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Summary of the *Economic Survey of Europe, 2005*: the economic situation in Europe and the Commonwealth of Independent States in 2004-2005

Executive summary

The report provides a summary of the assessment of main economic developments in 2004 and the short-run outlook in the Economic Commission for Europe (ECE) region that was published in the *Economic Survey of Europe, 2005 No. 1*. It highlights major developments in 2004 and the macroeconomic developments in the ECE subregions, namely in Western Europe and the New EU-10, South-East Europe, and the Commonwealth of Independent States (CIS). It reviews the short-term outlook, which is still a favourable but somewhat less supportive international economic environment. It explores some selected policy issues such as structural reforms and macroeconomic policy framework in Europe; the policy challenge of economic diversification in the Commonwealth of Independent States (CIS); financial vulnerability in the ECE emerging market economies; and the upcoming challenges posed by globalization.

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I. Major developments in 2004

A strong global recovery

1. The global economic recovery maintained strong momentum in 2004. World output increased by some 5 per cent compared with the preceding year. That was the fastest average annual rate of increase in 30 years. The sharp rise in oil prices appears to have dampened global economic activity only moderately in the course of 2004.

2. The United States of America and China remained the principal engines of global growth. The continued dynamism of the Asian emerging market economies stood out. In contrast, in Japan, the recovery faltered after the first quarter of 2004. There has also been remarkably rapid growth in the CIS, largely because of the boom in commodity prices. Economic activity also picked up strongly in Latin America. In most of central and eastern European countries, economic activity continued at high momentum. The euro area, as in 2003, remained the laggard of the global recovery.

3. Global inflation remained moderate despite the significant upward pressures on energy prices. The so-called second round effects of higher energy prices were largely absent, a reflection of continued wage moderation and the credibility attained by monetary authorities to stem any nascent inflationary spiral.

4. The continued moderate inflationary expectations were a factor in the persistence of very low long-term interest rates in the international capital markets. Emerging markets continued to benefit from favourable financing conditions, with risk premia remaining at very low levels. Net private capital flows to developing and emerging markets rose to their highest level since the East Asian crisis.

5. A matter of strong concern is the widening of external imbalances among major economies and regions in the world economy. The large United States current-account deficit increased further to a level corresponding to 5.75 per cent of gross domestic product (GDP) in 2004. The main counterparts to that deficit are large current-account surpluses in Japan and Asian emerging markets and to a lesser extent in the euro area (mainly Germany). Redressing those global imbalances without disruptive changes in international capital flows and exchange rates among major currencies will require appropriate national and international economic policy responses.

Strong domestic demand continued to drive United States recovery

6. In the United States, economic activity grew at a brisk pace in 2004, driven by domestic demand. Exports picked up in a favourable external environment and helped by the weaker dollar. But the ongoing surge in imports meant that the change in real net exports continued to be a drag on domestic output. Real GDP rose by 4.4 per cent, significantly above the trend rate of output growth of some 3.25 per cent; as a result, the gap between potential and actual output became quite small in 2004. Private consumption, supported by a slowly recovering labour market, low interest rates and the wealth effect from the booming housing market, was the mainstay of economic activity. The personal savings rate remained at a very low level. Business spending on equipment and software was buoyant, stimulated by significantly improved corporate profits, higher capacity utilization rates and tax incentives. The

recovery, with an unusually long lag, was also reflected in an upturn of employment, although that was relatively subdued by historical standards. Consumer price inflation edged up somewhat, largely because of higher energy prices. The trade and current-account deficit surged to record levels in 2004.

7. Against the background of robust economic growth, the Federal Reserve started to gradually raise the target for the federal funds rate. But monetary policy remained still very supportive of economic growth. Moreover, the moderate tightening of monetary policy was offset by the further depreciation of the dollar, entailing overall very accommodative monetary conditions. At the same time, long-term interest rates remained very low. Following two years of strong fiscal stimuli, fiscal policy was only slightly expansionary in 2004. The general government budget deficit corresponded to more than 4 per cent of GDP in 2004.

Euro area recovery lost momentum

8. In the euro area, the cyclical recovery lost significant momentum in the second half of 2004. Export growth, which had been leading the recovery, weakened against the background of a moderate slowdown in the global economy and the adverse effects of the appreciation of the euro on price competitiveness. Domestic demand was sluggish and consequently lacked the vigour to offset the weakening of external demand. Private household consumption remained lacklustre, held back by low consumer confidence and modest growth in real wage incomes, also reflecting the sluggish employment recovery. Fixed investment picked up somewhat in 2004, but failed to gather significant momentum. Business fixed investment was held back by uncertainties regarding the medium-term outlook for demand as well as the surge in oil prices. That appears to have offset the potentially better conditions for investment spending owing to continued progress in redressing corporate balance sheets, supportive financial conditions, and improved profitability on the back of a cyclical recovery in productivity combined with wage moderation. In the event, real GDP rose by some 2 per cent in 2004 compared with the preceding year. The average outcome masks quite some variation in the growth performance of the individual member countries of the euro area, ranging from increases in real GDP by little more than 1 per cent in Italy, the Netherlands and Portugal, to buoyant growth of 4 per cent and more in Ireland and Luxembourg (see below, table 1.1.1). Germany, the major economy of the euro area, witnessed a return to positive average annual growth in 2004, following two years of virtual stagnation.

