EASTERN EUROPEAN ANALYSIS AND OUTLOOK 2002:

SUMMARY

A Report by the ICEG European Center

June 2002

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INTRODUCTION

This short study on the macroeconomic developments of Eastern European economies in 2002 gives a summary of the major regional trends. It focuses on those region-wide trends that shape macroeconomic developments in the economies of the region.

First, the study explores in brief the reasons of the better than the average growth performance of emerging economies of the region and the changes in growth patterns.

Besides that, it also discusses the major factors of inflation and the recent success in disinflation, which came together with sizeable real and sometimes nominal appreciation of local currencies.

Finally, the analysis gives a brief assessment of the evolution of fiscal and current account balances and the factors determining them.

I. GLOBAL CONDITIONS AND THEIR EFFECT ON EASTERN EUROPE

The two years under analysis are especially difficult ones for the world economy. The simultaneous and synchronized decline of GDP in the three advanced regions resulted in the deepest recession and reduction of world output growth in recent decades. The decline of growth rates hit especially the advanced economies, while the reduction of output growth was less pronounced in emerging economies: while world GDP growth is expected to decline from the average 2,8 % of 1998-2000 to 1,2% in 2001-2002, the same figures are 4,1% and 1,2% for the US, 2,9% and 1,3% for the Euro-zone and -,1% and –1,2% for Japan. Moreover, the recession seems to be more long-lasting than expected, as GDP growth rates are to moderate further in 2002 compared to 2001 and recovery may start half a year later than earlier expected.

Table 1. Changes in global economic conditions (%)

	2000	2001	2002
World GDP	3,9	1,2	1,3
USA	4,1	1,1	1,3
Japan	2,2	-0,8	-1,5
Euro-area	3,5	1,4	1,2
Developing economies	5,4	2,8	3,2
Latin-America	3,8	0,6	0,5
East-Asia	7,1	2,3	3,5
Transition economies	6	4,3	3
World trade	13,1	0,8	1,8
Oil prices	56,2	-13,7	-17,9
LIBOR	6,7	3,3	2,3
EURIBOR	4,5	4	3

The growth performance of developing economies is much better: on average growth rates declined from 3,3% (1998-2000) to 3% (2001-2002), but these general figures reflect significant differences between individual regions and countries. The recent economic slow-down has especially strongly affected growth performance in Latin-America (GDP growth declined from the average 2,8 % of 1998-2000 to mere 0,5% in 2001-2002), while the East-Asian (4,5 % between 1998-2000 and 3% in 2001-2002) and Eastern-European economies (average growth rates for 2001-2002(3,6%) will be higher than for 1998-2000(3,3%) due to low growth in 1998 following the Russian crisis) have weathered the exogenous shocks much better.

The steep reduction of output growth has been accompanied by similar declines in world trade. After expanding with a record 13,1% in 2000, world trade grew by mere 0,8% in 2001 and the expected recovery in 2002 will result still only in 1,8% expansion. The decline of world trade have been driven by the reduction of export and import volumes of advanced economies due to the size of their economies and the importance of trade between them. The steepest decline of both export and – which is important for emerging economies – import volumes of advanced economies have been registered in Japan and USA, where both figures turned to be negative.

Table 2. Changes in export and import volumes

	Export 00	Export 01	Import 00	Import 01
World	11,5	0,8	11,3	0,9
Japan	9,4	-5	10,9	0,3
USA	9,5	-3	11,4	-0,9
EU	11,6	2,8	10,6	2,7
Developing countries	13,7	0,5	16,8	0,8
Transition economies	16,1	8,4	15	11,3
Latin-America	11	2,5	14	3
East-Asia	21,5	0,3	18,4	-0,4

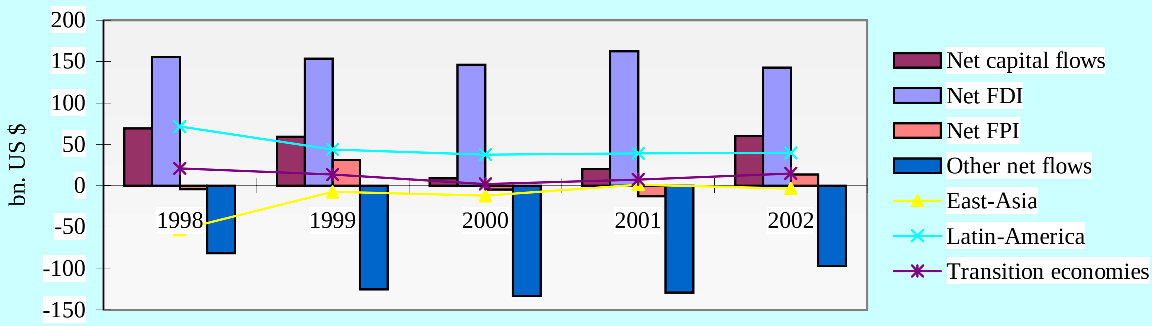
The Euro zone also experienced sharp decline in trade, but the delayed and smaller decline of output resulted in much smaller decline of trade volumes: while export volumes for USA and Japan declined by 12,5 and 14,5%, and import ones by 12,5 and 10,5%, the same figures for the Euro-zone were 8,8% and 7,6%. Contrary to output performance the decline of trade volumes in developing economies was above the figures for advanced ones: export volumes declined by 13%, while import volumes by 16%.

But these figures hide significant regional differences: terms of trade losses, decline of import demand and unfavorable exchange rate developments have extremely hardly hit foreign trade of Latin-American and to lesser extent East-Asian economies, while export and particularly import volumes were less affected in Eastern-Europe. In Eastern-Europe the slowdown of world trade is to be felt with some delay and will be reflected more in the trade performance in 2002.

Among the developments exogenous for the countries of the region, the decline of oil prices in 2001-2002 is a positive sign for most of them. Oil price increases in 2000 resulted in the reversal of disinflation, forced central banks to increase policy rates, while their decline in 2001 reversed these trends and affected adversely only Russia, whose economy realized sizeable windfall gains from oil price and export increases in 2000. The synchronized reduction of output growth led to prompt reaction by monetary authorities and central banks in advanced economies have significantly reduced their policy rates. While interest rates in many transition economies move relatively independently from the advanced ones, policy rates in most of them have declined, supported besides global trends by the decline of domestic inflationary pressures.

Developing and especially emerging market economies may expect increasing amounts of net capital inflows due to capital market weaknesses in developed countries and their low rates of economic growth. Within the increasing net inflows the major contribution comes from the decline of outflows in case of other flows which include repayments of credits and debt service expenditures. Besides that net inflows of foreign portfolio investments are expected to increase reflecting the mentioned low returns in advanced economies and net foreign direct investments are expected to remain unchanged. For transition economies 2001-2002 show slight increase of net capital inflows, though there are huge differences between the individual economies, as some of them are significant recipients of inflows, while many of them are small ones or even experience net capital outflows like Russia.

Chart 1. Changes in global capital flows



The Eastern European economies are heavily dependent on the macroeconomic performance of the Euro-zone. The data in the table confirm for this zone the earlier mentioned findings for the advanced economies, and show an additional constraint for the Eastern European region: the recovery in the Euro-zone may start only in the last quarter of this year and this will have minor effects on its growth and import demand. Both of these figures are expected to decline in 2002 compared to 2001, which makes the negative demand shocks on transition economies more persistent and protracted than expected before.

