C O N T E N T S

Editorial

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Pessimism Confounded?

Recovery in Eastern Europe

Introduction

When I last had the privilege of addressing an East Jour Fixe on the prospects for growth in eastern Europe, now almost exactly two years ago, I was relatively pessimistic.[1] The forecast I presented then showed real GDP growth for 1995 of just 2.3% for 1995 for the six main countries of the region.

Fortunately, I was wrong. Growth in fact turned out at 4.2% for the region, and we now expect it to stay in the 4½-5% range for the next two years as well.

Nov-95

Table 1 -- Gross Domestic Product

	1993 level	**1994**	**1995**	**1996**	**1997**
	million US$	*Real percentage change*			
Bulgaria	10,831	1.4	2.8	2.6	1.9
Czech republic	31,238	2.6	4.0	4.4	4.8
Hungary	38,437	2.0	0.9	2.8	3.0
Poland	85,853	5.0	6.0	6.0	5.0
Romania	25,524	3.4	3.1	4.3	5.0
Slovakia	11,049	4.9	5.2	4.7	4.1
Total	***202,932***	***3.7***	***4.2***	***4.8***	***4.5***

** Note: aggregate across countries weigthed using GDP converted at market exchange rates*

Yet I maintain a slightly cautious outlook even in the face of so much good news. First, it should be pointed out that catching up with European Union per capita income levels will still take several decades even at the current growth rates: for instance, assuming Poland continues to grow at 6% per annum from now on, and the European Union (EU) economy grows at 3%, Polish GDP/head will rise from 31.5% of EU average in 1993 to 46% in 2005. Second, Table 1 shows a slight edging down of growth in 1997 for a number of countries. This expresses a concern that current growth performance may not be sustainable.

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This paper is based on forecasts prepared by my colleagues Anne Bucher (P), Mark Hayden (BG, H). Renzo Daviddi (R). Bernard Naudts (SR) and Cathy Staples (CR, SL); they also drafted the country-specific text in this paper. Comments are welcome at: 200 rue de la Loi, B-1049 Brussels, Belgium; E-mail r.wissels @dg2.cec.be; phone (+32.2)299.34.82; fax (+32.2)295.27.91.

1 R. Wissels, "Prospects for Growth in Eastern Europe", Austrian National Bank Working Paper 15, March 1994.

Overview

Recent macroeconomic developments

The recovery started in Poland in 1992, and since then it has spread over most of eastern Europe. In 1994, growth ranged from less than 2% in Bulgaria and Latvia to 5% and more in Slovakia and Poland. It is expected that in 1995 economic growth will be at least at the same level as last year in almost all countries. Noticeable exceptions are Hungary, where growth will be affected by very restrictive macroeconomic policies that were introduced to reduce the large current account and government budget deficits, and Latvia, which was hit by a serious banking crisis. Still, with the exception of Poland, output has not yet increased enough to offset the contraction in the early years of the transition process. Catching up with EU output levels is obviously an even more remote objective.

In general, the recovery has been export-led. Due to the economic upswing in western Europe, and the competitive prices and increased quality of eastern European products, exports to the EU grew rapidly. In addition, trade among transition countries also rose substantially, an evolution that can be expected to continue given the recently decided further extension of the Central European Free Trade Agreement (CEFTA), both as regards the number of product categories included, and as to the number of participating countries. The improved export performance has led to a lowering of the trade deficit in most countries in 1994.

In the more advanced countries, the role of exports as the engine of growth is increasingly being taken over by investment, mainly in machinery and equipment. Much of the rise in investment results from increased export possibilities, and, when it is supported by foreign direct investment, from increased confidence in the stability of the economy. In more and more countries, the recovery is even creating some room for real wage improvements, which support private consumption. It can be expected that in those countries where domestic demand is improving, imports will rise and the trade balance might deteriorate again. However, to the extent that higher imports consist of investment goods, which will increase future productivity and growth, this should only be a temporary phenomenon.