9. Consumer price inflation in the euro area has remained moderate in 2004, averaging slightly above 2 per cent. Upward pressure on the headline inflation rate came from the sharp rise in energy prices and increases in administered prices and indirect taxes. But that was offset by favourable price developments for other items — notably, a decline in prices of unprocessed food. Core inflation, which excludes prices of energy products and unprocessed food, was broadly the same as headline inflation in 2004. Owing to stronger productivity increases in combination with continued wage restraint, unit labour costs (in the whole economy) rose only slightly in 2004.

10. Labour markets in the euro area remained generally weak. Employment rose by only about 0.5 per cent higher in 2004 compared with the preceding year. The unemployment rate edged up further to nearly 9 per cent in 2004, compared with an average annual low of 7.8 per cent in 2001.

11. Economic activity in the euro area continued to be supported by low interest rates. In view of the fragile cyclical growth forces and moderate inflationary expectations, the European Central Bank has left its main refinancing rate unchanged at 2 per cent since June 2003. Real short-term interest rates were close to zero for most of 2004. Interest rates also remained very low at the longer end of the maturity spectrum. In the bond markets, average yields on 10-year euro area government bonds peaked at 4.4 per cent in June 2004, but fell below 4 per cent in the final quarter of 2004. But the further real effective appreciation of the euro led to some tightening of monetary conditions in the second half of 2004.

12. Fiscal policy in the euro area was slightly expansionary in 2004, as indicated by a small decline of the surplus on the cyclically adjusted primary balance. The actual general government budget deficit averaged some 2.75 per cent of GDP in 2004, broadly unchanged from the preceding year. Budget deficits were significantly above the threshold of 3 per cent (fixed in the Stability and Growth Pact) in France, Germany and especially Greece.

Favourable growth performance in other western European economies

13. In the United Kingdom, the cyclical recovery maintained relatively strong momentum in 2004. Real GDP rose by somewhat more than 3 per cent compared with 2003. Private consumption was again the mainstay of economic growth, supported by wealth effects originating in the housing market boom. But higher interest rates, associated with the gradual tightening of monetary policy, appear to have had a somewhat cooling effect on the housing market, as suggested by the deceleration of house price increases in the second half of the year. Gross fixed capital formation also rose strongly in 2004. Robust economic growth has gone along with a further increase in the demand for labour; at the same time, the unemployment rate fell to a record low. Revised estimates show that the stance of fiscal policy was broadly neutral in 2004, following two years of strong fiscal stimulus. The general government budget deficit in 2004 was slightly above the 3 per cent threshold stipulated in the European Union's fiscal rules.

14. In the other EU countries outside the euro area, economic growth recovered strongly in Denmark and Sweden in 2004, with output rising at a rate above its long-term trend. Economic performance in the western European economies outside the EU (Iceland, Norway and Switzerland) was also quite favourable in 2004. All told, real GDP in western Europe as a whole rose by some 2.25 per cent in 2004 compared with the preceding year.

Central and eastern Europe preserved a positive growth differential vis-à-vis western Europe

15. Economic activity in the eight new EU member States from central and eastern Europe (EU-8) picked up noticeably in 2004. Their aggregate GDP grew by some 5 per cent led by a strengthening recovery in Poland. All Baltic economies continued to grow at a brisk pace. In 2004, growth in the EU-8 economies became more broadly based, driven by robust consumption and investment expenditures and strong external demand. Import growth was dynamic, reflecting strong domestic demand and exports. Net exports continued to make a positive contribution to GDP growth in Poland and Slovakia but their impact remained negative elsewhere. Macroeconomic policies were broadly supportive of growth. Good fiscal outcomes

allowed the central banks to maintain accommodating monetary conditions. However, despite the acceleration of output growth, net job creation was rather weak while unemployment declined slightly. The duality of the labour market is apparent in skilled-labour bottlenecks coexisting with the absence of vacancies for the low-skilled jobseekers who dominate the pool of long-term unemployed. Inflation in the EU-8 countries increased slightly, largely reflecting one-off factors related to the EU accession as well as the rising prices of imported energy.

16. Economic growth in south-east Europe also accelerated considerably, underpinned by strong domestic demand and exports. Aggregate GDP rose by some 8 per cent (see below, table 1.1.2) on the strength of the recovery in the region's largest economies, Romania and Turkey. Some countries in the region (in particular the EU candidate countries Bulgaria, Croatia and Romania) continued to benefit from a surge in inward foreign direct investment, which has contributed to a deepening of the restructuring and modernization of their economies and acceleration of export growth.

17. In 2004 employment grew in Bulgaria but remained stagnant in Croatia and even declined somewhat in Romania. The situation in the labour markets of the remaining countries generally deteriorated in 2004, with some countries facing excessively high unemployment rates. Disinflation continued in most countries in 2004 reflecting relatively tight fiscal policies and in some cases, nominal effective exchange rate appreciation. However, several economies still face important macroeconomic policy challenges such as large fiscal deficits (Romania and Serbia and Montenegro) and current-account deficits (most south-east European economies). Croatia has been experiencing a chronic twin deficit.

For a second consecutive year the CIS was one of the fastest growing regions in the world

18. With GDP increasing by almost 8 per cent, the whole CIS region, including the largest economy, Russia, continued to benefit from the surge in world commodity prices. In most resource-rich CIS economies, the main factor behind their output growth was the rapid growth of commodity exports (particularly oil and natural gas). At the same time, several years of strong output growth have been associated with a surge in domestic demand, especially private consumption. In many countries, fixed investment has also recovered, most of it in extractive industries. Total employment in the CIS has continued to increase since the last quarter of 2003; however, this mainly reflects developments in some of the largest economies (foremost Russia). Towards the end of 2004, the number of involuntarily unemployed in the CIS averaged some 10 million people, accounting for 8 per cent of the economically active population in the region.

