute respiratory syndrome (SARS) epidemic in Asia had dissipated. Rising activity was accompanied by increases in business and consumer confidence and was mirrored in stronger demand and rising prices for industrial raw materials and crude oil. In the international financial markets, the recovery of investor confidence, in anticipation of increased profits, led to a rebound of equity prices, which in turn has improved the financing conditions for enterprises. Narrowing yield spreads on corporate sector borrowing reflected a more optimistic assessment of risks by financial investors. In the financial and non-financial corporate sectors, the necessary balance-sheet adjustments required to reduce the excessive leverage built up during the boom in the second half of the 1990s have been significant, although the process has not finished yet. These have been reflected in rising profitability. Global economic activity continued to be supported by expansionary economic policies, especially in the United States of America, which has been leading the recovery. The buoyancy of the Asian economies, notably the continued boom in China and the unexpectedly strong recovery in Japan, has also underpinned the global recovery.

2. In the Economic Commission for Europe (ECE) region, economic activity continued to be marked by pronounced differences among the major economies and subregions in 2003 (see annex, table 1). In the United States of America, the annual increase in real gross domestic product (GDP) accelerated to 3.1 per cent. In contrast, the euro area remained the principal "weak spot" of the global economy in 2003, mainly because of sluggish activity in the three largest economies (France, Germany and Italy — see annex, table 2). Real GDP in the euro area as a whole rose by only 0.5 per cent in 2003. For the European Union (EU) as a whole, real GDP rose by 0.8 per cent in 2003, slightly more than for the euro area because of the resilience of the United Kingdom to the global downturn during 2002. The disappointing overall performance of most of the current EU member States contrasts with the strong economic growth in the 10 countries that will be joining the Union at the beginning of May 2004. Real GDP in these 10 countries combined rose by 3.6 per cent in 2003, up from 2.5 per cent in 2002 (see annex, table 1). Had these countries already been members in 2003, real GDP growth in the enlarged Union would have risen to 1 per cent, the small improvement over that of the EU reflecting the relatively small weight of the accession countries, which currently account for only some 5 per cent of the nominal GDP of the enlarged EU. But their economic weight will increase in the future if they are successful in their medium- and longer-term objective of catching up with the average real per capita income in the EU.

3. Economic activity in Eastern Europe as a whole strengthened in 2003, aggregate GDP growth accelerating to 3.8 per cent. As in 2001 and 2002, domestic demand remained the principal source of growth throughout the region; with very few exceptions (Poland and Slovakia), net exports pulled down the growth of output. Thanks to the ongoing restructuring of these economies and the expansion of their productive capacity, domestic suppliers were able to benefit from the strong domestic demand; some East European economies also greatly increased their exports despite the continuing weakness of the West European economies. Improved financial intermediation and a booming credit market, a consequence of successful

banking reforms, also contributed to the general strengthening of economic activity in the region.

4. While all the East European economies grew in 2003, economic performance varied considerably among them. After two years of near stagnation, growth in Eastern Europe's largest economy — Poland — gained momentum during the year and GDP rose by 3.7 per cent (see annex, table 3). The accelerating recovery in Poland was underpinned by expansionary fiscal and monetary policies and by gains in competitiveness that boosted the contribution of net exports to GDP growth. At the same time, there was a slowdown of growth in Hungary and Slovenia, where aggregate output increased by less than 3 per cent. Activity in the Czech Republic picked up somewhat compared with 2002 but GDP grew only moderately (by some 3 per cent). In all three countries growth in 2003 was mostly driven by private domestic demand, net exports generally making a negative contribution to GDP growth despite some recovery of exports in the Czech Republic and Hungary.

5. Latvia and Lithuania were the fastest growing East European economies in 2003, with GDP increasing by 7 and 8.9 per cent, respectively. Both economies benefited from growth in all the components of final demand, which provided a strong stimulus to domestic economic activity. Growth also remained relatively strong (above 4 per cent) in Albania, Bulgaria, Croatia, Estonia, Romania and Slovakia. Slovakia was the only East European economy where GDP growth was entirely driven by a surge in net exports (reflecting increases in the capacity of the foreign direct investment-driven and export-oriented automotive industry). In the other economies, the strength of output mirrored strong domestic demand coupled with a negative impact of net exports on GDP growth. Thus, while exports of goods and services from Bulgaria, Croatia and Romania grew strongly in 2003 (following the recent acceleration of foreign direct investment-led restructuring of these economies), they were outpaced by an even stronger growth of imports.

6. In parts of South-East Europe, economic activity remained weak in 2003. In Serbia and Montenegro GDP was almost stagnant, reflecting a difficult adjustment to the opening up of the economy and the start of major reforms. Economic activity in the former Yugoslav Republic of Macedonia picked up somewhat in 2003 but the economy has still not fully recovered from the slump caused by the internal conflict in 2001. In contrast, growth in Bosnia and Herzegovina continued to slow down for a fourth consecutive year (see annex, table 3). In both countries the rate of GDP growth in 2003 was below the average for Eastern Europe as a whole.

7. After some deceleration in 2002, economic activity in the Commonwealth of Independent States (CIS) region surged in 2003, led by rapid growth in Russia. Aggregate GDP in the CIS grew by 7.6 per cent, making it one of the fastest growing regions in the world. A combination of favourable external conditions (especially higher export prices for oil and gas) and a continuing strong recovery in domestic demand contributed to this outcome. The enduring buoyancy in domestic demand — reflecting growing consumer and investor confidence in many of the CIS economies — is a sign that the difficult reforms in these transition economies are finally starting to bear fruit. Several years of strong growth have also contributed to some improvement in living standards in the region.