As transition began, unemployment soared in all associated countries. This was the net effect of rapid lay-offs in the (former) public sector and a slower increase of labour demand in the emerging private sector. Only in the Czech Republic these two movements apparently offset each other, preventing an increase of the unemployment rate. Still, in most countries the recovery is starting to have beneficial effects on employment. Combined with an ongoing reduction of the supply of labour, mainly as a result of falling female participation rates from their previously high levels, this results in declining unemployment rates.

Despite the economic recovery, inflation has been reduced in all countries through the introduction or prolongation of tighter monetary and fiscal policies. In the third quarter of 1995, price increases slowed down also in Hungary, the only country where inflation had been accelerating in the first half of the year as a consequence of indirect tax increases and a considerable devaluation of the forint. Albania and the Czech and Slovak Republics recently reached single digit inflation rates, and Slovenia will probably join them soon. However, in the other associated countries inflation is still considerably higher.

Fiscal and monetary policies continued to be relatively tight in most countries. With the exception of Romania, Latvia and Lithuania, budget deficits were further reduced in all countries in 1994; Estonia and the Czech Republic even recorded a surplus. Meanwhile, nominal and real interest rates remain high, and domestic credit is restricted in many countries. However, there is more diversity in the choice of exchange rate regimes: the Baltic countries and the Czech and Slovak Republics have a fixed exchange rate (in the case of Estonia and Lithuania this is done through a currency board), Hungary follows a crawling peg policy, and the others have a managed float regime. Contrary to last year, in recent months even Bulgaria was able to avoid large exchange rate fluctuations.

As a consequence of the improved trade performance, the balance of payments is improving in most countries. The official foreign reserve positions have been steadily improving (except in Romania) and are now equivalent to at least two months of imports in all countries. In some countries, such as the Czech Republic, Poland and Slovenia, strong inflows of foreign capital even pose a problem for monetary management: if the authorities sterilize the increase in international reserves by issuing bonds, this entails a substantial cost in the form of interest charges, and if they don't sterilize, the domestic-currency counterpart of the inflows add to the money supply, which is potentially inflationary. The alternative – letting the currency appreciate – is unattractive because it would hurt exports.

Main lines of the forecast

Against this background, the forecast for 1996/1997 is relatively optimistic. Output growth is projected to strengthen further to between 4 and 6%, except for Hungary which is assumed to persevere with its stabilization programme, and reform laggard Bulgaria. Macroeconomic equilibria are improving: inflation continues to decline, and fiscal and external balances become more favourable as well.

Perhaps the most exemplary macroeconomic development is projected for the Czech Republic: very strong demand for imported investment goods in 1995 first feeds into stockbuilding, but as the imported equipment becomes part of the capital stock in 1996, investment surges and capacity is increased – just in time to avoid overheating – and exports can increase further. If this could be true, and true everywhere...

Some macro questions

Foreign trade developments are obviously of key importance. One set of hypotheses has been used in this connection, in particular in the Polish forecast, to explain the major terms of trade gains that seem to come out of recent customs data. Two factors are assumed to be at work. First, for exports, these countries are currently so competitive because of the low level of their exchange rate that they are in effect price makers in their market niches; they seem to have little problem in letting export prices increase in line with domestic inflation. For imports, they are obviously price takers. Second, there is a quality effect that allows them to increase export prices. How long this will go on depends on our judgement on: i) what the equilibrium exchange rate is, and ii) how much scope for further quality improvement there is in the absence of dramatic restructuring progress.

Inflation presents another, related puzzle. Is it realistic to forecast a further slowing down? We see a clear beginning of wage pressure in several countries – fortunately, in one way, in view of the severe declines of household incomes since the start of reform. But how much scope is there for further increases in wage costs in excess of productivity (cf. the Czech Republic, with its tight labour market), before the competitive advantage gained by the initial devaluation a few years ago is completely eroded?

Also, we like to say that fiscal and monetary policies remain restrictive, but is that really the case? As soon as capital inflows become somewhat large, they pose a problem for monetary management (see above), but tightening does not seem to be the normal response. And fiscal restraint? If the economy is booming, a certain reduction in public deficits is only normal, and one could ask whether more should not be done in these circumstances to reform public finance. Romania this year decided to spend the windfall revenue straight away. Poland is making no particular extra efforts, e.g. by eliminating the import surcharge.