19. Macroeconomic policy in many CIS economies was expansionary, which gave a further boost to economic activity. The pro-cyclical bias in public spending became apparent in some countries in 2004, resulting in a deterioration of their structural fiscal balances. One consequence, however, was that rates of inflation began to fall more slowly, and in some cases there was also a deterioration of fiscal balances. Cost pressures have intensified with labour costs rising faster than producer prices. The strong recovery in consumer demand is likely to fuel further inflationary pressure. The currencies of most commodity-exporting economies were under growing pressure to appreciate as a result of their surging export revenues.

The symptoms of the “Dutch Disease” are increasingly evident in some economies, particularly Russia, putting monetary management under considerable strain.

II. The short-term outlook

A still favourable but somewhat less supportive international economic environment

20. Global economic growth is expected to slow down in 2005, but it should still average some 4.25 per cent. Robust growth of world trade will continue to rely on China and the United States as the main locomotives of that growth.

21. In the United States, real GDP is forecast to increase by some 3.5 per cent in 2005, down from 4.4 per cent in 2004 (see below, table 1.1.1). The rate of growth will still remain slightly above potential in 2005. Overall, activity will be supported by the continued, albeit moderating, strength of domestic demand. Exports should be stimulated by the depreciation of the dollar and by strong external demand in the United States major markets in Asia and Latin America. But imports will also rise and so the change in real net exports will continue to act as a drag on economic activity. The Federal Reserve is expected to continue gradually raising short-term interest rates to move monetary policy closer to a neutral stance during 2005. Fiscal policy will be slightly restrictive in 2005.

Continued growth in Europe and the CIS but at different rates

22. The short-term outlook for Europe and the CIS is for economic growth to continue in 2005, albeit at significantly different rates in the major subregions. The euro area will continue to lag behind the other major regions of the world economy. Central and eastern Europe will continue to perform significantly better than the euro area. Economic growth will weaken somewhat in the CIS, but average rates will remain well above the European average.

A moderate rate of recovery in the euro area

23. For the euro area, real GDP is forecast to increase on average by 1.8 per cent in 2005 (see below, table 1.1.1). For western Europe as a whole, the growth rate will be marginally higher at 2 per cent, reflecting the slightly stronger growth momentum in countries outside the euro area. Those growth rates for 2005 are slightly lower than in 2004, partly because of a smaller number of working days. Positive growth in the rest of the world will continue to support exports, which remain the mainstay of growth. For the recovery to accelerate, domestic demand would have to pick up more strongly than is currently expected. Among three major euro area economies, economic growth will remain sluggish in Germany and Italy in 2005; in France, real GDP is forecast to increase by some 2 per cent. Outside the euro area, in the United Kingdom, the average annual rate of economic expansion is expected to slow down to 2.5 per cent. The stance of fiscal policy is expected to be broadly neutral (possibly even slightly restrictive) for the euro area and western Europe in aggregate in 2005. In view of the fragility of factors of domestic growth and the dampening effects of the stronger euro on domestic economic activity and inflation, monetary policy in the euro area is likely to continue to “wait and see”. The European Central Bank is expected to leave interest rates unchanged in 2005,

but there is scope for countering any weakening of the recovery by lowering interest rates, particularly as the stronger euro will dampen imported inflation.

Economic growth should remain strong in central and eastern Europe and the CIS

24. Although GDP growth has started to decelerate in the EU-8 countries, recent economic indicators suggest a favourable short-term outlook. In 2005, the average rate of growth in the EU-8 may slow down somewhat compared with 2004 but, at some 4.5 per cent, will remain considerably above the average of western Europe. A noticeable surge in greenfield foreign direct investment projects should accelerate the ongoing process of restructuring and boost exports. Further fiscal consolidation is envisaged in some countries in 2005 but its dampening effect on domestic demand should be marginal. Most of the south-eastern European economies are also set to maintain strong rates of growth in 2005 but the unusually high rates in some countries in 2004 will be difficult to sustain. Overall, domestic demand is set to remain buoyant, and should provide solid support to economic activity in those countries. Better financial intermediation and rapid credit expansion will continue to fuel output growth throughout central and eastern Europe. However, despite the relatively strong rates of output growth in 2005 the increases in employment are likely to be small.

25. Economic activity in the CIS as a whole may lose some steam in 2005, but aggregate GDP is nevertheless expected to expand by some 6.5 per cent. Decelerating growth rates will prevail in all the large CIS economies — Belarus, Kazakhstan, Russia and Ukraine — following the evolution of external factors such as commodity prices and demand in the region’s main markets. Domestic demand in the CIS should generally remain buoyant but its effect on domestic economic activity will depend on the responsiveness of domestic supply. The macroeconomic policy stance should remain broadly neutral in the large economies, with the possible exception of Ukraine, where some fiscal tightening can be expected. While in the short run there may be some further improvement in the labour markets, many CIS economies still have to address the challenge of restructuring as labour adjustment has in general been lagging behind that in output.

Downside risks are dominating

26. The baseline short-term outlook is relatively favourable for the global economy, although that masks disappointingly weak growth in the euro area. But the outlook is surrounded by risks, which continue to be predominantly on the downside. A major uncertainty is the likely development of the international oil markets. Another potential important downside risk for the global economy is the large and rising current-account deficit of the United States. The fact that the global economy continues to rely so much on the United States as a major engine of growth evidently makes the outlook all the more vulnerable to a more pronounced slowdown of the United States economy than anticipated in current forecasts. Moreover, the necessary correction of the large domestic and external imbalances that have developed in the United States economy will hardly be possible without a more or less pronounced slowdown of domestic demand and output growth.