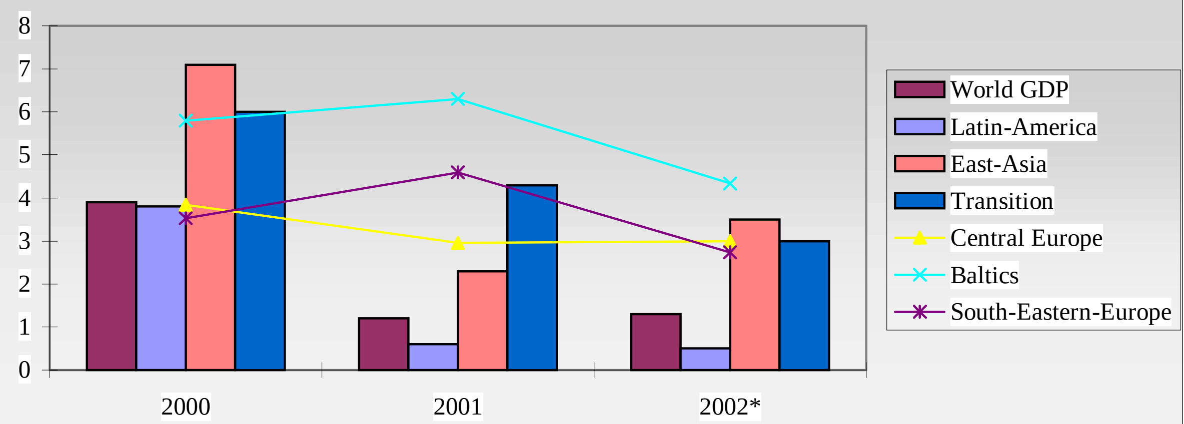
Table 3. Major indicators of the Euro-zone (% change)

	1999	2000	2001	2002*
GDP	2,6	3,4	1,6	1,3
Domestic demand	3,2	2,8	0,8	1,3
Import	3,7	10,4	1,4	1,2
CPI	1,1	2,4	2,6	1,8
General government balance	-1,3	-0,8	-1,1	-1,4

II. Declining, but Still Robust in International Comparison Increase of Output

In recent global slow-down emerging markets have performed better than advanced economies, and the Central and Eastern European economies have recorded the best growth rates among emerging economies. The slowdown of output growth in Central Europe (with the exception of Poland) was modest in 2001 and in 2002 output growth will be close to 2001, output expanded in the Baltics and in the three South-Eastern European economies. As the chart below shows, while output growth in the three groups of transition economies (and especially in Russia and the Ukraine) was below the Latin-American, Asian (and shown as a reference EU) rates in 1999-2000, it is to exceed these levels significantly in 2001-2002.

Chart 2. Regional growth rates in 2000-2002



The relatively good output performance is due both to external and domestic macroeconomic and policy related factors. While global slowdown and growing uncertainty hit transition economies too, their effect has been weaker than in the Latin-American and East-Asian economies. First, the latter economies are more exposed to the US and Japanese economies, and their slowdown and its spillover effect on their import demand was much stronger than the slowdown in the European Union, to which the Central and Eastern European economies are most exposed to (with the average share of exports directed to the EU reaching 75% of total exports). Moreover, the Latin-American and East Asian economies were hit by regional shocks, too: the former countries by the Argentine currency collapse, while the latter by the falling Japanese economy.

Second, besides differences in import demand on their major markets, terms of trade developments also differed between transition and other emerging markets. Declining oil prices, weaker commodity prices improved terms of trade in most of transition countries[1], while terms of trade worsened in Latin-America due to the decline of commodity (and in case of Mexico and Venezuela oil) prices, and in East Asia of prices of electrical equipments.

Third, some of the global shocks hitting emerging economies have resulted in developments favorable for transition economies: amidst general decline of net financial flows to developing economies, Eastern Europe has increased the volume and its share in total and FDI related capital flows. Declining real returns in advanced economies and improving financial stability

[1] Russia behaves in that respect just in reverse compared to all other transition economies.

of transition economies vis-a-vis other emerging ones made the region increasingly attractive to foreign investors, though the division of inflows between the individual economies is very unequal.

Table 4. Growth rates in Central and Eastern Europe

	1998	1999	2000	2001	2002*
Central-Eastern Europe	3,3	3,1	3,8	3	3
Czech Republic	-1,2	-0,4	2,9	3,6	3,4
Hungary	5,1	4,5	5,2	3,8	3,5
Poland	4,8	4,1	4,1	1,1	1,4
Slovakia	4,1	1,9	2,2	3,3	3,6
Slovenia	3,8	5,2	4,8	3	3,1
Baltics	4,7	-1,3	5,8	6,3	4,3
Estonia	5	-0,7	6,9	5,4	4
Latvia	3,9	1,1	6,6	7,6	5
Lithuania	5,1	-4,2	3,9	5,9	4
South-Eastern-Europe	0,2	-0,4	3,5	4,6	2,7
Bulgaria	3,5	2,4	5,3	4,3	4
Croatia	2,5	-0,4	3,7	4,2	4,2
Romania	-5,4	-3,2	1,6	5,3	
CIS	-3,7	1,5	7,1	7,1	4,2
Russia	-5,5	3,2	8,3	5	3,5
Ukraine	-1,9	-0,2	5,8	9,1	4,8

While import demand for Eastern European exports declined less than for other emerging markets, the more significant contribution of net exports to growth was also linked to increasing competitiveness of their tradable sectors, resulting in the growth of their share in world exports and more modest decline of their export growth. Productivity gains and improvements in price and cost competitiveness are linked to privatization and structural reforms, growth of stock and flow levels of foreign direct investment, directed mainly to tradable sector or to non-tradable one closely linked to the tradable (forwarding, banking, other tradable sector related services).

Besides external factors the relatively good growth in transition economies is also due to the impact of declining oil prices, global inflation and interest rates on domestic policies. These exogenous developments affect in 2001 and 2002 positively current account and inflation, allow policy makers to pursue more accommodative policies without significantly jeopardizing macroeconomic stability. Fiscal policies have generally been relaxed (either as an outcome of built-in automatic stabilizers or as a result of increasing fiscal expenditures) and in 2001 monetary policies became more accommodative, resulting in declining real interest rate levels. This allowed (with the notable exception of Poland) a rapid increase of private consumption and – with significant differences between the individual economies- investments, which served as a partial substitute for weakening external demand. Though recently monetary policies have become more conservative, fiscal and incomes policies in most of countries remained loose, increasing further domestic demand.

Output developments in the three major regions within Eastern Europe were driven by different factors. Central European economies experienced some decline in growth rates, as they were strongly exposed to shocks from the Euro-zone: growth rates in 2001-2002 are still only slightly below the average of 1998-2000. In the Baltics output expanded in 2001 robustly for the second year in row returning to the high growth path temporarily interrupted in 1999 by the spill-over effects of the Russian crisis. The same applies to South-Eastern Europe, where the acceleration of growth in 2000 and 2001 followed the years of stagnating output, caused by domestic macroeconomic frictions. In Russia and the Ukraine growth remained very robust, but compared with 2000 decelerated in Russia thanks to worse terms of trade and accelerated in Ukraine due to the delayed effect of the Russian expansion and increase in domestic demand.

While contrary to the most of advanced and emerging economies growth rates did not decline in Eastern Europe, there has been a significant change in the composition of output growth. The major shift has occurred in the relative contribution of domestic demand and net exports to growth as the latter declined rapidly in 2001. Its impact on growth has been significant due to the high real openness of these economies and the strength of shocks affecting their net exports in 2001. The contribution of net exports to growth worsened everywhere except Hungary and Poland, where the decline of import growth exceeded exports.

Two patterns emerge behind declining net exports to GDP. In those economies, whose openness is above the average and whose exports have high import content, the decline of exports was followed within short lag by a smaller decline in imports (Slovenia, Estonia)[2]. In those economies, where domestic demand expanded rapidly and/or real openness is smaller, imports accelerated (Bulgaria, Latvia, Lithuania and Slovakia) or grew above exports (Czech Republic, Romania), which resulted in worsening contribution of net exports to growth.

Behind the described shift in the contribution to growth from net exports to domestic demand the three major regions show different patterns. The shift from net exports to domestic demand has been the most pronounced in the Baltics and Southeastern-European economies, as the contribution of net exports changed from positive to negative: in the Baltics it was due to terms of trade losses, while in South-Eastern Europe to general competitiveness problems. In Central-Europe the contribution of net exports to growth remained positive, though it declined compared with 2000 and there are significant differences between the 5 countries as in the Czech Republic and Slovakia the robust expansion of imports led to negative net exports.

The worsening contribution of net exports to growth was however compensated by increase of domestic demand and stock-building: domestic demand grew in Central-Europe economies too, but stock-building remained unchanged. This may reflect that in the Baltics and South-Eastern Europe companies face demand constraint and the rapid growth observed in 2001 is likely to fall as net exports do not recover.