Some micro questions

The key stylized fact that seems to come out of most of the country forecasts is: macroeconomic performance is quite good, but progress with microeconomic and structural change is much slower, and could well constrain growth in the medium term.[2]

Privatization is the most obvious problem here. Slovakia is a puzzling case: an almost exemplary macro performance, but mass privatization has effectively been cancelled. This is bound to adversely affect the speed of enterprise restructuring, which should feed through in growth at some point.

Another major question relates to the state of the financial sector. Clearly, a sound banking system is of vital importance not just for macroeconomic reasons, but also because it acts as an agent of restructuring through its impact on corporate governance. In fact, the east European economies started transition with an unenviable legacy of poorly supervised banks, with few skills or experience relevant to market conditions, and a bad portfolio of outstanding loans. The first years of reform saw important changes - introduction of two-tier banking systems, more competition, some privatization - but not all wrongs were righted and some things got worse. Small new banks with a low capital base proliferated, and the stock of bad loans continued to grow - paradoxically, this was especially problematic for those countries most successful in reducing inflation.

Country detail

Bulgaria

The forecast assumes no policy changes.

By the second half of 1995, tentative signs that Bulgaria's recovery could already be beginning to run out of steam were emerging. The rise in industrial production appeared to be slowing as inventories built up; the growth in exports and associated improvement in the current account balance may be petering out. Structural reform continues at only a slow pace, with the government directing most of its efforts towards a relatively modest mass privatization programme.

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[2] A key challenge for forecasters thus becomes: how should these microeconomic weaknesses be reflected in macroeconomic performance, and within what time frame. This paper presents one way of addressing this problem. This implies a methodological point: clearly, forecasts for eastern Europe still need to be essentially judgmental rather than model-based; there is no way we can estimate the parameters needed to reflect these microeconomic condition changes in macroeconomic projections. The accounting framework we use is described briefly in ONB Working Paper 15 (quoted in footnote 1)

With real interest rates at 15 to 20%, the government seems to have no difficulty in financing budget deficits of 6% and more of GDP. Under the impact of increased interest payments on foreign debt, the deficit seems set to widen in 1996. Given the size of the deficit and the level of real interest rates, it is difficult to see any prospect for a dramatic pick-up in investment.

The major success of 1995 has been the slowdown in inflation - helped by the central bank's restrictive monetary policy, which has also contributed to a remarkable stability in the nominal exchange rate following the turbulence of 1994. Some real depreciation seems likely in the short-to-medium term, but the government's financing needs are likely to keep interest rates high, encouraging the stability of the currency, and ensuring that this year's improved inflation performance does not disappear in another round of rapid lev depreciation.

The downside to this is a crowding out of investment. Coupled with lack of radical structural reform, this points to a gradual slowing down of GDP growth in the coming years.

An alternative, more optimistic scenario would see structural reform accelerating under pressure from the IMF in particular, with possible additional benefits flowing from a stable settlement in former Yugoslavia.

Czech Republic

In the first half of 1995 the Czech Republic experienced a rapid increase in the trade deficit and capital inflows. The deficit was due to strong growth in imports and weak growth in exports: the deficit is expected to reach 7.6% of GDP in 1995. A significant current account deficit will also emerge though it will be financed by the large capital inflows which are expected to continue for the forecast period. The poor export performance is due not only to a lack of competitiveness but also the diversion of production from exports to the domestic market.

Economic growth in the first half of 1995 is being driven by investment, both fixed and stock: the share of investment in GDP is on a par with Japan in the 1960s. The investment is expected to feed through rapidly to improved productivity and export performance in 1996 and 1997. Private consumption, which is relatively low as a share of GDP, is expected to strengthen in the second half of 1995 and growth is likely to remain at around 5.7% for the remainder of the forecast period. As exports recover and consumption strengthens, economic growth will become more balanced and the trade and current account will improve as a proportion of GDP. Real growth is expected to accelerate gradually to 4.8% in 1997.