27. Long-term interest rates in international capital markets have, furthermore, remained at unusually low levels in the recovery so far, reflecting, inter alia, the

persistence of moderate inflationary expectations, a weak supply of corporate bonds (a reflection of balance sheet consolidation) and the massive purchase of United States treasury bills by Asian central banks. A stronger than expected rise in long-term interest rates could be caused by the fading of those factors but also by increasing concerns in financial markets about the persistently large United States fiscal deficit, with a consequent dampening effect on economic growth.

28. In western Europe, given its current strong reliance on export growth, the recovery is very vulnerable to a more pronounced weakening of global growth than is currently forecast. A further sharp appreciation of the euro could considerably dampen growth prospects with even the risk of economic growth stalling in 2005. In some countries (France, Ireland, Spain, United Kingdom), the downside risks also include a possible sudden and pronounced reversal of the rise in house prices, with consequent negative wealth effects and, in turn, severe repercussions on private household consumption and the overall rate of economic growth. A potential upside risk is that business investment may respond more favourably than anticipated to the continuation of favourable financing conditions and improved profitability. But the probability of the latter occurring is not very high given the expected deceleration in economic growth.

29. The main external risks to the outlook for central and eastern Europe include a possible sharp deceleration of economic growth in the euro zone and significantly higher than expected energy prices. If imported inflation continues to rise, that may prompt a more restrictive policy stance, with negative implications for economic activity. A number of economies in the region still face important macroeconomic policy challenges, such as large fiscal and current-account deficits. Forthcoming elections in several countries carry the risk of pre-election increases in public spending, which could undermine policy credibility and probably result in monetary tightening, lower inflows of foreign direct investment and reduced competitiveness. The most pressing policy challenges facing the new EU member States are to achieve sustainable fiscal consolidation and implement structural reforms for job-rich growth.

30. The main structural weakness of the CIS economies remains their high dependence on exports of natural resources and low value-added products, implying a high degree of vulnerability to external shocks. In addition, there are already signs, especially in Russia, that the loss of competitiveness associated with real exchange rate appreciation (the “Dutch Disease”) is becoming a burden on local producers and is choking off aggregate domestic economic activity. The capacity of macroeconomic policy to address those negative developments is fairly limited. Unless local producers manage to counteract them at the micro level through further restructuring, there are likely to be negative repercussions on output growth in the affected countries, especially in their manufacturing industries. The long-term growth prospects of the CIS economies thus hinge on their success in diversifying their economies and implementing key reforms in product and financial markets.

III. Selected policy issues

A. Finding the balance: structural reforms and the macroeconomic policy framework in Europe

31. In Europe, the short-term prospects for weak domestic demand growth being offset by a strengthening of exports to the rest of the world do not look very favourable. The recovery in the European economy virtually came to a halt in the third quarter of 2004 and current forecasts are for only a moderate rise in economic activity in 2005.

32. The main policy challenge is to bridge the gap between the rhetoric of the ambitious Lisbon agenda, which aims at creating a competitive and dynamic economy at par with the United States, and the disappointing reality of progress falling significantly short of the intermediate targets. A major problem with the Lisbon agenda is its almost exclusive focus on supply-side reforms as a basis for creating a dynamic economy that combines both strong employment and productivity growth. But market outcomes are not determined solely by supply but by the interaction of the forces of supply and demand. It will be difficult to meet the targets of the Lisbon agenda in a context of weak growth of domestic demand.

33. Sustaining higher rates of growth is also a *conditio sine qua non* for preserving the European model, with its strong concern for social cohesion. The adjustment pressures arising from the intensification of international competitive pressures, rapid rates of technical change (with a clear bias against low-skilled labour), as well as population ageing, all make that challenge even more difficult.

34. A recent report on the Lisbon strategy, the so-called Kok report, has concluded that the agenda is far too broad and has partly conflicting objectives. It therefore proposed that the strategy should focus on five, although still quite broad, priority areas where progress is to be pursued within the framework of national action programmes. The areas are the formation of a knowledge society with a strong emphasis on innovation and research; the completion of the internal market, which requires a closer integration of services markets and network industries; the fostering of a more conducive business climate, inter alia, by facilitating market entry and the development of venture capital markets; further reforms of labour markets designed to improve intra-EU labour mobility; and the promotion of environmental sustainability.

35. Raising Europe’s growth potential, however, requires not only supply-side reforms but also a sufficiently flexible macroeconomic policy framework (i.e., mainly monetary and fiscal policy) that is “as supportive of growth as possible” (Kok report) while paying adequate attention to preserving macroeconomic stability. In a similar vein, the Sapir report has emphasized the need for combining microeconomic reforms with a revision of the Economic and Monetary Union’s macroeconomic policy framework, taking especially into account the increased heterogeneity of the EU after enlargement, which calls for more flexible rules to limit the potentially adverse implications of “one-size-fits-all” policies. The challenge is to find the proper balance between discipline and flexibility.

36. A sensible reform of the Stability and Growth Pact, combined with realistic and firm objectives for medium-term fiscal consolidation, could also create a new basis for a kind of European “policy mix”, that is, for cooperation between the

European Central Bank and the European Council (or the so-called euro group). Monetary policy should be symmetric over the business cycle, giving equal weight to upside and downside risks to both price stability and economic growth. That becomes even more important given the general orientation of fiscal policy towards ambitious consolidation targets, which will be achieved much more easily in a context of sustained economic growth.