Looking at the expansion of domestic demand interesting and different between the individual economies patterns emerge. The major part of the increased contribution of domestic demand to growth was the expansion of private investments. Private investments increased with double-digit rates in the three Baltic countries, Bulgaria and Slovakia. As the growth of

[2] Hungary and Poland follow this pattern but there the decline of imports exceeded those of exports. This was caused in Poland by the extreme slowdown of GDP and domestic demand, while in Hungary by the relatively high competitiveness of tradable sector.

private investments was close to 10 % in Croatia and Romania too, this region on average recorded a double-digit investment growth. Only Central-European economies lagged behind, as private investments grew by only 1,9%: but this average growth hides significant differences, while the Czech Republic and Slovakia recorded high levels of growth, private investments collapsed in Poland and grew very slowly in Hungary.

Table 5. The changes in fixed capital formation (in %)

	2000	2001	2002
Czech Republic	4,2	7	6,8
Hungary	6,6	3,1	2,5
Poland	3,3	-10,2	0,8
Slovakia	-0,7	11,6	6
Slovenia	0,2	-2	4
Estonia	2,0	17,2	15
Bulgaria	9,8	21	8
Romania	4,6	6,6	8
Russia	31,9	17	9

The robust increase of private capital formation is both explained by demand and supply side factors. On the demand side the increase in disposable incomes, growth of domestic demand improved growth and profit expectations and this stimulated capital formation. On the supply side the main explanatory factor is the impact of high foreign direct investments on corporate restructuring: as inflows were very high in recent years, this created the background for the recent expansion of private investments. This is especially visible in the case of the Czech Republic, Slovakia and the Baltics.

Finally, in some cases rapid investment growth can be explained by the low investment rate: in Bulgaria, Romania private investments to GDP is well below their level of development and catch-up needs, and thus record level growth reflects also basis effects. The differences in investment rates are still significant, as noted in our previous report: while rates of private capital formation in Central-Europe and the Baltics are in accordance both with the level of their development and investment needs, they are much lower in South-Eastern Europe and Russia/Ukraine.

Private consumption grew rapidly in the majority of economies, but its contribution to growth increased only in Central-European economies. Three factors seem to contribute to the rapid growth of private consumption.

First, as incomes policies were loosened, nominal wage growth accelerated and resulted in sizeable growth of real wages and disposable incomes.

Second, the growth of incomes has been recently accompanied by the decline of private savings: this has been either a reflection of delayed increase in private consumption which leads to reduction of savings or the decline of real returns on savings. Finally, liquidity constraints of private consumers became less tight, as increasing competition and new services resulted in rapid growth of consumer credits, boosting private consumption.

Table 6. Changes in private consumption	2000	2001	2002*
Czech Republic	1,9	3,7	3,5
Hungary	4,1	4,0	4,5
Poland	2,6	2,1	2,0
Slovakia	-3,4	4,0	3,1
Slovenia	0,8	1,9	2,7
Estonia	8,0	3,4	5,0
Bulgaria	3,4	2,0	3,0
Romania	0,1	6,4	3,8
Russia	9,3	8,7	14,0

Finally, public consumption increased in all countries except the Czech Republic and has positively contributed to the growth of output. As explained below, this increase is closely linked to looser fiscal policies, as fiscal authorities tried to mitigate the negative growth effect of declining net exports by expanding public expenditures. The growth of public consumption in 2001 was relatively modest with the exception of Ukraine, where government expanded its expenditures rapidly, thanks to the rapid growth of economy and government revenues. The relatively modest growth of public consumption elsewhere shows that fiscal loosening worked more through the increase of public wages, which also explains the robust growth of private consumption.

Table 7. Changes in public consumption	2000	2001	2002*
Czech Republic	-1,3	-1,0	0,2
Hungary	2,9	0,4	2,5
Poland	1,5	0,5	0,5
Slovakia	-0,9	5,2	2,8
Slovenia	3,1	3,2	2,7
Estonia	0,1	0,3	1,5
Bulgaria	9,8	5,0	3,0
Romania	15,9	-1,9	1,0
Russia	0,6	1,4	0,5

In 2002 Eastern Europe will remain among the regions, which grow robustly, but growth rates will moderate compared with the previous year. The average growth rates for the 14 economies under analysis are forecasted to decline from 4,7% in 2001 to 3,2% in 2002. This growth is still above the expected growth of world output (1,2%), Euro-zone (1,5%), or most of the emerging economies (developing countries 3%, Latin-America 0,5%) with the exception of East Asia (3,5%). On the other hand, while output growth in Central-Europe will remain around its 2001 rate, growth rates will decline considerably in the three other analyzed regions. In 2002 average expected GDP growth will be lower by 2% points in the Baltics, by 1,9% point in South-Eastern Europe and by almost 3 percentage points in the CIS-2 economies.

The slow-down of growth rates is due again both to domestic and external factors. The slow recovery of the world economy, low world trade growth weaken export growth and the contribution of net exports to GDP. Besides weak external import demand, terms of trade are to worsen for most of the economies. Due to high concentration of their exports, the slow and delayed recovery of the Euro zone and within that of Germany has an especially strong negative spill-over effect on exports and output.

But domestic factors contribute to the forecasted slow-down, too. We expect that the contribution of domestic demand to growth will differ in 2002 compared with 2001. In Central Europe an acceleration of domestic demand is expected, especially because of its recovery in Poland and more rapid growth in Slovenia. In the Baltics and South-Eastern Europe the expansion of domestic demand will be more moderate than in 2001, thanks to its deceleration in Estonia and Bulgaria.

Another important feature is that contrary to 2001 we do not expect that stock-piling will contribute positively to growth, which can be a reflection of strengthening corporate sector financial discipline, as companies can no longer afford the build up of unsold stocks.

Looking at the contribution of individual components to growth, private investment will remain the most robust part of aggregate demand, but investment growth rates will decline considerably. This is especially true for the Baltics and South-Eastern Europe, which had double-digit rates of growth in 2001, while investments are to accelerate in Central-Europe due to the improved investment climate in Poland and Slovenia. While the gap between the Central-Europe on one hand and Baltics and South-Eastern Europe economies on the other will narrow in 2002, the rate of growth of private investment is twice higher in the latter two groups compared to the Central-European economies.

Contrary to private investments less change is expected in private consumption growth, as they will expand robustly and close to their 2001 levels in all three county groups. Private consumption will be driven by similar to 2001 factors: growth of real wages and disposable incomes, improved liquidity position of households and declining private savings. As fiscal and incomes policies are tightened with some lag and they remain relatively expansive in 2002, their positive effect on private consumption will be strong in 2002, and can moderate it only from 2003. Concerning public consumption, the effect of looser fiscal policies will be felt in 2002 in the Czech Republic, Hungary, Estonia, Lithuania and Bulgaria, where public consumption is expected to expand more robustly than in 2001. In other countries the growth of public consumption expenditures will moderate, though in some countries (Ukraine among them) will still remain very strong.

The forecast of output growth is upward biased as several factors add to the general uncertainty surrounding projection, which may reduce actual growth. First, acceleration of output growth hinges critically on the duration of the downturn in the EU: if this lasts longer than currently foreseen, this may lead to more sizeable and longer-term slow-down in exports notwithstanding the mentioned competitiveness gains. If the world economy is hit by a negative shock, or US and German recoveries are slower than expected, this might have strong negative spill-over effects on Eastern European growth.

Another source of uncertainty and fragility for the recovery of the region is likely related to the evolution of interest rates in advanced economies. If the inflationary pressures intensify, this may lead to the adjustment of interest rates and their increase may slow-down the recovery of advanced economies and lead to similar interest rates in Eastern European economies.

Third, the extent of fiscal imbalances and the timing of fiscal adjustment is also a factor of concern for output performance, as fiscal policies in some cases (Czech Republic, Slovakia and Hungary among others) should inevitably be corrected. Private consumption and increasingly private investment should replace the fiscal stimulus provided recently as the main engine of growth, if it is expected to be long-term and sustainable. While lower deficits will result in declining interest rates and may contribute to lower inflation, in short-term they may have some negative effects on output growth, the extent of which depends on timing and degree of fiscal correction.