8. The average rate of growth in the CIS reflects the strong performance of the region's largest economies: the Russian Federation, Ukraine and Kazakhstan, where GDP increased by 7.3 per cent, 8.5 per cent and 9.1 per cent, respectively. All the

factors mentioned above apply with full force to the explanation of the robust performance in these three countries. The strong upturn in the Russian Federation was also underpinned by an expansionary monetary policy, which sought in the first place to prevent an excessive real appreciation of the ruble. There were also signs of a deeper and more extensive restructuring of the Russian enterprise sector, partly in response to growing competitive pressure. Thanks to the strength of its domestic demand and its impact on imports, the Russian Federation's role as an engine of growth for the neighbouring CIS economies increased in 2003.

9. Kazakhstan's economic growth — which continued for a fourth consecutive year — was mostly due to the rapid expansion of fuel-related exports. In 2003 the continued surge in the volume of commodity exports was coupled with large windfall revenue gains from higher export prices. There has also been a notable recovery in other sectors of the economy in recent years and this continued in 2003. In Ukraine, a sharp export-driven upturn in some manufacturing sectors (such as steel and chemicals, which benefited from strong external demand) contributed to the large increase in GDP in 2003. Other CIS economies were also unusually buoyant in 2003. Gross domestic product (GDP) grew at double-digit rates in Armenia, Azerbaijan, Tajikistan and Turkmenistan (although the official GDP data for the latter country should be treated with caution — see the note to table 3). Economic growth accelerated in Belarus and Georgia (with GDP increasing by 6.8 per cent and 8.6 per cent, respectively) and in Kyrgyzstan the economy recovered from the stagnation (caused by a major mining disaster) of 2002. Despite some slowdown, GDP in the Republic of Moldova rose by 6.3 per cent. A remarkable sign of the general strength of growth in the CIS is the fact that in Uzbekistan, the slowest growing economy in the region, GDP still increased by some 5 per cent in 2003.

II. The short-term economic outlook

A. Western Europe and North America

10. World economic activity is expected to strengthen further in 2004. World output growth is set to exceed 4 per cent, up from 3.25 per cent in 2003. This should be accompanied by a marked acceleration in the volume growth of world merchandise trade to some 8 per cent, twice the rate in 2003.

11. In the United States, real GDP growth is expected to accelerate to an average annual rate of some 4.5 per cent in 2004, up from 3.1 per cent in 2003.[1] The recovery should continue to be supported by the strong growth of domestic demand. Personal consumption spending is forecast to remain strong, rising by some 3.5 per cent over 2003. The expected pick-up in employment and a further fall in the rate of inflation support the continued growth of real disposable incomes. But the savings ratio is expected to edge up and the stimulus from the tax cuts and mortgage equity to diminish. Non-residential business fixed investment is expected to rise strongly by some 10 per cent in 2004, encouraged by expectations of further increases in profits and rising capacity utilization rates. Residential investment is also forecast to continue rising strongly, although less favourable financing conditions are likely to lead to a slower rate of increase than in 2003. Exports are expected to grow at a brisk rate, supported by the depreciation of the dollar and a broadening global

recovery. These external influences on GDP, however, are likely to continue to be more than offset by the strong growth of imports.

12. Strong labour productivity growth is likely to weaken the demand for labour, although it should, nevertheless, begin to edge up in 2004. The unemployment rate is forecast to decline somewhat in 2004 and consumer price inflation is expected to fall below 2 per cent. The current account deficit is forecast to increase to some $575 billion in 2004, although it should remain at some 5 per cent of GDP. The stance of monetary policy is expected to remain very accommodative as long as there are no firm indications of a self-sustaining recovery. This holds notwithstanding the change in the language of the Federal Open Market Committee, which recently stated that "it can be patient in removing its policy accommodation",[2] in contrast to preceding statements that "policy accommodation can be maintained for a considerable period". Fiscal policy will probably remain expansionary, but the fiscal impulse should diminish significantly (to about half a percentage point of GDP), which is appropriate given that most of the output gap is likely to disappear in 2004 and in view of the significant deterioration of the medium-term fiscal outlook. The federal Government's budget deficit is projected to rise to $477 billion, or 4.2 per cent of GDP, in fiscal year 2004.

13. In the euro area, recovery is expected to gain some momentum in the course of 2004 but, for the year as a whole, real GDP is currently forecast to rise by only 1.9 per cent. This reflects the combined effect of a pick-up in exports and a slight strengthening of final domestic demand. Exports should benefit from the stronger growth in world trade, which should help to offset the dampening effects of the recent appreciation of the euro in real effective terms. Changes in the volume of net exports, however, are likely to have a broadly neutral effect overall as a result of the stimulus to imports from the stronger euro. The forecast rise in final domestic demand largely reflects an upturn in business spending on machinery and equipment; construction investment is also picking up slightly, following two years of consecutive decline. Private consumption growth in 2004 is unlikely to be much stronger than in 2003. The recovery might produce a slight increase in demand for labour — a reflection of both the weak rate of output expansion in 2004 and labour hoarding during the cyclical downturn — but this will probably not be sufficient to prevent the unemployment rate from rising to an annual average of 9 per cent. Consumer price inflation should fall to an average of some 1.5 per cent in 2004, significantly below the European Central Bank's (ECB) ceiling of 2 per cent.