B. The policy challenge of economic diversification in the CIS

37. While rates of GDP growth in most CIS economies have been impressive in recent years, there are nevertheless concerns about their sustainability. The key factor behind the economic boom in the resource-rich CIS economies has been the expansion of their extractive industries (especially, the crude oil and natural gas sectors) coupled with a surge in world commodity prices in the last few years. The narrow base of the recovery exposes those economies to fluctuations in the highly volatile global commodity markets, making them vulnerable to external shocks. Besides, mineral extraction is a capital-intensive activity generating little employment and is likely to result in geographically unbalanced development and greater income inequality.

38. The key policy issue is whether and how public policy can help to broaden the growth base and reduce the excessive reliance on natural resources in the medium and longer term. The recent policy debate in some CIS economies has focused on the need for economic diversification as a key factor of economic development as well as the basis of high and sustainable rates of growth. Despite the differences in national circumstances, diversification has figured prominently in the development strategies recently elaborated in some countries. However, there is still much ambiguity with regard to the ways and means to achieve that objective.

39. The disintegration of the CMEA and then of the Soviet Union triggered a collapse of much of the manufacturing industry in the CIS. As a result, the production and export structures in most CIS economies have become more specialized and concentrated, especially in the resource-rich economies. For example, in Russia the share of the top five export products in total exports increased from 62 per cent in 1996 to 68 per cent in 2003 (four of those five products were primary commodities and fuels) and the share of the top 10 products increased from 72 per cent to 77 per cent. A similar process of concentration towards commodity exports is observable in many CIS economies. Such a narrow specialization pattern may be counterproductive for a balanced development path, especially for the low-income CIS countries.

40. Economic diversification has, of course, different aspects and dimensions across the CIS countries. There is a clear distinction between economies with abundant resources of crude oil and natural gas, and the less richly endowed countries, where the increased shares of commodity exports mostly reflect the outcomes of post-Soviet deindustrialization. At the same time, resource-rich economies face specific problems that may even risk becoming impediments to their economic development.

41. While natural resource abundance can in principle be an important source of development finance, the relationship between natural resource endowments and economic performance cannot be considered as deterministic. In fact, past

experience provides ample evidence of a negative relationship, sometimes referred to as the “resource curse”. The channels through which the “resource curse” can emerge and escalate include, inter alia, a weak institutional environment and poor public governance (notably, resource riches tend to be associated with higher degrees of corruption and rent-seeking activities). The real exchange rate appreciation associated with large and rising exports of natural resources can become an impediment to other economic activities (the so-called Dutch Disease). Another problem is the general economic volatility and vulnerability of the economy to external shocks. However, there have also been a number of cases where natural resources have served as a basis for successful economic diversification and development of a country. Prudent financial management and an appropriate institutional environment (Norway being a good example) can prevent or minimize the potential negative side effects. Whether a resource-rich country falls into the trap of the “resource curse” or manages to use the resource endowment to jump-start economic diversification largely depends on the country-specific institutional context and the policy framework designed to foster economic development. In any case, a carefully designed, and duly implemented, policy agenda can greatly reduce the risks of the “resource curse” in the resource-rich CIS countries and can facilitate the process of their economic diversification.

42. The policy challenge of economic diversification is even more daunting in the CIS countries that are not so rich in natural resources. They are also the countries with lower levels of per capita income and a higher incidence of poverty. While policymakers in those economies face some basic development problems, they do not have at their disposal the financial cushion created by resource windfalls. Nevertheless, the main principles of addressing the goal of economic diversification should be broadly similar across the CIS.

43. The economic argument underlying diversification policies is that a comparative advantage in the international division of labour should not be regarded as something given once and for all. Comparative advantage (as revealed in the structure of net exports) changes over time as a result of shifts in the pattern of physical and human capital accumulation. But new areas of comparative advantage will be cultivated only if properly developed by venturing entrepreneurs. The CIS economies are by no means doomed to be locked into their current, highly skewed production and export structures; they need, however, to undertake a dedicated long-term effort to cultivate their potential and develop new areas of comparative advantage.

44. The potential existence of comparative advantage (of the type discussed above) that is not cultivated under market conditions may be regarded as a case of market failure. Both economic theory and experience indicate that one of the efficient ways to deal with that type of market failure is through appropriate policy intervention. In a global perspective, successful industrialization or economic diversification (including western European industrialization in the nineteenth century but also the post-war rise of the south-east Asian economies and, more recently, the experience of Ireland), has almost always been driven by an active government policy stance. However, experience has also shown that while markets alone may not be sufficient to steer economic restructuring, Governments alone cannot deliver satisfactory results either, as illustrated by the disastrous welfare outcome of central planning (of which the CIS economies still bear the cost). Also, some traditional approaches to industrial policy (such as “picking winners”, or

import substitution policies) are notorious for negative side effects such as market distortions, inefficient resource allocation and corruption.

45. In the absence of well-functioning markets, there may be other factors impeding the cultivation of potential comparative advantage (for example, poor protection of property rights, weak contract enforcement, etc.). That argument applies to many of the CIS economies, especially those that are less advanced in their economic transformation. The establishment of well-functioning markets is thus not only a necessary condition for the successful implementation of diversification policies but can be expected to provide a further boost to that process.