III. High and Persistent Unemployment

The short-term evolution of unemployment in 2001 and 2002 is affected both by cyclical and structural factors. The recent cyclical slow-down had significant effects on employment growth and unemployment rates in several economies, mainly through its effect on the tradable sectors. The structural component of unemployment is affected by the rapid restructuring of corporate sector, driven by strengthening of financial discipline, and increased inflow of foreign capital.

Looking at recent unemployment rates, the 13 countries in the sample (with the exception of Yugoslavia, where unemployment is driven by very special factors, not comparable to other transition economies) may be divided to 4 major groups. The first group includes Hungary and the Czech Republic, where unemployment rates are persistently low, structural changes having high employment costs have been implemented, and output growth – while is mainly labor-substituting - is robust enough to generate new employment. The Ukraine has comparable and even lower rates of unemployment, but it faces huge structural distortions, which are bound to increase unemployment rate.

Table 8. Unemployment rates in %

	1999	2000	2001	2002*
Central-Eastern Europe				
Czech Republic	9,4	8,8	8,9	8,8
Hungary	7	5,9	5,8	5,8
Poland	13	15	17,5	19
Slovakia	19,2	18,6	19,2	19
Slovenia	13	12	11,8	11,5
Baltics				
Estonia	11,5	13,7	13,2	12,5
Latvia	14,1	14,4	13,3	12,5
Lithuania	15,3	16,1	16,5	12,1
South-Eastern-Europe				
Bulgaria	16	17,8	18,3	18,3
Romania	11,8	10,8	8	8,7
CIS				
Russia	13,2	9,8	9	9
Ukraine	4,3	4,2	3,7	3,8

The second group of countries includes Romania and Russia, which face significant structural adjustment needs and where the relocation of labor force has not been completed, but where the recent cyclical upturn has been strong to reduce spectacularly earlier high unemployment rates. The combination of favorable cyclical and moderate structural effects helped in reducing unemployment, but it is very likely that the trend will be reversed, if and when the nature of cyclical and structural factors changes.

The third group of countries includes the Baltics and Slovenia, which have high, but relatively persistent and stable rates of unemployment. In all countries unemployment rates are above 10 %, closer to this level in Slovenia and to 15% in the Baltics. Two major factors explain high and persistent levels of unemployment in these four countries. One is that the labor markets are rigid, rules are very inflexible and notwithstanding the small size of the countries labor mobility is low. The other factor, which is more pronounced in the Baltics, is that new investments (driven primarily by foreign investors) are capital intensive and labor substituting, which results in slow growth of employment. Related to that, the service sector - while it is expanding rapidly - is relatively underdeveloped compared to other advanced Central European economies and its labor absorbing capacity is more limited.

The last group of countries includes Bulgaria, Croatia, Poland and Slovakia, where unemployment rates have approached or even exceeded 20% of labor force: in Poland unemployment rates may almost double between 1998 and 2002 (increasing from 10,4% to 19,5%), in Bulgaria increase by half in same period from 12,2% of the total labor force to 18,3%. The major and common reason behind this high level of unemployment is the ongoing and fast restructuring, that is taking place in these economies.

These four countries have recently been the recipients of sizeable foreign direct investments both in nominal terms and in relation to GDP. The privatization and financial opening driven capital inflows have resulted in fast restructuring, which is accompanied by sizeable lay-offs, while the absorptive capacity of the expanding sector is insufficient to absorb the huge wave of unemployed. All four countries have very rigid labor markets and with the exception of Croatia immobile labor force.

Moreover, Poland and Bulgaria have been hit hard in 2001 by demand shocks, which increased the cyclical part of unemployment, while Croatia and Bulgaria suffer from long-term competitiveness problems. The short-term prospects for the reduction of unemployment are bad: it is expected that unemployment may increase further as the restructuring is completed and at least till mid 2003 the recovery does not develop fully.

Altogether in 2002 slightly increasing unemployment rates are expected in most economies and also on regional average. Aggressive and inevitable restructuring of the corporate sector, as well as weak demand and high real wage growth reduce employment growth. On the other hand, the significant differences between the individual economies in terms of their unemployment level will remain present in 2002.

IV. RAPID AND CONSIDERABLE DISINFLATION

While the Central and Eastern European economies can be divided in terms of their inflation performance to three major groups[3], inflation rates are to decline considerably between 2000

[3] The first group includes the Baltics, Croatia and the Czech Republic, which have reached and maintained low levels of inflation in the early period of transition, the second includes Hungary, Slovakia, Slovenia and Poland, which have been able to achieve significant disinflation only recently after fighting with moderate inflation for many years, and the last one includes Romania, Russia and the Ukraine which still have double-digit and persistent rates of inflation. More about the inflation patterns and developments in Eastern Europe in the Trends in the Region series of ICEG European Center available at www.icegec.org

and 2002 in almost all analyzed countries. This decline allows many economies to reach and maintain in sustainable way one-digit rates of inflation, which had characterized only the Baltics, Croatia and the Czech Republic for longer period of time. Disinflation has been very significant in the recent 18 months in many of the analyzed countries, allowing them to reduce the rate of price increases to levels much below than observed earlier.

Table 9. Annual average change in CPI

	1998	1999	2000	2001	2002*
Central-Eastern Europe					
Czech Republic	10,7	2,1	4	4,7	3,9
Hungary	14,3	10	9,8	9,2	5,6
Poland	11,6	7,2	10,1	5,5	4
Slovakia	6,7	10,6	12	7,3	4,1
Slovenia	7,9	6,1	8,9	8,6	7,5
Baltics					
Estonia	8,1	3,3	4,0	5,8	4,1
Latvia	4,5	2,4	2,6	2,4	3
Lithuania	5,1	0,8	0,9	1,5	2,7
South-Eastern-Europe					
Bulgaria	18,7	2,6	10,3	7,3	7,5
Croatia	5,7	4,2	6,2	5	
Romania	59,1	45,8	45,7	34,5	26
CIS					
Russia	84,4	36,5	20,2	21,6	16
Ukraine	20	19	26	12	5,7

The significant decline of inflation in 2001 and its likely downward trend in 2002 is caused by simultaneous effect of domestic and external factors. First, in 2001 and 2002 cost pressures are much weaker than they were on average in 1999-2000. This is mainly caused by the favorable evolution of imported prices, driven partly by the world-wide and among it Euro-zone inflation. More importantly, fuel and especially oil prices have been on decline: while their increase in 2000 added a significant momentum to inflation, they have had a moderating effect on price increases in 2001-2002.

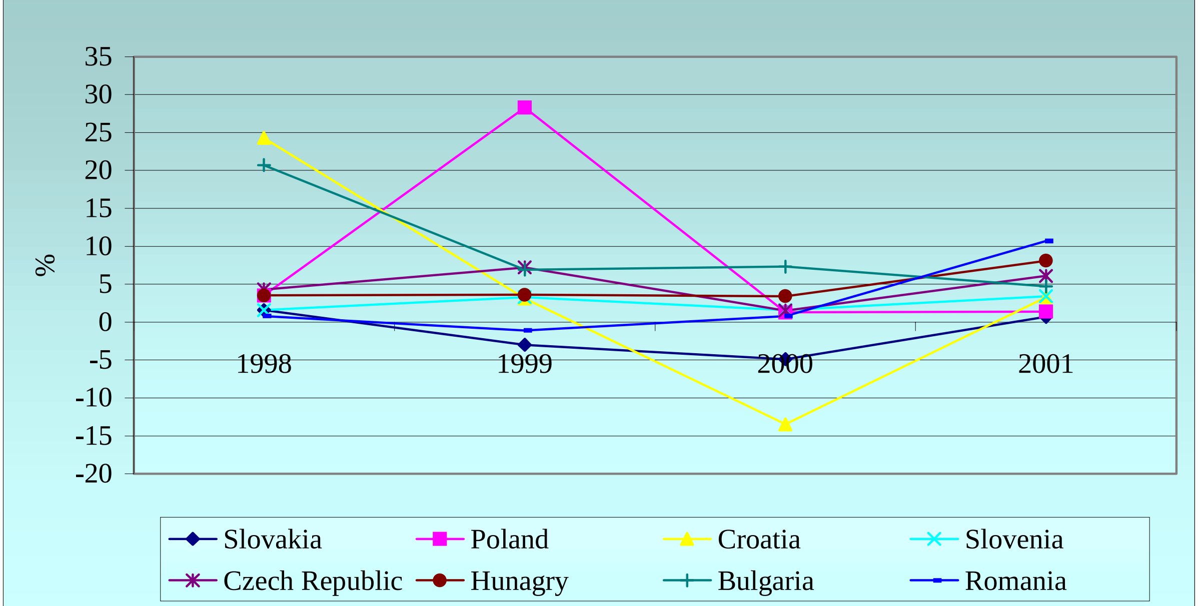
As foodstuffs and food products represent a significant and still higher than in advanced economies share of consumption basket and consumer price index, changes in agricultural prices have a strong effect on inflation. Due to supply side problems agricultural prices increased rapidly in 2000, but the good harvests reversed this tend in 2001. Due to the decline in oil and agricultural price increases, producer price growth moderated and remained well below consumer price indices, while in 2000 the reversed relationship reflected significant cost pressures.