14. The stance of monetary policy is assumed to remain broadly accommodative in view of the restraining effects of the real effective appreciation of the euro and the favourable inflation forecasts. Earlier expectations of a tightening of monetary policy in the first half of 2004 have been revised; indeed, in view of the strong appreciation of the euro, a lowering of interest rates would now appear to be necessary to avoid a further tightening of monetary conditions let alone to provide a relaxation. This is all the more necessary because fiscal policy is set to be broadly neutral in 2004.

15. Among the three major economies of the euro area, real GDP in France is forecast to grow slightly below the euro area average in 2004 (table 2). An export-led recovery is expected to be supported in the course of the year by a moderate pick-up in business fixed investment and the rebuilding of inventories. Private consumption growth is likely to remain moderate, reflecting cautious consumer

behaviour in the face of a weak labour market and only small gains in real disposable income. Fiscal policy is expected to be tightened significantly, but the actual budget deficit is forecast to remain above the 3 per cent Maastricht reference value.

16. In Germany, the cyclical recovery is expected to be relatively subdued in 2004. Real GDP is forecast to increase by only 1.7 per cent after a slight fall in 2003.[3] The export-led recovery should stimulate business fixed investment. Industrial output, moreover, should be supported by the rise in global demand for investment goods, a traditional specialization of the German economy. But consumer spending should increase only moderately, given the depressing effects of falling employment on aggregate disposable income and consumer confidence. The cautious spending behaviour of consumers is likely to lead to a further rise in savings. The modest tax cuts adopted in December 2003 are expected to have only a negligible impact (equivalent to 0.2 percentage points of GDP), since they will be partly offset by increases in health charges and cuts in subsidies and social security benefits. The general government budget deficit is forecast to fall somewhat but to remain significantly above the Maastricht threshold of 3 per cent.

17. In Italy, the export-led recovery in 2004 is forecast to be supported by a moderate increase in private consumption and a pick-up of business investment in machinery and equipment, following a sharp fall in 2003. Construction investment should continue to increase at a relatively strong rate. Increased import demand is expected to neutralize the effect of the rise in exports on economic growth in 2004. Fiscal policy is set to be slightly restrictive and the general government budget deficit is projected to rise further, approaching the 3 per cent reference value in 2004. In sum, real GDP is forecast to increase by 1.6 per cent in 2004.

18. Outside the euro area, real GDP is forecast to increase by 2.8 per cent in the United Kingdom of Great Britain and Northern Ireland in 2004. More than half of the increase will be due to the continued strength of private household consumption. Government spending will also continue to make a substantial contribution to growth. Exports are expected to recover strongly, driven by the increase in world trade, but strong import demand will more than offset the positive impact on domestic activity. The current account deficit is expected to increase to some 3.5 per cent of GDP. Fiscal policy remains expansionary, but the fiscal stimulus is likely to be much smaller than in 2003. The general government budget deficit is set to exceed the EU Treaty’s 3 per cent mark. Monetary policy was tightened again in early February 2004 (the base rate was raised by a quarter of a percentage point to 4 per cent) against a background of above-trend growth in the final quarter of 2003 and low margins of spare capacity in the total economy. A major policy concern remains the housing boom and the considerable build-up of household debt, which now corresponds to more than 130 per cent of annual disposable income.

B. Risks to the short-term outlook

19. Although the baseline forecast is for a sustained global recovery in 2004 and its continuation in 2005, the short-term economic outlook remains, nevertheless, vulnerable to serious downside risks. Some of these have been present for some time and are mainly related to the legacy of the United States economic boom in the late

1990s. Additionally, a recent emerging concern is that avian influenza could spread from Asia to the rest of the world.

20. A major source of uncertainty, given its strong impact on economic growth in the rest of the world, is the sustainability of the recovery in the United States. A persistent source of worry is the large current account deficit, which now corresponds to 5 per cent of GDP, the highest level on record. The other side of this large and rising deficit is the progressive deterioration in the net international investment position of the United States, which has led to a significant rise in its net foreign debt since the late 1990s, which now corresponds to 25 per cent of GDP. The "financing" of the current account deficit now relies to a large degree on purchases of United States Government bonds by foreign central banks and private investors and not, as in the late 1990s, on inflows of foreign direct investment (FDI).

21. Concerns in international financial markets about the sustainability of the current account deficit are reflected in the pronounced weakening of the dollar since early 2002. Selling pressure on the dollar could well increase in the short and medium term, because the United States recovery and the associated strength of domestic demand is likely to offset, with a lag[4] and to a more or less large extent, the favourable effects of the dollar's depreciation on net exports. The correction of the current account deficit will also be restrained by the asymmetric reaction of net exports to changes in domestic and foreign incomes: a 1 percentage point increase in United States real incomes tends to lead to a larger increase in imports than a corresponding rise in real incomes abroad stimulates exports.[5] In the face of a persistently large current account imbalance, therefore, the risk of sudden and disruptive capital flows and the associated changes in exchange rates cannot be excluded.[6]

22. The problem is that the weakness of the dollar has occurred at a time when the recovery in both the euro area and Japan is still fragile, and when both, to a large extent, are relying on an initial strong impulse from foreign demand. A dilemma is that the adjustment of the current account imbalance cannot be brought about by the exchange rate alone. What is also required is a stronger rate of growth of domestic demand in the rest of the world.[7] Also required is a sustained slowdown in real income growth in the United States of America,[8] combined with an increase in the national savings rate.