46. Based on the experiences of other countries, the broad paradigm of a policy framework targeting economic diversification in the CIS economies should incorporate key ingredients such as:

- A coherent long-term strategy outlining the main goals to be achieved. Importantly, the formulation of long-term goals should involve a broad public debate. It is essential that the strategy reflect national goals that enjoy broad public support and popular legitimacy and will not be subject to revisions over the political cycles

- An incentive structure that will stimulate economic agents to act in a direction consistent with the policy goals as well as the mechanisms of coordination and management of conflicting interests (for example, between the public and private sectors). Incentives should include both “carrots” (motivating agents to undertake specific actions) and “sticks” (including early identification of failure and exit strategies)

- An appropriate framework of public institutions with delegated authority to implement the related policies. Clear rules of practical implementation of policy conventions coupled with transparency and accountability in the operation of those institutions are essential to avoid the capture of policy by vested interests and to prevent corrupt practices

- Adequate funding. Policy actions targeting diversification inevitably involve public funding. Resource-rich economies can in principle draw on the rents associated with natural resources to fund the strategies targeting new areas of comparative advantage. When natural wealth is not abundant, the channelling of public funds towards diversification policies should not endanger long-term fiscal sustainability.

47. There is no unique policy model of economic diversification (and for that matter, no unique diversification pattern); success (as well as failure) can take many different forms, and that applies with full force to the related policy agenda in the CIS. But experience of other countries unambiguously suggests that the adequacy and quality of the institutional arrangement is probably the key factor of success in implementing diversification policies. In other words, the normative policy rules and objectives must be matched by an appropriate institutional framework in the broader sense of formal and informal “rules of the game”. Many negative side effects of industrial policy in the traditional sense can be directly linked to the deficiency or inadequacy of the institutional framework within which it was being implemented. In that regard, the establishment of adequate institutions should be regarded as part and parcel of the diversification strategy. Strong and dependable

institutions are also required for high rates of GDP growth to be sustained in the context of adverse shocks. The actual institutional changes will depend on the specific socio-economic and political context in the country where such a strategy is being implemented.

48. In countries that are still undergoing a profound economic transformation, such as the CIS economies, the policy challenges of economic diversification are compounded by the unfinished systemic and structural reforms required to establish a fully functioning market economy. At the same time, the existing gaps in some areas of market development can also be regarded as an opportunity for policymakers. Indeed, it may be easier to establish a new, well-functioning institution starting from scratch (provided it is well designed and properly assembled) than by trying to change or amend an already existing (but malfunctioning) institution.

49. Recent experience suggests that the most effective institutional arrangements targeting economic diversification are those that engage all the relevant stakeholders (both from the public and from the private sector) in the process of policy design and in its implementation, and steer them towards the common goal. Instead of “picking winners” in the sense of traditional industrial policy, that approach involves a more flexible strategic alliance (that can be of a long-term nature) in which the Government and the private sector exchange information and ideas, and coordinate their actions in the development of new activities, products or technologies. Through strategic collaboration between the parties involved, that policy model seeks to identify the causes of market failures that result in the underprovision of entrepreneurship in the pursuit of economic restructuring. If properly designed and instituted, the rules of interaction, the shared commitments and responsibilities, the transparency in operation and accountability in the use of public funds within such alliances should help to minimize the market distortions and corrupt practices that sometimes taint conventional industrial policy.

50. Obviously, the appropriate institutional framework is only one component of the broad policy agenda targeting economic diversification and development in the CIS economies. Overall, reform initiatives should focus on those areas that have a general impact on the cost of economic activities, including basic infrastructures, where public investment plays a central role. In that context, as the private sector becomes the means of achieving public goals, public policy should foster private sector development and entrepreneurship by reducing the cost of doing business and establishing a conducive environment for the attraction of both domestic and foreign investment. Further efforts are also needed to improve public and corporate governance and eliminate the existing numerous market imperfections.

51. The broader policy agenda should also target innovation and human capital development, which are key factors of long-term growth and competitiveness. In fact, many of the CIS countries (in particular Russia and other larger economies) are better placed to pursue an innovation-driven diversification agenda than some of the resource-rich developing countries due to their already existing human capital endowment. But policy should also seek to eliminate existing structural rigidities that may hamper the transformation of human capital endowments into innovative entrepreneurial activity.

52. The development of the financial system is of particular importance in fostering productive investment and hence diversification. Facilitating credit access

would ease a key constraint on the development of new economic activities and the promotion of innovation. A well-functioning banking system in resource-rich economies is also required to efficiently channel the surpluses generated in fast-growing, commodity-based activities to investment opportunities in other sectors.

53. Wider regional economic cooperation and further integration into the global economy can also serve to foster economic diversification by increasing the effective size of the market and encouraging foreign direct investment outside the resource sectors. That is particularly relevant for the smaller CIS economies, where the role of external demand for economic development is more obvious and for many landlocked countries where transit issues are more painfully felt. But as a word of caution, trade liberalization alone may not necessarily stimulate new economic activities (as evidenced by recent experience); for those to materialize, the integration efforts should complement domestic policies fostering diversification. In addition, it is crucial that trade and transit arrangements that increase market access are perceived as stable and not subject to possible reversals if those beneficial effects are to be obtained.

54. In addition, diversification policies require specific skills from the government agencies that will be involved in implementation. A public administration with adequate capacity is in fact a precondition for engaging in any large-scale government-sponsored programmes. Capacity-building efforts thus emerge as an important policy step that should be assigned high priority, especially in the lower-income CIS countries. Obviously, that is also an area where targeted assistance by the international community (which will not necessarily require large-scale funding) can generate high returns in terms of its welfare effect in the recipient countries.

55. Economic diversification in the CIS region should be regarded as a long-term policy goal. Given the economic structures that currently prevail, dependence on commodity exports is likely to remain a dominant feature of many CIS economies for some time to come. Successful economic diversification requires an integrated and consistent policy framework that relies on comprehensive reforms in many areas and calls for a lasting and dedicated policy effort.