Another factor that has a strong impact on inflation both from demand and cost sides is the evolution of nominal wages and the relation of changes in real wages to labor productivity. Looking at these two components and their effect on inflation in the last two years different conclusions can be reached, as nominal and thus real wage increases have accelerated in most economies, while the rapid increase of labor productivity resulted in an improving gap between real wage and labor productivity changes.

Table 10. Annual average changes in PPI					
	1998	**1999**	**2000**	**2001**	**2002***
Central-Eastern Europe					
Czech Republic	4,9	1,1	5,1	0,8	1,1
Hungary	11,4	5	11,4	5,2	0,5
Poland	7,2	5,7	7,8	1,8	0,8
Slovakia	3,3	3,7	9,8	3,4	6
Slovenia	6	2,2	7,7	9	6,8
South-Eastern-Europe					
Bulgaria	20	3,2	16,9	0,7	5,3
Romania	33,2	41,2	53,4	41	23,9
CIS					
Russia	7	59,1	46,5	19,1	10
Ukraine	13,2	31,1	20,8	8,6	4,2

There has been a significant difference in the evolution of nominal wages depending on the cyclical position of economies and the pursued fiscal and incomes policies. In some countries, where the economy was on downturn and policy adjustments were implemented (Slovakia, Croatia and Poland) nominal wage increases moderated compared with the previous years, when they had increased robustly. On the other hand, in most economies nominal wages have increased fast in 2001 and also in 2002, due to relaxed incomes and fiscal policies (Czech Republic, Bulgaria, Hungary, Romania), effect of political cycle driven wage adjustments (Bulgaria, Hungary, Czech Republic), income recovery to compensate earlier real wage losses (Ukraine and Russia) which is allowed by windfall gains due to improving terms of trades. As the table shows, sizeable nominal wage increases have resulted in acceleration of real wage growth, reaching in some cases high and clearly unsustainable levels.

Chart 3. Changes in CPI deflated real wages



While the picture is relatively uniform for nominal and real wage increases, it is more mixed when real wage increases are compared with changes in labor productivity. In recent two years there has been a significant increase of labor productivity in those economies that earlier lagged behind towards the ones, where productivity increases were sizeable (Hungary, Poland, Estonia). This increase shifted the positive gap between real wage and labor productivity growth in many countries: the most spectacular changes occurred in Poland, Slovakia, Latvia and Croatia, but the gap declined, though remained positive in other countries, too (Romania and the Czech Republic). The two countries that have still significant gaps between these two variables are Russia and the Ukraine, where both real wage increases have been significant and productivity increases low due to the slowness of corporate restructuring and low level of foreign capital inflows.

Table 11. The gap between real wage and productivity growth

	1998	1999	2000	2001
Croatia	18,4	6,5	-21,4	-3,7
Czech Republic	4,2	5	-3,5	2,5
Estonia	4,4	6,4	-2,4	1,4
Hungary	0,1	2,5	-0,8	4,6
Latvia	5,7	8,6	-1,2	-2,6
Poland	1,1	21,3	-5,2	-1,8
Romania	2,6	-2,2	-1,9	1,5
Russia	-9,7	-27,2	12,5	16,8
Slovakia	-2,9	-8,1	-8,5	-1,3
Slovenia	-1,9	-0,1	-1,7	2
Ukraine	-2,5	-7,6	-7,5	10,5

The negative or small positive gap between real wage and productivity changes allowed the corporate sector to absorb the increase of real wages without resorting to price increases. Productivity growth is important for disinflation in transition economies, as they are ahead of significant increases of wages and incomes, while on the other hand their real catch-up is to be driven by productivity gains.

The third important factor that contributed to the decline of inflation has been the observed absolute and relative strength of local currencies. In the analyzed economies nominal exchange rates have either become more stable against the major international currencies (Russia, Czech Republic), or have even appreciated in nominal terms (Poland, Hungary, Ukraine). As described in details later, several factors account for this appreciation, including the changes in monetary arrangements, shift in priorities of monetary authorities from exchange rate to inflation targets, increase in net foreign capital (or in some economies reserve) inflows.

The strength of local currencies has helped disinflation to considerable extent. In real terms these economies are very open and import prices affect strongly inflation, and the recent nominal appreciation weakened this effect. This dampening effect of appreciation was strong also because – as most analyses show - the exchange rate channel is the fastest and most efficient monetary transmission mechanism. This is true even for those economies, which have shifted their monetary arrangements towards more flexible ones, and where inflation targeting has been adopted and implemented. The appreciation of local currencies had a strong direct effect on tradable prices, that comprise 35-45% of the consumer price basket, and had also a strong indirect effect on non-tradable ones.

Behind the generally good inflation performance some worrying trends could also be detected. First, within the declining average inflation rates two groups of economies can be separated in terms of inflation persistence and speed of disinflation. While there are countries that could achieve significant reduction of price increases (Poland, Slovakia, Hungary, to smaller extent Croatia and Bulgaria), there were some economies that experienced significant downward price rigidity, including economies with upper low (Slovenia), or medium moderate inflation rates (Russia and Romania).

Several factors contribute to the downward rigidity of inflation rates in this group of countries. One of them are the cost pressures that arise from energy price and nominal wage increases. Inflation persistence has also been associated with the liberalization of administrative prices, as these economies embarked on a step-by-step liberalization. Finally, Russia and to lesser extent Romania, too experienced problems with net reserve inflows and their effect on money supply. As instruments to sterilize net capital inflows were underdeveloped, these inflows contributed to inflation, as resulted in sizeable increases in money supply.

Second, the recent one and a half year revealed the difficulties related to changing expectations and associated wage formation from backward to forward-looking. Third, while the rapid increase of labor productivity helped in containing inflationary effects of nominal wage increases, it also points to the increasing importance of the Balassa-Samuelson-effect in these countries. While there are very different estimates for the individual economies, most of the studies put the extent of this effect between 1,5 and 2,5% annually. The recent acceleration of productivity increases has been observed mainly in the tradable sector and the gap between productivity increases in tradable and non-tradable widened, too.

Finally, while in the last two years - with the exception of Bulgaria and Romania - inflation has been affected less by price liberalization and changes in the tax regime, these two factors still remain a sizeable source of inflation. This could be observed soon in Slovakia, Hungary, Czech Republic among others, where the elections driven delays in liberalization require further liberalization of prices. The extent of liberalization can be gauged also from the share of administratively regulated prices, which varies in the analyzed economies between 15% and 30% of all prices: this shows that there is a broad range of goods and services, where prices should be liberalized. Finally, as most of the analyzed economies are pre-accession ones, their future inclusion to the European Union should be accompanied by further changes in taxes and price structures, which will have an effect on inflation, too.

V. EXCHANGE RATE: STRONG NOMINAL AND REAL APPRECIATION

In recent months the nominal appreciation of currencies in the region against the key currencies continued further. This process started in 2000 following the significant depreciation after the Russian and other emerging market currency crises. The nominal appreciation of local currencies is reflected in the chart, which shows their changes against the Euro: the correspondent change against the dollar would be less due to the appreciation of US$ against the Euro in 2001. In some Eastern European economies appreciation has been significant (in Poland, Lithuania and Latvia it was on average 6,7% annually in 2000-2001), while in other economies smoother and less pronounced.