23. In principle, creditor countries (i.e. those with current account surpluses) should be prepared to facilitate the adjustment of debtor countries (i.e. those with current account deficits) by accepting an appreciation of their currencies. But the risk is that the dollar depreciation will overshoot in 2004 and choke off the recovery in Europe and Japan, via its adverse impact on exports, profits and business investment.

24. The main challenge for Governments, therefore, is how to ensure both a sustained global recovery and a steady and progressive correction of the major current account imbalances in the global economy. As noted above, exchange rate flexibility is a necessary but not sufficient condition to accommodate this inevitable adjustment process. Another major issue is how to ensure an acceptable sharing of the burden of a dollar depreciation among the major trading partners of the United States of America.[9] So far, this burden has fallen disproportionately on the euro area, although in recent months there has also been a significant appreciation of the

yen.[10] But there remains the thorny issue of Asian currencies, such as the Chinese renminbi, that are formally or informally pegged to the dollar.

25. It is very important to bring about a more balanced distribution of growth among the major regions of the world economy. In Europe, the successive downward revisions of (already moderate) growth forecasts risk having a negative effect on long-term growth expectations in the business sector, with attendant negative effects on productive investment and the growth of potential output. The ambitious goals of the Lisbon strategy of the European Union now look increasingly elusive and are likely to be even more out of reach after enlargement.[11] While the need for supply-side reforms is undisputed, they need to be complemented with a coherent macroeconomic policy framework that is conducive to economic growth. It is therefore important that the envisaged reform of the Stability and Growth Pact finds an appropriate balance between the need to ensure fiscal sustainability over the medium and longer term and sufficient flexibility for fiscal policy to support economic growth. A broader mandate for the European Central Bank (ECB) — emphasizing the importance of giving due attention to both inflation and the growth of employment — would also be helpful.

26. In the United States of America, the downside risks continue to be associated with the persistently high level of private household debt. This could become a serious problem in the event of a large increase in interest rates, leading to a higher debt-servicing burden. A sharp reversal of the boom in the housing market, which helped to sustain personal consumption growth during the cyclical downturn, would dampen household demand and overall economic growth as a result of the negative wealth effects. Another uncertainty is the currently much weaker link between economic growth and employment compared with previous recoveries, at least so far. If new job creation continues to be weaker than expected, it could dampen consumer confidence and spending propensity. Persistently large fiscal deficits could, moreover, trigger a rise in United States long-term interest rates, which would probably spill over to the euro area and Japan, with adverse consequences for interest-sensitive expenditure items. The sharp rise in equity prices in 2003 appears to have been based on very favourable expectations about profits growth. Any slowdown in the rate of recovery is therefore likely to trigger a significant fall in prices, with negative wealth effects on households and the financing conditions for the corporate sector and hence on private sector spending.

27. In the euro area, apart from the concern that a stronger euro could choke off the recovery, business investment could be held back by the lingering balance sheet problems in the corporate sector in several countries, especially France, Germany and Italy. Such problems would risk being amplified by a sharp fall of equity prices. Another uncertainty is how far household spending propensities will be affected by the long-standing discussions about future pension entitlements and the funding of increased health-care costs. There has also been a sizeable increase in household debt in recent years, largely related to a surge in house prices in several countries (notably Greece, Ireland, the Netherlands and Spain). As in the United Kingdom and the United States, there is a risk that rising interest rates could trigger a fall in house prices with adverse effects on consumer spending.

28. Another concern is the boom in emerging market debt in 2003, largely a result of low interest rates in the industrialized countries stimulating investors to search for higher yields on riskier assets. As a result of the surge in demand for emerging

market bonds, yield spreads (over United States treasuries) have fallen to very low levels that were last seen before the Asian and Russian financial crises. An unanticipated rise in United States interest rates, or a weaker than expected global recovery, could trigger a sharp change in investors' perceptions of risk in emerging bond markets and lead to disruptive capital outflows.[12]

C. Eastern Europe and the Commonwealth of Independent States

29. In the short run, Eastern Europe and the Commonwealth of Independent States (CIS) are poised to remain the most dynamic parts of the ECE region. However, growth rates in these two groups are forecast to diverge in 2004: while GDP growth in Eastern Europe is expected to accelerate to some 4.5 per cent (from 3 per cent in 2002 and 3.8 per cent in 2003), in the CIS it is set to slow down from the exceptionally high rate of 7.6 per cent in 2003 to a still relatively high 5.7 per cent in 2004, a rate similar to that in 2001 and 2002 (table 3).

30. The generally optimistic forecasts for the East European economies reflect expectations of a strengthening of the recovery in Western Europe, which is their main export market. Most countries in Eastern Europe are relying on stronger demand for their exports in 2004 (than was the case in the previous two years), not only to support domestic activity but also as a way to revert to a more balanced pattern of growth. Growth in Eastern Europe in 2002 and 2003 was predominantly driven by domestic demand (and often largely by consumption), which in some cases led to sizeable macroeconomic imbalances. A shift towards export-led growth (a pattern that prevailed throughout most of the 1990s) would help to reduce these imbalances.