C. Financial vulnerability in the ECE emerging market economies

56. The level of net capital inflows and the corresponding current-account deficits of the majority of the ECE emerging market economies have been relatively large for the last decade. That has allowed investment and consumption to be maintained at levels above those that would have been possible in their absence. Growth can be increased with external finance since the level of domestic investment is no longer constrained by domestic savings. Those capital inflows have allowed the emerging market economies to partially rebuild the productive capital stocks that were inadequate for a market economy. In addition, that inflow allowed consumption levels to be partially maintained despite the collapse in economic activity during the transition phase. Although those advantages are very important, the emerging market economies should remain cognizant of a number of additional constraints and qualifications that apply to a development strategy based upon a strong reliance on external finance. Those primarily include more stringent constraints on macroeconomic policy, the opportunity cost of holding increased amounts of international reserves, and the loss of national income during a currency crisis if one

should occur. Owing to those constraints, the benefits of capital market openness may well be smaller for emerging markets than for more advanced economies.

57. Given the significant levels of capital inflows into the emerging market economies, there is the possibility that for some of those economies capital account liberalization may have proceeded too rapidly given their domestic institutional reforms. Since boom-bust cycles seem to characterize emerging market economies throughout the world, especially given the current international financial architecture, additional prudence towards adjusting both current-account and fiscal deficits to sustainable levels during this period of relatively favourable performance would be in order.

58. It is difficult to assess the degree to which the emerging market economies current-account deficits are likely to be problematic for economic stability. Almost all analyses of previous exchange rate crises have concluded that large or increasing current-account deficits were a significant contributing factor. However, the risk posed by a current-account deficit cannot be evaluated solely by its size; it will also depend on how it is being financed, how it is being used, the exchange rate regime, current debt levels, the size of international reserves, the health of the financial system and the country's overall macroeconomic condition. Although there has been some progress in understanding the factors that may eventually trigger a currency crisis, there remain significant gaps in knowledge, and each crisis appears to be somewhat different from previous ones. The fundamental problem is that current-account deficits that appear sustainable under current conditions may no longer be viewed as such after some unforeseen, and perhaps totally external, shock. The question of sustainability is often raised for countries with current-account deficits significantly above their GDP growth rates. That is especially the case for those countries with double-digit current-account deficits and high levels of external debt relative to official reserves or GDP. Most of the emerging market economies have maintained current-account deficits below 10 per cent of GDP, the level of Mexico's deficit in the years prior to its financial crisis in 1994. However, many have deficits that are larger than several of the East Asian countries prior to their financial crises in 1997-1998. Given that the region has limited experience with open capital accounts and a susceptibility to currency crises, including Bulgaria in 1996, the Czech Republic and Romania in 1997, Russia in 1998, Turkey in 2000-2001, and several speculative attacks against Hungary in 2003, concern about possible future currency instability would seem to be warranted. Attention towards current-account deficits and possible financing difficulties needs to be heightened during periods, such as the current one, when global liquidity is being tightened.

D. Upcoming challenges from globalization

59. In order to reap the benefits of international trade integration, just as with financial integration, it is necessary to have in place the necessary complementary domestic institutions and policies. The failure to do so can be just as costly although not as dramatic as a currency crisis resulting from an institutional failure under financial integration. In the case of trade integration, the result can be increased unemployment, lower investment and increased inequality. The traditional benefits of increased specialization from trade openness can be easily negated if the displaced workers become unemployed, and the benefits of higher national income can be lost if it is more unequally distributed.

60. Each of the emerging market economies subregions will need to find a niche for themselves in the global production system. The EU-10 should be able to find a place in the manufacturing chain given their open access to the EU market, their relatively high levels of human capital but considerably lower wages. Market fragmentation and limited institutional reform are continuing to limit manufacturing in some of the south-east European countries. Currently, the CIS economies appear to be largely outside the global manufacturing network; that is due to both the devastation of their manufacturing sectors during the transition phase and their natural competitive advantage in natural resource products. However, those primary commodities will not provide the countries with the basis to become dynamic growth economies.

61. Over the last half-century, countries in the middle of the global income distribution, which were also integrating into the world trading system, had relatively good growth rates and were able to converge towards the per capita income levels of the richer countries. If that historical pattern were to hold in the coming decades, most of the emerging market economies, which clearly fit into that middle zone, would be expected to do relatively well. However, over the last half-century, those industrializing middle-income countries were not under a significant competitive threat from industrializing countries with even lower per capita incomes. In the coming decades, however, the emerging market economies will have to compete with countries such as Brazil, China and India; those countries have not only much lower wages but are in many areas as advanced or even more advanced technologically than the emerging market economies. There are of course some high-tech niche markets in the emerging market economies, but they are not sufficient to employ large numbers of people. Thus, the challenge will be to determine the sectors in which they will have a comparative advantage and also the potential for technological growth along with high and increasing wages. To avoid the undesirable situation of having to compete on the basis of low wages, the emerging market economies would appear to have little choice but to create knowledge-based societies by increasing investment in human capital formation and implementing policies to promote more entrepreneurship and innovation.