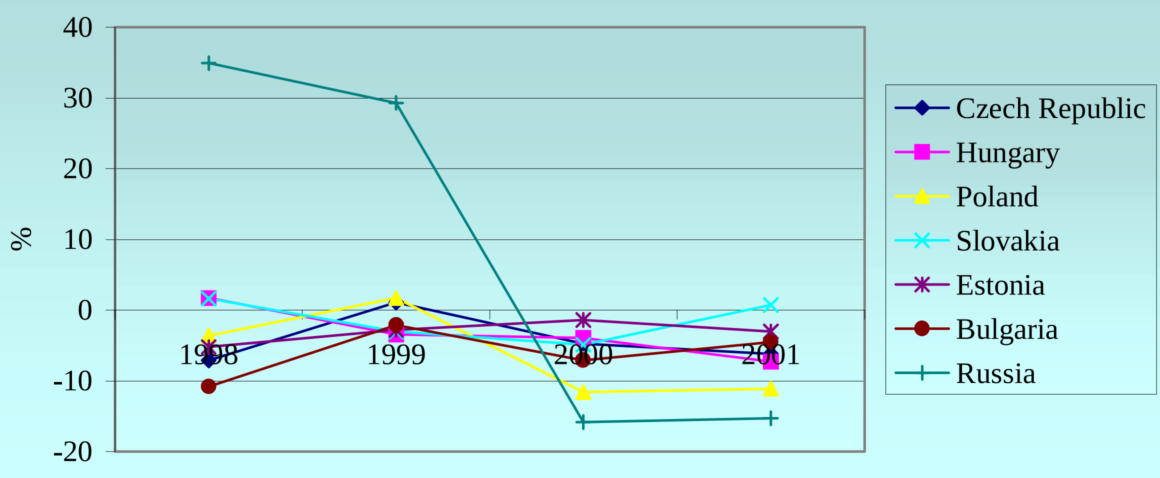
Table 12. Nominal exchange rate against the US $					
	1998	**1999**	**2000**	**2001**	**2002***
Central-Eastern Europe					
Czech Republic	32,3	34,7	38,6	38,9	35,2
Hungary	214,5	237,3	282,3	286,5	260
Poland	3,50	4,14	4,35	4,09	4,3
Slovakia	35,23	41,36	46,17	48,4	48,4
Slovenia	166,1	181,8	222,7	242,8	
South-Eastern-Europe					
Bulgaria	1,76	1,84	2,12	2,18	2,25
Romania	8874	15333	21692	29061	35012
CIS					
Russia	20,7	27	28,2	29,16	31,7
Ukraine	2,45	4,13	5,44	5,37	5,43

The reasons for this appreciation are manifold and country specific, but behind them there are four common sources. The major one is related to the renewed reliance of monetary authorities on the use of exchange rate for disinflation, which has however been accomplished this time in ways different from approaches adopted in the 1990s. By that time many central banks relied either on unilaterally pegged or predetermined exchange rates to help disinflation through their discipline and credibility effects. This approach in some cases was successful, while in many it led finally to currency collapses (Czech Republic, Russia and Slovakia). Central banks recently follow different approach: where the hard pegs were not adopted increased exchange rate flexibility is allowed and more room is given for nominal appreciation without intervention. The reason behind this strategy is the strength of the exchange rate channel of monetary transmission and the still significant levels of exchange rate passthrough.

Closely related reason of appreciation is linked to the changes in monetary arrangements. Many economies have adopted inflation targeting, which requires increased exchange rate flexibility and less concern by central banks for external competitiveness and current account balance. The increased flexibility of exchange rates allowed in many countries the market forces to adjust the level of earlier undervalued local currencies, as more flexible arrangements gave more scope for appreciation of currencies.

The next source of appreciation is related to higher capital and reserve inflows, which led to increased nominal and real demand for local currencies. Reserve inflows had three origins: increased privatization and new investments related FDI-inflows (Czech Republic, Slovakia, Croatia, Bulgaria), increased inflow of foreign portfolio investments due to interest differentials and improved financial stability (Russia, Romania, Poland, Hungary), and increased inflows of reserves due to improved current account balances (Russia, Ukraine). While different measures were implemented to mitigate the effect of reserve inflows on appreciation (including active sterilization by central banks, keeping privatization revenues on government accounts, moral suasion and verbal interventions on the markets), their efficiency remained limited and could not reverse nominal appreciation.

Chart 4. Changes in CPI based real exchange rate index



What have been the consequences of nominal exchange rate appreciation on the evolution of real exchange rate indices and price as well as cost competitiveness? The effect seems to differ slightly for cost and price competitiveness. The appreciation of both CPI and PPI deflated nominal exchange rate indices has been significant and followed the trend observed in 1998-2000, but the source of appreciation changed recently. In the second half of the 1990s real appreciation was driven by the differences in world and transition countries' inflation rates, which was accompanied by nominal weakening of local currencies. Recently the sources changed as inflation gap declined and the major source of real exchange rate appreciation has become the nominal strengthening of local currencies. Real appreciation and loss of price competitiveness is not a novelty and the private sector has been accustomed to it for longer period.

Table 13. Changes in unit labor costs

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	8,2	4	5	10,1
Hungary	0,1	7,4	6	15,5
Poland	6,7	19,4	10,5	13,4
Slovakia	-0,4	-8,4	6,5	4,1
Slovenia	2,5	2	1,2	4,3
Baltics				
Estonia	7,7	4,9	2,5	5,8
Latvia	6,9	10,4	10,8	-1,3
Lithuania	13,7	15,6	9,3	-1,6
South-Eastern-Europe				
Bulgaria	32,8	5,8	6,8	7,1
Croatia	13,2	2,6	0,7	1,3
Romania	32,2	-12,6	16,9	4,4
Serbia				
CIS				
Russia	-32,1	-41,9	35,8	40,7
Ukraine	-17,7	-28,5	4,3	28,1

The same is not true for cost competitiveness, measured in this summary by the changes in unit labor costs expressed in Euro. Here one can see that there has been either a very significant loss of cost competitiveness (ULC grew by double digit rates in 2001 in Hungary, Czech Republic, Poland, Russia and the Ukraine), or the earlier trend of declining ULC was reversed (Slovakia, Romania), while cost competitiveness improved only in the Baltics and Croatia. Weakening cost competitiveness expressed in Euro is simultaneously due to significant nominal wage increases and appreciation of local currencies, which sometimes was however compensated by the accompanying increase of labor productivity. Worsening cost competitiveness occurred simultaneously with weaker external demand and has contributed to the decline of export growth of these economies. In 2002 some reversal of this trend may be expected as both local currencies will appreciate less and nominal wage increases will moderate compared to 2001.

VI. WORSENING FISCAL PERFORMANCE

Fiscal performance has been mixed in Eastern Europe, as fiscal balances worsened in Central Europe and the former CIS economies, while they have improved to varying degree in the Baltics and South-Eastern Europe. Worsening balances in the first group mean in Central Europe rapidly increasing fiscal deficits, which eventually reached critical levels, and declining surpluses in the CIS economies. In the Baltics improvements resulted in small surpluses in Estonia and Lithuania, while in South-Eastern Europe in sustainable deficits below the average of the 1990s.

Fiscal performance in this two groups of countries evolved differently already since the Russian crisis. In Central Europe and CIS balances improved performance following the Russian crisis due to fiscal adjustment adopted for preventive purposes, accelerating growth (Hungary, Czech Republic, Russia), improving terms of trade and windfall gains generated by them (Russia, Ukraine), and gains from slower than expected disinflation and higher than planned revenues (Hungary and Poland). In the other group of countries the negative spillover effect of the Russian crisis and thus the output slow-down was bigger, the terms of trade worsened and structural tensions intensified.

This initial post-crisis effect was however reversed rapidly from 2000, when balances worsened significantly in Central Europe and started to worsen in Russia and the Ukraine. These developments reflected negative cyclical effects, especially the impact of economic slow-down and worsening terms of trade. These revenue reducing effects are especially strong in economies which show above the average levels of slow-down (Poland and Russia). In some Central European economies the recent progress in disinflation has also negative effects on primary revenues and balance due to the slower growth of nominal GDP and tax base: this effect is especially pronounced in Poland, Hungary and Slovakia. Cyclical factors play an important role in improving fiscal balances in the Baltics and SEE, where the acceleration of growth compared with 1998-1999 averages resulted in significant positive cyclical effects.