31. In Central Europe it is expected that the strengthening of West European import demand, coupled with the positive effects of EU accession on business and consumer sentiment, should lead to stronger growth in 2004. Growth in Eastern Europe's largest economy, Poland, was steadily accelerating during the course of 2003 and is expected to continue to do so in 2004, thanks to exports of manufactured goods and a strong revival of private fixed investment. Supportive policies (as envisaged in the budgetary policy framework for the year) and the recovery of private consumption should provide further support to activity. Taken together those factors should underpin an acceleration of Polish GDP growth to some 5 per cent in 2004. However, the envisaged fiscal stimulus implies a further increase in the budget deficit and a worrying escalation in the level of public debt. Hence, the implementation of the long-delayed reforms in the country's public finances is increasingly urgent, despite their possible negative short-term implications for economic activity.

32. In Hungary, the expected modest strengthening of GDP growth in 2004 (to 3.3 per cent) presupposes a major shift towards export-driven growth. This, in turn, is conditional on significant gains in competitiveness and profitability (resulting from wage moderation and rapid productivity growth) leading to a stronger recovery of business investment, a revival of foreign direct investment (FDI) inflows and a sharp upturn in exports. If successful, this adjustment should lead to a large increase in the contribution of net exports to GDP growth, which would be sufficient to offset the negative effects of the envisaged tightening of macroeconomic policy (in response to the twin deficit problem and the currency turmoil in 2003) on private

and public consumption. Similarly, the Czech authorities face difficult policy choices related to the threat of unsustainable twin deficits, a consequence of earlier expansionary policies. The response to these threats is likely to involve fiscal retrenchment and, possibly, a tightening of monetary policy as well. The possible withdrawal of policy support to domestic activity (a support that prevented a more severe slowdown in 2002 and 2003) is expected to lead to a deceleration in growth to 2.8 per cent in 2004, despite the likely revival of exports. In Slovenia, the present policy of wage restraint should strengthen competitiveness and this, together with the recovery of West European demand, should provide a boost to exports in 2004. As a result, the recovery in aggregate output should accelerate to 3.6 per cent in 2004. In Slovakia, growth is set to remain strong in 2004, with GDP increasing by some 4 per cent. The export-oriented manufacturing sector should benefit from stronger external demand, and the economy as a whole should also gain from the confidence-enhancing effects of EU membership and structural reforms focused on improving the fiscal position and strengthening work incentives. In contrast to other Central European economies, final domestic absorption can also be expected to increase in Slovakia in 2004, providing further support to domestic economic activity. Strong GDP growth (at rates around 6 per cent or more) is expected to continue in all three Baltic States in 2004. The three economies rely heavily on exports to Western Europe and should benefit from a recovery in domestic and import demand in the EU. However, the very large current account deficits in Estonia and Latvia may lead to a tightening of macroeconomic policies, which may, in turn, somewhat moderate their growth rates.

33. Economic performance in South-East Europe is likely to remain mixed in 2004. Robust growth is set to continue in Bulgaria, Croatia and Romania, with GDP in each of them increasing by some 5 per cent or more. The prospect of EU membership has not only provided a stimulus to policy reforms but has also raised the attractiveness of these economies in the eyes of foreign investors, leading to a surge in inward FDI.[13] In turn, the acceleration of FDI-led restructuring has strengthened the supply side of their economies, and this provides a basis for a sustained recovery in the coming years. However, all three countries have large (and in some cases growing) current account deficits; Croatia also suffers from a chronically large fiscal deficit. Consequently, a tightening of policies in some of these economies, with possible adverse effects on economic activity, cannot be excluded. In Serbia and Montenegro, after a considerable slowdown in 2003, growth is expected to gain some momentum in 2004, with GDP increasing by 3-4 per cent. The completion of a number of major privatization deals in 2003 (some of them to strategic foreign investors) should boost the process of enterprise restructuring in this country. At the same time, a number of important policy reforms have been put on hold as a result of the early parliamentary elections held in 2003. The other south-east European economies are expected to maintain their rates of growth in 2004.

34. While the short-term outlook for Eastern Europe as a whole is generally positive, there are some important downside risks to these forecasts. The most serious is the presently lacklustre West European import demand, which, if it fails to improve, could disappoint East European hopes of robust export growth. Additional uncertainties about East European export growth stem from the increasingly strong competitive pressures coming from Asian producers. The macroeconomic imbalances in a number of East European economies are another important source of

downside risks: policy makers are under increasing pressure to take action to correct large and sometimes growing current account deficits. In addition, if efforts to consolidate the public finances in Central Europe fail to reduce the large fiscal deficits, a further tightening of monetary policy (driven by efforts to meet the Maastricht targets) may be the prospect. Such policy responses are likely to have negative consequences for economic activity in the countries involved and in Eastern Europe as a whole.

35. In the Commonwealth of Independent States, some moderation of growth is expected in 2004, with aggregate GDP increasing by some 5.7 per cent. This reflects expectations of a slowdown in the region's largest economies (especially the Russian Federation), which, in turn, is mostly related to uncertainties surrounding the external environment. Nevertheless, robust output growth should generally prevail throughout the CIS region.