The forecast assumes that the fixed exchange rate system will be maintained: the nominal exchange rate will be constant. There will be some real appreciation as inflation remains above that of other countries: consumer inflation slows to 7.9% over the forecast period. Several inflationary pressures persist: strong capital inflows, accelerating wage growth consistently above productivity, and the economy remaining near full capacity. The labour market remains tight but the unemployment rate is expected to rise to 3.5% by 1997 as a result of restructuring. The forecast also assumes that the government will maintain a balanced budget: the outturn will give surpluses in 1995 and 1996 because of higher revenues possible because of higher growth. Government expenditure as a proportion of GDP will fall in line with announced policy.

Hungary

The forecast[3] assumes that the government sticks to its current and announced policies aimed at gradually reducing the budget and current account deficits. With regard to the exchange rate, official announcements on the pace of crawling peg devaluation for 1996 have been incorporated; this is likely to give rise to a modest real appreciation of the forint.

It is also assumed that the import surcharge is eliminated by mid-1997 (but not before then), in line with government commitments, and that alternative revenue sources are found. This in turn implies continuing reform of the public sector.

Indications are that the package of measures announced by the government in March this year have been effective in reining in public expenditure and stemming the rise in imports. The government has increased the credibility of its commitments by rapidly taking alternative measures when parts of the package were declared unconstitutional by the courts.

The main downside risk is that the government is unable, for political or legal considerations, to implement its programme. The vagueness of the "medium-term economic strategy", received after most of the work on the forecast had been done, makes this risk far from negligible, particularly in the area of pension reform. Should the government continue to procrastinate, the budget deficit could sharply increase (the projected reduction in 1997 will already be difficult to achieve, given that the government will no longer have sizeable revenues from the import surcharge and privatization). This in turn would call into question the improvement in the current account balance, raising the spectre of an external crisis.

Latvia

[3] In early October Hungary revised its 1994 GDP growth estimate upwards to 2.9%. In the absence of any detailed information concerning this revision, it has not as yet been incorporated into the forecast.

In early 1995, two crises developed: one in the banking sector and the other in the budget. As a result of the first there has been a dramatic reduction in liquidity: some 50% of consumers' and producers' assets and funds have been frozen. As a result of this the economy is expected to contract by 1.6% in 1995. Growth is then expected to resume in 1996.

The budget crisis is expected to lead to a government deficit of 4% of GDP. This will create inflationary pressures, despite the reduction in liquidity resulting from the banking crisis, so although inflation will slow, it will persist at relatively high levels. This will lead to a real appreciation of the exchange rate, despite an anticipated depreciation of the nominal exchange rate.

Recovery will resume in 1996 with investment picking up. This in turn will allow export production to recover. Economic growth is expected to be positive, though modest, in both 1996 and 1997. The recession will therefore be short-lived though real private consumption growth will not recover at the same rate and therefore will not reach its 1994 level by the end of the forecast period. The recovery will be modest in part because of the need for fiscal austerity in view of the budget deficit.

Romania

After years of uncertain economic performance and policy slippages, Romania seems to have moved to a more solid economic recovery. A greater commitment to stabilization and to an acceleration of privatization has led to the consolidation of the positive growth performance recorded since 1993.

Recovery is expected to continue and GDP growth can pick up in 1996 and 1997. The growth is led by a substantial increase in fixed investment, paired by a noticeable increase in private consumption. The upturn in GDP growth is expected to release some pressure on the state budget: a moderate increase in public consumption is also forecast, without major deterioration of the general government balance as percentage of GDP. Inflation is expected to decline further in 1996 and to remain moderate afterwards. The exchange rate is anticipated to stay almost constant in real terms. The increase in output, together with an increase in working time are expected to produce major labour productivity increases, partly enhanced by the process of industrial restructuring, which will reduce overmanning. Unemployment is expected to stabilize, mostly as a result of increased activity in the private sector.