Another factor contributing to worsening fiscal balances in Central Europe has been the counter-cyclical fiscal policy, as governments tried to increase fiscal expenditures to mitigate the negative cyclical effects. To weaken the negative growth effects of export slow-down and either declining (Poland) or decelerating (Hungary and Czech Republic) private investments, governments increased their spending, motivated also by the political factors. Looser fiscal policies can be observed from the structure of central and general government balances, as their worsening was caused to equal extent by the increase of expenditures and decline of revenues. In the Baltics and South-Eastern Europe fiscal policies have been much more conservative and fiscal stimulus was constrained to reduce financial fragility (Baltics and Bulgaria), or to implement fiscal stabilization programs (Romania and Croatia).

Table 14. General government balance in % of GDP

	1998	1999	2000	2001	2002*
Central-Eastern Europe					
Czech Republic	-1,9	-3,2	-4,2	-5,5	-6,7
Hungary	-6,3	-3,4	-3,5	-4,3	-5,5
Poland	-3,2	-3,7	-3,2	-5,6	-6,3
Slovakia	-4,8	-3,6	-3,4	-5,5	-5
Slovenia	-0,8	-0,6	-1,4	-1,3	-1,3
Baltics					
Estonia	-0,3	-4,7	-0,7	0,2	0,2
Latvia	-0,8	-4,0	-2,8	-1,7	-2,8
Lithuania	-5,9	-8,5	-2,8	-1,7	1,8
South-Eastern-Europe					
Bulgaria	0,9	-0,9	-0,7	1,8	-0,8
Romania	-3,6	-1,9	-4	-3,3	-3
CIS					
Russia	-8	-3,3	3	1	0
Ukraine	-2,7	-2,4	-1,2	-1	-0,5

The worsening of fiscal balances is also caused by structural factors, among them by increasing and sometimes persistently high unemployment. In some economies budgets have to bear the costs of earlier structural reforms: the strengthening of financial sector discipline and consolidation of banking sectors has resulted in significant increase of related fiscal expenditures in Slovakia and the Czech Republic. In other cases (Poland and to less extent Russia) fiscal balances reflect the impact of accelerating structural changes, improving efficiency and productivity, partly caused by recent surges in capital inflows.

These effects have simultaneously negative impact on expenditures and revenues, as they increase unemployment and pension expenses, and reduce tax revenues due to the restructuring of the corporate sector. The negative effect of structural factors has been in some cases so strong, that some of expenditures were financed by below-the line items leading to the rapid accumulation of public debt (Slovakia and the Czech Republic).While these expenditures were partly financed out of temporary increase in privatization and capital revenues, the expected decline in privatization related capital inflows forecasts increased fiscal tensions.

Fiscal policies have different macroeconomic and policy related implications in the region. In Central Europe they have contributed to the change in policy mix towards loosening fiscal policy combined with stricter monetary conditions. Central banks have had to allow stricter monetary conditions to avoid the negative effect of loosening fiscal pollicies on disinflation (Poland and Hungary) or worsening current account balance (Czech Republic and Slovakia).

Second, looser fiscal policies could only marginally improve growth performance of economies, but have had unfavorable macroeconomic implications. In economies, where private investments and consumption are very sensitive to interest rates, they may have actually reduced growth rates, while the increase of interest sensitive capital inflows accelerated real exchange rate appreciation, worsening current account balances and weakening export competitiveness. Finally, worsening balances require adjustment either to reduce the unwelcome consequences of deficits and meet convergence criteria, or - as in Russia - to adjust the budget to the absence of windfall revenues.

VII. Trade and Current Account Balances

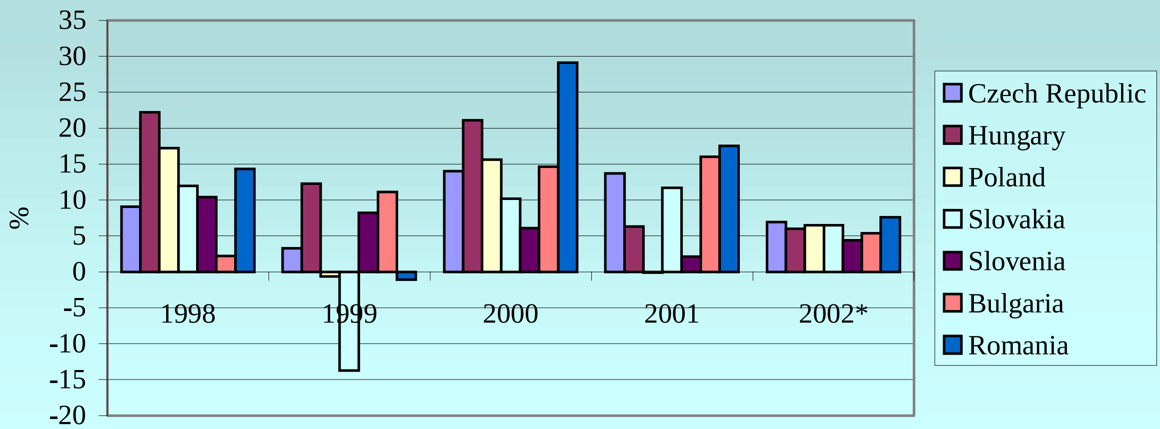
Two major factors have driven the evolution of trade balance of Central and Eastern European economies. One of them is the effect of global slow-down and the decline of import demand for Eastern European products, which have affected these countries differently, depending on the commodity and geographical composition of their exports and competitiveness. This channel worked primarily through the slow-down of exports, which directly reduced import demand due to the high import content of exports and indirectly via the slow-down of domestic GDP growth. Another major factor determining trade balance was the effect of increase in aggregate domestic demand, which differed both in its extent and structure between the economies. Both the sustainability of trade deficits and its level depended on whether private and public consumption, or private investments grew faster than before.

Table15. Trade balances in % of GDP

	1998	1999	2000	2001	2002*
Central-Eastern Europe					
Czech Republic	-4,5	-3,5	-6,2	-5,8	-5,3
Hungary	-5,8	-6	-3,8	-3,9	-5
Poland	-8,7	-9,3	-8,4	-6,6	-6,9
Slovakia	-11,5	-6,5	-4,8	-10,7	-10,1
Slovenia	-4	-6,2	-6,2	-3,2	-3,2
Baltics					
Estonia	-21,4	-17,2	-16,0	-14,6	-15
Latvia	-18,6	-15,4	-15,0	-17,8	-16,5
Lithuania	-23,5	-24,0	-14,7	-9,3	-9
South-Eastern-Europe					
Bulgaria	-3,1	-8,7	-9,5	-12,6	-11,8
Croatia	-17,7	-17,4	-18,35	-20	
Romania	-6,3	-3,2	-4,5	-7,5	-7,5
CIS					
Russia	6,5	17	25,1	16,1	8,9
Ukraine	-4,2	-0,9	1,9	0,5	0,2

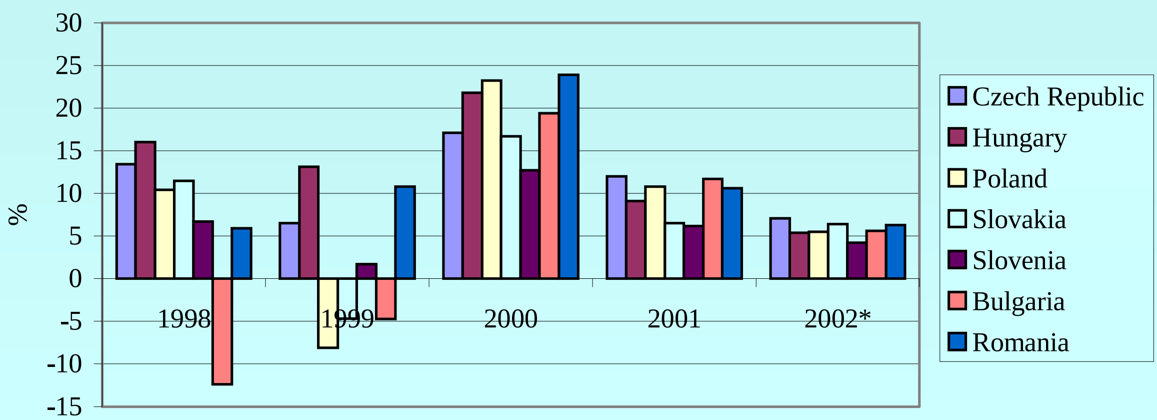
Looking at these differences three groups of countries can clearly be distinguished based on their trade balance performance. In Central Europe trade deficits declined due to the unchanged or positive gap between the rate of growth of exports and imports. In these countries trade balances were mainly determined by the direct and indirect effect of worsening growth: exports declined, which was however followed by even bigger decline of imports. The only exception to that pattern was Slovakia, where domestic demand (and especially FDI driven investments) expanded fast, and to lesser extent the Czech Republic, where also FDI-driven private investments maintained the rate of import growth at levels close to the growth of exports. In Poland trade balance improved thanks to declining domestic demand, while in Hungary and Slovenia mainly due to the slow-down of private investments, which was caused by weaker export performance.