36. Russia's long-term economic strategy, adopted in 2003, calls for the doubling of GDP in 10 years. This implies that the GDP of the Russian Federation should grow by more than an average annual rate of 7 per cent during this period. While in principle the Russian economy has the potential to grow rapidly, provided its resources are used more efficiently, its declining population (which leads to a diminishing labour force) could become a serious constraint on its ability to meet such an ambitious growth target. In addition, the realization of its long-run growth potential — which is in any case below the annual target mentioned above — will depend on the acceleration and deepening of systemic and structural reforms.

37. In the short run, economic activity should generally remain buoyant in the Russian Federation but GDP growth is set to slow down slightly in 2004, to some 5 to 6 per cent. The Russian economy is still very dependent on the oil sector and developments there are likely to have a major impact on its overall economic performance. According to recent estimates, the growth of Russian oil production (which has been a major driving force of the economy in recent years) is expected to decelerate considerably in 2004 (to some 3 per cent, after increasing by 11 per cent in 2003) and this will undoubtedly affect the growth of GDP.[14] An additional uncertainty surrounding Russia's economic prospects in 2004 is the outlook for world oil prices. Economic performance in the non-oil sectors of the economy will also depend on the ruble's exchange rate: a sharp real appreciation could place another obstacle in the way of a stronger recovery in the manufacturing sector, unless key product market reforms (including bankruptcy proceedings) are implemented more effectively than hitherto.

38. Despite some moderation, Kazakhstan's economic expansion should continue at a fast pace in 2004, with GDP expected to increase by some 7 per cent. Several years of strong growth have contributed to a significant rise in living standards and to a rehabilitation of public finances. In turn, this has allowed the Government, after years of austerity, to refocus the priorities in its budgetary policy. In particular, the 2004 budget envisages an increase of the share of social programmes in public expenditure; in addition, the Government plans to allocate more resources to economic diversification, innovation and technological development.[15] While these policies target important economic and social goals, the authorities probably need to exercise some caution when engaging in policy activism. The current robust economic performance and the budgetary surplus largely reflect windfalls from the recent high world market prices for energy resources; an abrupt reversal of such

prices could quickly undermine the Government's ability to allocate large funds to social programmes and industrial policy. At the same time, some of these measures (especially those related to entitlements) could be very difficult to reverse. From this point of view, a less risky policy priority, but nevertheless with significant long-term returns, would be public investment in the development of human capital and in growth-enhancing public infrastructure. Attracting foreign direct investment to the non-oil sectors could be another important way to promote economic diversification.

39. After exceptionally strong growth in 2003, Ukraine's economy is also expected to slow down in 2004 with GDP increasing by some 5 per cent. The outcome in 2003 was partly due to a one-off recovery in the external demand for some key export items (such as steel and chemicals) for which spare capacity was available; such a concurrence of factors is unlikely to be repeated in 2004. Domestic economic policy (and performance) in 2004 is likely to be influenced by the forthcoming elections. Some planned reforms, such as the restructuring of key sectors of the economy (the coal and mining industries, energy and telecommunications, among others), are likely be put on hold until after the elections. At the same time, some loosening of policy ahead of the elections, involving a shift in public spending from investment to consumption, cannot be ruled out.

40. In January 2004, the Belarusian Government adopted a set of long-term policy measures intended to accelerate the restructuring of the economy and raise its competitiveness. However, the success of this programme hinges on the willingness of the authorities to undertake the painful measures needed for the restructuring of the ailing enterprise sector, which has so far largely escaped reform. Belarusian firms have been shielded from competitive pressure through various subsidies (including directed soft bank credit), which have also had detrimental consequences for the banking system and for macroeconomic stability. The 2004 programme can only achieve its goals if the authorities radically change these policies by imposing hard budget constraints on firms and banks and accelerate the much delayed privatization of the enterprise sector. The economic programme calls for an increase in GDP of some 9 to 10 per cent in 2004; while growth in Belarus is likely to remain relatively strong, this is probably an overambitious target.

41. The Kyrgyz economy has recovered from the slump that followed the temporary closure of the Kumtor gold mine; however, due to existing macroeconomic imbalances, the forecast for 2004 is somewhat cautious, envisaging an increase in GDP of some 4 per cent. A deceleration in economic growth is also envisaged in 2004 in the Republic of Moldova where GDP is forecast to increase by some 5 per cent, which is below the average rate of the last three years. The slowdown is due to the balance of payments constraint arising from heavy foreign debt service requirements. The resumption of official assistance to the Republic of Moldova by the international financial institutions is vitally important for easing this constraint and thus releasing much needed resources for the restructuring of the economy and strengthening its prospects for growth. The macroeconomic situation in Georgia is similar to that in the Republic of Moldova: the more restrictive policy stance envisaged for 2004 (prompted by the large external deficits) is likely to result in a slowdown of GDP growth.

42. In Uzbekistan, the official GDP growth target for 2004 (6 per cent) should be judged against a major policy dilemma that the authorities are facing. On the one hand, if they maintain the relatively tight policy stance of 2003 — launched in an

effort to prevent an excessive depreciation of the sum ahead of the introduction of currency convertibility— without reverting to currency controls, the target may be rather difficult to achieve. On the other hand, a loosening of policy could trigger unwanted inflationary pressures (through the expected currency depreciation), while the eventual reintroduction of currency controls would compromise the effort to make the currency convertible. Growth in Tajikistan is expected to remain strong in 2004, at around 8 per cent, thanks to progress in macroeconomic stabilization and the general improvement in the economic climate in the country. Relatively high rates of growth are also expected in the rest of the CIS economies in 2004.