A marked deterioration of the external sector, both in terms of the trade balance and the current account of the balance of payments is envisaged. However, despite this deterioration, the current account as percentage of GDP is expected to remain well within the limits which are compatible with the improved performance of the real side and the low level of external indebtedness of the country.

The main downside risks are policy-related. The positive economic performance outlined above depends crucially on the respect of the moderately rigorous fiscal and monetary policies implemented so far, which have strengthened the credibility of the authorities and contributed to establish some track record of sustained reform. The ability of the Romanian economy to sustain an investment-led growth is also contingent on the acceleration of the privatization process and industrial restructuring.

Slovakia

At almost 5%, the Slovak economy grew much faster than expected in 1994. Economic growth in western Europe and the Czech Republic pushed up demand for Slovakia's exports, while the slump in domestic demand kept imports down. As a consequence, the very negative evolution of all domestic demand components was more than compensated by the significant net contribution from external trade to GDP growth.

Recent figures indicate that the rapid growth is still continuing; GDP growth is estimated at 6.1% in the first half of the year and industrial production increased by 10.6% in August. Therefore, the Spring GDP forecast of 3% seems to be too low.

For 1995, it is foreseen that domestic demand will recover from its low 1994 level. All components of domestic demand are expected to improve; in particular investment will grow significantly. Provisional trade figures indicate that exports also keep performing very well. Still, the improvement of domestic demand and the gradual reduction of protectionist measures (e.g. import surcharge) will also push up imports substantially. As a consequence, the contribution to growth from net exports is expected to become negative in 1995. Still, as a result of higher than previously expected domestic demand, stockbuilding and exports, forecast GDP growth for 1995 is revised upwards from 3 to 5.2%.

No further growth acceleration is expected in 1996 and 1997. Uncertainty about structural reform and the minor role for foreign investors in future privatizations will prevent a faster expansion of domestic growth. Furthermore, because of a slight deceleration of export growth, we expect no additional growth contribution from net exports.

Economic policy is assumed to remain stability oriented. This holds for both monetary policy and fiscal policy. In consequence, inflation will continue to slow down, be it at a slower pace because of the substantial growth in economic activity. Because of the favourable economic evolution, employment is expected to grow again, causing a decline of unemployment. Consequently, disposable income rises fast enough to allow a modest increase of the savings ratio.

Slovenia

Economic growth in Slovenia accelerated rapidly in 1994 and early 1995. As a result the trade deficit increased. The deficit is expected to persist for the forecast period, though it will fall as a percentage of GDP. Export growth improved in 1995 but is to some extent held in check by the real appreciation of the tolar. Services, in particular tourism, are expected to perform well and therefore the current account surplus is set to increase in all three years. Economic growth is expected to reach 5.5% in 1996.

As a result of the recovery, employment is expected to grow - in particular self-employment - and unemployment to fall. Wage growth is expected to moderate from the very high recent rate as a result of the social pact to keep wage rises below inflation agreed between the government, trade unions and employers. Inflation is expected to slow in accordance with government targets as wage growth and the budget deficit, as a percentage of GDP, are kept in check.

The Slovenian economy is a service based economy - with 55% of GDP being produced by the service sector. This is expected to change slightly during the forecast period as a result of more rapid industrial growth. This has been made possible by recent growth in investment goods, financed by both domestic and external sources.

Poland

There is a wide consensus on the capacity of the Polish economy to sustain a medium term growth of 5 to 6%. Investment is growing fast allowing the investment ratio to return to a level above 20% by the end of 1997. Consumption is supported by increases in wage and non-wage income of households. Such demand conditions are favourable to employment and the unemployment rate declines slowly. Productivity gains remain high and it is likely that the relatively centralized wage setting mechanism succeeds in keeping real wage increases below productivity gains. Overall domestic conditions for growth are sound. However, structural reform is not assumed to speed up and this results in a very slow disinflation pace.