Table 1.1.1

Annual changes in real GDP in Europe, North America and Japan, 2002-2005

(Percentage change over the previous year)

	2002	*2003*	*2004*[a]	*2005*[a]
France	1.2	0.5	2.2	1.9
Germany	0.1	-0.1	1.7	1.3
Italy	0.4	0.3	1.2	1.6
Austria	1.2	0.8	1.8	2.3
Belgium	0.9	1.3	2.6	2.4
Finland	2.3	1.9	2.9	2.9
Greece	3.6	4.5	3.8	2.7
Ireland	6.1	3.7	4.3	4.6
Luxembourg	2.5	2.9	4.0	3.5
Netherlands	0.6	-0.9	1.2	1.6
Portugal	0.4	-1.2	1.2	1.9
Spain	2.2	2.5	2.6	2.5

	2002	2003	2004[a]	2005[a]
Euro area	0.9	0.6	1.9	1.8
United Kingdom	1.8	2.2	3.2	2.5
Denmark	1.0	0.5	2.2	2.3
Sweden	2.0	1.5	3.4	2.9
EU-15	1.1	0.9	2.2	2.0
Cyprus	2.1	1.9	3.2	3.6
Czech Republic	1.5	3.7	3.8	3.9
Estonia	7.2	5.1	5.9	5.6
Hungary	3.5	3.0	3.8	3.8
Latvia	6.4	7.5	7.0	6.0
Lithuania	6.8	9.7	6.7	5.8
Malta	2.6	-0.3	1.0	1.5
Poland	1.4	3.8	5.7	4.9
Slovakia	4.6	4.5	5.1	5.0
Slovenia	3.3	2.5	3.8	3.9
New EU members-10	2.4	4.0	4.9	4.5
EU-25	1.2	1.1	2.4	2.2
Iceland	-0.5	4.0	4.3	4.7
Israel	-0.7	1.3	3.5	3.7
Norway	1.4	0.4	3.4	2.9
Switzerland	0.3	-0.4	1.8	1.7
WECEE	1.2	1.1	2.4	2.2
Canada	3.4	2.0	2.7	3.0
United States	1.9	3.0	4.4	3.5
North America	2.0	3.0	4.3	3.5
Japan	-0.3	1.3	3.9	1.5
Europe, North America and Japan	1.3	1.9	3.4	2.7
Memorandum items:				
EU-8	2.4	4.0	5.0	4.6
Western Europe-20	1.1	0.9	2.2	2.0
Western Europe and North America	1.6	2.0	3.3	2.8

Source: Eurostat; OECD national accounts and national statistics; ECE secretariat estimates; Consensus Economics, *Consensus Forecasts*, 6 December 2004 and *Eastern Europe Consensus Forecasts*, 15 November 2004.

Note: All aggregates exclude Israel. WECEE (Western Europe, central and eastern Europe) comprises the EU-25 plus Iceland, Norway and Switzerland. EU-8 (central Europe and the Baltic States) includes the new EU members less Cyprus and Malta. Western Europe-20 comprises the EU-15 plus Cyprus, Iceland, Malta, Norway and Switzerland. For data on south-east European and European CIS countries, see table 1.1.2.

[a] Forecasts.

Table 1.1.2
Annual changes in real GDP in south-east Europe and the CIS, 2002-2005
(Percentage change over the previous year)

	2002	*2003*	*2004*[a]	*2005*[a]
South-east Europe	6.5	5.1	7.9	5.2
Albania	3.4	6.0	6.0	6.0
Bosnia and Herzegovina	3.7	3.2	4.0	4.3
Bulgaria	4.9	4.3	5.5	5.3
Croatia	5.2	4.3	4.0	4.4
Romania	5.0	4.9	7.5	5.2
Serbia and Montenegro[b]	3.8	1.5	7.0	4.5
The former Yugoslav Republic of Macedonia	0.9	3.4	2.5	3.5
Turkey	7.9	5.8	9.0	5.3
CIS	5.2	7.7	7.9	6.4
Armenia	15.1	13.9	10.0	8.0
Azerbaijan	10.6	11.2	9.5	14.0
Belarus	5.0	6.8	10.0	9.0
Georgia	5.5	11.1	6.0	5.0
Kazakhstan	9.8	9.3	9.3	7.9
Kyrgyzstan	0.0	6.7	6.5	7.0
Republic of Moldova[c]	7.8	6.3	8.0	6.0
Russian Federation	4.7	7.3	6.8	5.8
Tajikistan	9.5	10.2	11.0	8.3
Turkmenistan[d]	1.8	6.8	6.0	7.0
Ukraine	5.2	9.4	12.4	6.5
Uzbekistan	4.2	4.4	7.6	6.4
Total above	5.6	6.9	7.9	6.0
Memorandum items:				
South-east Europe without Turkey	4.6	4.2	6.4	5.0
CIS without Russian Federation	6.2	8.5	10.1	7.5
Caucasian CIS countries	9.9	11.7	8.6	10.0
Central Asian CIS countries	6.6	7.5	8.4	7.3
Three European CIS countries	5.3	8.6	11.6	7.2
Low-income CIS economies	6.3	7.7	8.1	7.9

Source: National statistics, CIS Statistical Committee; reports by official forecasting agencies.

Note: The aggregation was performed using weights based on purchasing power parities. Aggregates shown are: south-east Europe (the 8 countries below that line); CIS (the 12 member countries of the Commonwealth of Independent States). Sub-aggregates are: Caucasian CIS countries: Armenia, Azerbaijan, Georgia; central Asian CIS countries: Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan; three European CIS countries: Belarus, Republic of Moldova, Ukraine; low-income CIS economies: Armenia, Azerbaijan, Georgia, Republic of Moldova, Kyrgyzstan, Tajikistan and Uzbekistan. Unless otherwise noted, country forecasts shown are those reported by official forecasting agencies.

[a] Forecasts.
[b] Excluding Kosovo and Metohija.
[c] Excluding Transdniestria.
[d] UNECE secretariat estimates.