43. Apart from the uncertainties surrounding world commodity markets, there are additional downside risks to the short-term outlook for the CIS economies. Macroeconomic imbalances in some of them may prompt Governments to tighten macroeconomic policies (after a general relaxation in 2003), and this could lead to some moderation in growth rates. Some of the more indebted CIS economies may encounter balance of payments constraints that could further weaken their growth. Finally, developments in the Russian economy in 2004 will continue to have a significant influence on economic performance in the rest of the CIS: if growth in the Russian Federation falls below expectations, there will be negative repercussions for all the other economies in the region.

Notes

[1] The strong cyclical momentum in the United States of America in the course of 2003 created a significant statistical carry-over effect of 1.9 percentage points. If real GDP in the United States were to stagnate in 2004 at its level in the fourth quarter of 2003, the annual growth rate would still be 1.9 per cent in 2004. Thus, even a stagnating United States economy, in the course of 2004, would still produce the same average annual rate of economic growth in 2004 as is currently forecast for the euro area.

[2] Federal Reserve Board, *FOMC Statement*, Press Release, 28 January 2004 (www.federalreserve.gov).

[3] Annual GDP data are not adjusted for variations in the number of working days. In Germany, about half a percentage point of the average annual growth rate in 2004 is accounted for by calendar effects, which lead to an exceptional increase in the total number of working days compared with the preceding year.

[4] This is the so-called J-curve effect, which describes the adjustment path of the trade balance in response to a real depreciation.

[5] C. Mann, *Is the U.S. Trade Deficit Sustainable?*, Institute for International Economics (Washington, D.C.), 1999.

[6] See, *Economic Survey of Europe, 2003*, No. 1, United Nations publication, Sales No. E.03.11.E.26.

[7] Ibid.

[8] C. Freund, *Current Account Adjustment in Industrialized Countries*, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 692 (Washington, D.C.), December 2000.

[9] *Statement of G-7 Finance Ministers and Central Bank Governors* (Boca Raton, FL), 7 February 2004 (www.g7.utoronto.ca).

[10] The Japanese authorities, however, continued to intervene strongly in the foreign exchange

markets in January 2004 to check the appreciation of the yen.

[11] Commission of the European Communities, "Delivering Lisbon — reforms for the enlarged Union", *Report from the Commission to the Spring European Council*, COM (2004) 29 (Brussels), 21 January 2004.

[12] International Institute of Finance, "Net private capital flows to emerging markets rose sharply in 2003 and are set to continue at robust rate in 2004", Press Release, 16 January 2004 [www.iif.com].

[13] Bulgaria and Romania are aiming at a quick finalization of their accession negotiations in pursuit of their ambition to join the EU in 2007, while Croatia has recently voiced its desire for speedy accession to the EU.

[14] Statement published by Russia's Ministry of Energy, *Reuters News*, 31 December 2003, reported in Dow Jones Reuters Business Interactive (Factiva).

[15] In a broader context, these measures are the first steps in implementing the long-term national Industrial Development Strategy (covering the period until 2015), which was adopted in 2003.

Annex

Table 1

Annual changes in real GDP in the ECE region, 2000-2004

(Percentage change over previous year)

	2000	*2001*	*2002*	*2003*	*2004*
ECE region	4.1	1.4	2.1	2.5	3.6
Western Europe	3.7	1.3	1.3	0.9	2.2
European Union	3.6	1.7	1.1	0.8	2.1
Euro area	3.5	1.7	0.9	0.5	1.9
North America	3.8	0.6	2.3	3.0	4.5
United States	3.7	0.5	2.2	3.1	4.6
Eastern Europe	3.9	3.2	3.0	3.8	4.5
CIS	8.9	6.1	5.2	7.6	5.7
Russian Federation	10.0	5.1	4.7	7.3	5.5
Memorandum items:					
EU acceding countries-10	4.0	2.6	2.5	3.6	4.2
Enlarged EU-25	3.6	1.8	1.2	1.0	2.3
Europe (east and west)	3.8	1.5	1.5	1.2	2.5
Europe (east and west) and CIS	4.4	2.1	2.0	2.1	2.9

Source: Tables 2 and 3.

Note: The regional aggregates are computed by summing over all countries the constant prices series rescaled to the price level of the common base year 2000 and converted into dollars using the GDP purchasing power parity of the year 2000.

Table 2
Changes in real GDP in the developed market economies, 2001-2004
(Percentage change over previous year)

	2001	*2002*	*2003*	*2004*
France	2.1	1.2	0.2	1.7
Germany	0.8	0.2	-0.1	1.7
Italy	1.8	0.4	0.5	1.6
Austria	0.8	1.4	0.9	1.9
Belgium	0.6	0.7	1.0	1.9
Finland	1.2	2.2	1.4	2.6
Greece	4.0	3.8	4.0	4.1
Ireland	6.2	6.9	2.3	3.8
Luxembourg	1.2	1.3	1.2	2.0
Netherlands	1.2	0.2	-0.8	1.0
Portugal	1.6	0.4	-0.8	1.4
Spain	2.8	2.0	2.4	3.0
Euro area	1.7	0.9	0.5	1.9
United Kingdom	2.1	1.7	2.1	2.8
Denmark	1.4	2.1	0.3	2.2
Sweden	1.1	1.9	1.6	2.4
European Union	1.7	1.1	0.8	2.1
Cyprus	4.0	2.0	2.0	3.4
Iceland	2.9	-0.5	1.9	3.7
Israel	-0.9	-0.8	0.8	1.9
Malta	-1.2	1.7	0.8	2.7
Norway	1.9	1.0	0.4	2.9
Switzerland	0.9	0.2	-0.4	1.6
Turkey	-7.5	7.8	5.0	4.9
Western Europe	1.3	1.3	0.9	2.2
Canada	1.9	3.3	1.7	3.1
United States	0.5	2.2	3.1	4.6
North America	0.6	2.3	3.0	4.5
Japan	0.4	0.1	2.3	2.1
Total above	0.9	1.6	2.0	3.2
Memorandum items**:**				
EU acceding countries-10	2.6	2.5	3.6	4.2
Enlarged EU-25	1.8	1.2	1.0	2.3
Western Europe and North America	1.0	1.8	2.0	3.4