Chart 5. Import growth in selected countries



The Baltics are the most heterogeneous group in terms of trade performance. Estonia followed the pattern of Central European economies, as its exports growth was reversed and exports declined by 2% due to declining export prices, and this was followed by a similar adjustment of imports (decline of 0,5% following 29% growth in 2000). The Latvian and Lithuanian foreign trade developed quite differently. On the one hand these economies were affected less by exogenous shocks due to the differences in their structure and geographical destination of exports. On the other hand the growth of domestic demand was much stronger, which resulted in sizeable expansion of imports.

Chart 6. Export growth in selected countries



In the South-Eastern European economies trade balances worsened, as both foreign import and domestic demand behaved differently. Exports of these countries declined steeply, mainly because of supply side competitiveness problems and due to their geographical composition (for example significant part of Bulgarian and Romanian exports was directed to Turkey, which experienced currency crash in 2001). The exports of these economies are more sensitive to changes in foreign import demand, as they are less diversified and sophisticated, and declining EU demand had a stronger negative effect on exports than the case of the Central European economies. On the other hand domestic demand in all countries increased rapidly. This was fuelled in Bulgaria by the extremely fast increase of private investments reflecting FDI- related investments and recovery of earlier delayed private capital formation, in Romania by the expansion of private and public consumption due to the loosening fiscal and incomes policies, while in Croatia to both of these factors. As an outcome, declining export growth rates were accompanied - with the sole exception of Romania - by accelerating import growth, which widened trade deficits (in Bulgaria and Croatia to high, double-digit levels in GDP).

The trade and also current account performance of Russia and the Ukraine differs considerably from the other three regions as especially Russia, but to lesser extent the Ukraine too are major primary commodity exporters, where trade balances are driven by the changes of their terms of trade. The huge improvements recorded in 2000 were reversed and export growth rates declined, in Russia becoming negative due to the very steep reduction of oil prices. The Ukrainian and Russian economies responded differently to this negative shock, as import demand moderated in line with export growth in the Ukraine, while imports increased fast in Russia due to the rapid growth of disposable incomes. The trend of moderating trade and current account surplus will characterize both countries in 2002 : in Russia exports are expected to decline even more than in 2001, which will lead to much smaller trade and current account surpluses.

Table 16. Current account balances in % of GDP

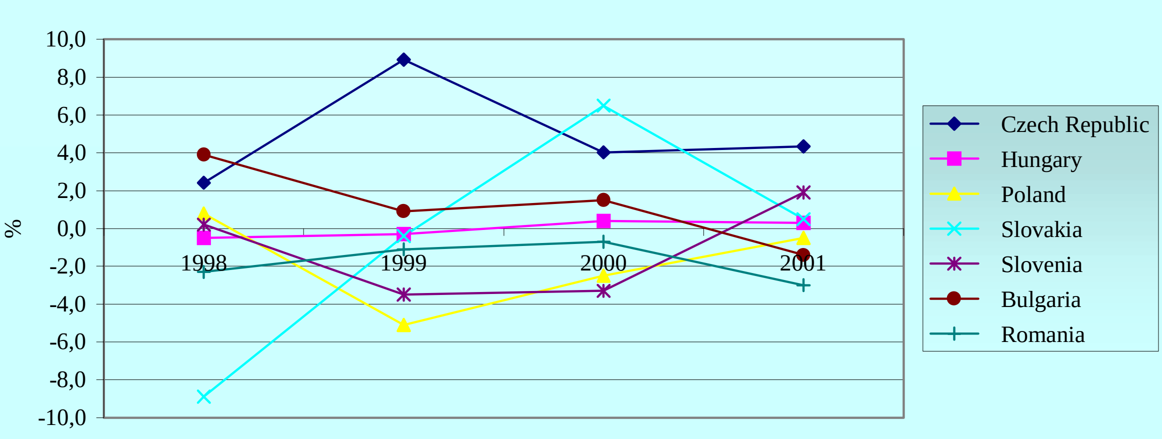
	1998	1999	2000	2001	2002*
Central-Eastern Europe					
Czech Republic	-2,3	-2,9	-4,7	-4,7	-4,5
Hungary	-4,8	-4,4	-3,3	-2,2	-3,5
Poland	-4,3	-7,5	-6,3	-4	-4,3
Slovakia	-10,4	-4,9	-3,7	-8,8	-8,1
Slovenia	-0,8	-3,9	-3,4	0	-0,2
Baltics					
Estonia	-9,2	-4,7	-6,4	-6,5	-6,8
Latvia	-10,6	-9,7	-6,9	-10,2	-9,4
Lithuania	-12,1	-11,2	-6,0	-4,9	-3,7
South-Eastern-Europe					
Bulgaria	-0,5	-5,5	-5,9	-6,9	-6
Croatia	-7	-6,9	-2,8	-3	
Romania	-7,2	-4,2	-3,7	-5,9	-5,5
CIS					
Russia	-0,5	12,3	18,4	11	4,5
Ukraine	-3	2,6	3,9	3,4	1,1

Contrary to trade balance, there has been less change in current account balance with the exception of those economies, which have recorded significant increases of domestic demand: in all economies except Slovakia, Lithuania and Romania current account deficits remained unchanged or declined in 2001 compared to 2000. The main reason behind that has been the improvement of trade balances, which – as mentioned in our first report - are strongly correlated with the exception of Croatia and Estonia, which countries have however huge surplus on services balance. Current account deficits are now much lower than before in economies, which had persistently high imbalances (Poland, Croatia), are high in economies having hard pegs (the Baltics and Bulgaria) and are on rise in countries, which have recently been recipients of foreign direct investments.

In the recent changes in current account balances more attention should be paid to two structural changes that characterize their evolution. The first is the gradual growth of surplus in the services balance, which is related ether to tourism revenues or transfer payments. The increase in the service surplus shows the accelerated catch-up of that sector.

Another important factor is the increasing effect of foreign direct investment on current account balance. One of them has already been mentioned: economies which have been recipients of significant foreign capital have experienced rapid rates of investment growth, which increased their import demand, too. On the other hand the growth of foreign direct investments in flow and stock terms has also led to the increased repatriation of profits and worsening of the income balance. The recent recipients of FDI inflows (Czech Republic, Slovakia and Bulgaria among others) start to experience increasing outflows on their incomes balance similarly to economies with higher stock of foreign capital (Estonia, Hungary and Poland): They are, however, at the beginning of this process, and they may expect worsening current account balances unless their trade or services balances remain unadjusted.

Chart 7. The gap between FDI inflows and current account balance



But foreign direct investments are not only the source of current account imbalances, they also represent a form of their financing. Recent increases of foreign direct investment inflows have benefited several economies allowing them to finance their increasing current account deficits: Slovakia, the Czech Republic, Bulgaria and Croatia had positive and sometimes significant gaps between the inflow of FDI and current account balance. But these surpluses declined sharply in 2001 and their decline is expected in 2002 too, which shows that current account deficits can no longer be financed in non-debt creating ways, but would involve the growth of foreign debt levels. In some cases, like Poland, the Baltic countries and Romania this has been the pattern for longer period and these economies have experienced some increase of their foreign debt levels.