Source: Eurostat; OECD national accounts; national statistics; European Commission, *European Economy*, No. 5 (Brussels), 2003; *OECD Economic Outlook* No. 74 (Paris), December 2003; Consensus Economics, *Consensus Forecasts*, 12 January 2004; *The Economist*, 5 February 2004.

Note: All aggregates exclude Israel. Data for 2003 are preliminary estimates. Data for 2004 are forecasts.

Table 3
Changes in real GDP in eastern Europe and the CIS, 2000-2004
(Percentage change over previous year)

	2000	*2001*	*2002*	*2003*	*2004 forecast*
Eastern Europe	3.9	3.2	3.0	3.8	4.5
Albania	7.7	6.5	4.7	6	6
Bosnia and Herzegovina	5.4	4.5	3.7	3.2	4
Bulgaria	5.4	4.1	4.8	4.8	5.3
Croatia	2.9	4.4	4.6	4.7	5
Czech Republic	3.3	3.1	2.0	3.0	2.8
Estonia	7.3	6.5	6.0	4.5	5-6
Hungary	5.2	3.8	3.5	2.8	3.3
Latvia	6.8	7.9	6.1	7	6-7
Lithuania	4.0	6.5	6.8	8.9	6.2
Poland	4.0	1.0	1.4	3.7	5
Romania	2.1	5.7	4.9	4.8	5.5
Serbia and Montenegro[a]	6.4	5.5	3.8	1	3-4
Slovakia	2.0	3.8	4.4	4.1	4.1
Slovenia	4.6	2.9	2.9	2.6	3.6
The former Yugoslav Republic of Macedonia	4.5	-4.5	0.9	3.1	3-4
CIS	9.0	6.1	5.2	7.6	5.7
Armenia	5.9	9.6	12.9	13	7
Azerbaijan	11.1	9.9	10.6	11.2	9
Belarus	5.8	4.7	5.0	6.8	6-7*
Georgia	1.8	4.8	5.5	8.6	4.5
Kazakhstan	9.8	13.2	9.9	9.1	7
Kyrgyzstan	5.4	5.3	–	6.7	4.1
Republic of Moldova[b]	2.1	6.1	7.8	6.3	5
Russian Federation	10.0	5.1	4.7	7.3	5.5
Tajikistan	8.3	10.2	9.5	10.2	8
Turkmenistan[c]	18.6	20.7	19.8	17	..
Ukraine	5.9	9.2	5.2	8.5	4.8
Uzbekistan	4.0	4.5	4.2	5	6
Total above	6.9	4.9	4.4	6.1	5.2
Memorandum items:					
EU acceding countries	4.0	2.5	2.5	3.7	4.3
Baltic states (BS-3)	5.6	6.9	6.4	7.3	6.1
Central Europe (CE-5)	3.9	2.2	2.2	3.4	4.1
South-East Europe (SEE-7)	3.7	4.9	4.5	4.3	5.1
CIS without Russian Federation (CIS-11)	6.6	8.4	6.5	8.2	6.1
Caucasian CIS countries (CCIS-3)	6.9	8.2	9.5	10.8	7.2
Central Asian CIS countries (CACIS-5)	7.7	9.2	7.5	7.9	6.9
Three European CIS countries (ECIS-3)	5.7	7.8	5.2	8.0	5.3

(Source and footnotes on following page)

(Source and footnotes to Table 3)

Source: National statistics, CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat; reports by official forecasting agencies.

Note: Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Aggregates are UNECE secretariat calculations, using PPPs obtained from the 1996 European Comparison Programme. Aggregates shown are: eastern Europe (the 15 countries below that line), CIS (the 12 member countries of the Commonwealth of Independent States). Sub-aggregates – Baltic States (BS-3): Estonia, Latvia, Lithuania; central Europe (CE-5): Czech Republic, Hungary, Poland, Slovakia, Slovenia; EU acceding countries: Baltic States and central Europe; south-east Europe (SEE-7): Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia and Montenegro, the former Yugoslav Republic of Macedonia; Caucasian CIS countries (CCIS-3): Armenia, Azerbaijan, Georgia; central Asian CIS countries (CACIS-5): Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan; three European CIS countries (ECIS-3): Belarus, Republic of Moldova, Ukraine.

[a] Excluding Kosovo and Metohia.

[b] Excluding Transdniestria.

[c] Figures for Turkmenistan should be treated with caution. In particular, the deflation procedures that are used to compute officially reported growth rates are not well documented and the reliability of these figures is questionable.