The main uncertainty is the developments affecting the external side. Both exports and imports are currently growing fast, with yearly growth rates of trade turnover in dollars close to 40%. This reflects partly the dynamism of the Polish economy, but also some large price adjustments stemming from the exchange rate policy: there is some evidence that Poland is recording large gains in terms of trade. Moreover, the zloty is still appreciating in real terms and the overall competitiveness of Polish products is being eroded. In our scenario, this is reflected in a slow down in growth at the end of the forecast period. We assume that the crawling peg for the zloty will be maintained though at a lower rate to contain the real appreciation of the zloty. Exports growth will continue partly as a result of recovery in world demand but will slow down as a result of a lower competitiveness. The massive import surge of this year is not expected to be reiterated and import growth will be lower in the future than in 1995. These expansionary trends generate trade and current account deficits which could be financed out of inflows of short- and long-term capital. However, they point to a deterioration of the current account which might become again a problem in particular if external trade becomes more elastic to prices. This is maybe the reason why the government does not let the zloty appreciate more in response to the large capital inflows which Poland received in the last two years.

The main debate about the perspective of the Polish economy is how long will the economy sustain a 5 to 6% growth rate. As mentioned above, the key variable of the Polish macroeconomic set up is the direction of change of the exchange rate. A continuation of present policies would lead to a slow deterioration of the external balance and a high inflation, implying a medium-term growth rate lower than current rates. Persistent large capital inflows would make an appreciation of the zloty unavoidable and this would in turn bring forward the turning point of expansion, but would help in lowering inflation. On the structural side, the scenario does not assume that the government will make any substantial progress in addressing the issue of restructuring of large unprofitable state owned companies which are mainly concentrated in the non-tradable sector and of banking reform. No major change is foreseen on the fiscal side either and adjustment in social transfers and taxes are made gradually. A stronger commitment to structural reform could also have short-term negative impact but would, however, create a large growth potential, in the service sector in particular, and would also contribute to faster disinflation. The third element of uncertainty is related to the labour market: the imbalances on the labour market are slightly reduced, but not enough to modify the outcome of wage settlements. However, a wage explosion cannot be excluded in a situation of sustained economic improvement. Overall this scenario incorporates upwards as downwards biases.

Josef Poeschl[*]

Remarks on Rutger Wissels'

Pessimism Confounded? Recovery in Eastern Europe

Any forecast relies on ideas about the functioning of an economy, the embedded interdependencies and tendencies. What are, for example, the most powerful forces producing inflation? What makes output growth weak or strong? What is decisive for a country's foreign position?
The forecast data presented in Rutger Wissels' paper do not differ substantially from those recently developed by the Vienna Institute for Comparative Economic Studies (WIIW). The latter are shown in Table 1. Instead of discussing differences in single positions, I would like to outline what I regard as background to the data.

As it seems, the Central and Eastern European Countries (CEECs) are facing a '**second phase of transition'** characterized by **microeconomic improvements**.

The **first phase put emphasis on macroeconomics**. After a 'shock' liberalization of prices and quantities, domestically as well as in foreign trade, macroeconomic policies aimed primarily at curbing inflation.

As a rather unexpected result, microeconomic restructuring could proceed only slowly – we could speak of an **unintended 'microeconomic gradualism'.** The idea was that a comprehensive restructuring would automatically follow from privatization. However, the privatization proceedings proved very time-consuming. Some privatization strategies kept foreign capital away for several years. In terms of the main macroeconomic indicators, countries that concentrated primarily on privatization procedures are now not always performing better than others.

In the first phase of transition enterprises should have restructured, but the conditions prevailing were, to express it mildly, very difficult:
– enterprises were burdened with old debt;
– they had lost their old foreign markets;
– an anti-inflationary policy depressed domestic demand and sales;
– devaluation increased the costs of imported inputs.

[*] The Vienna Institute for Comparative Economic Studies (WIIW)

The devaluation of the currencies had to serve as a protection and support for domestic enterprises on domestic as well as foreign markets. The resulting low exchange rate favoured producers of simple commodities where mainly prices (or price differences between individual suppliers) play the decisive role. The low exchange rate was less supportive to producers of more sophisticated finished goods; they remained poorly equipped for penetrating difficult new markets.

At present, the CEECs tend to produce or elaborate **primarily semi-finished goods**, while western Europe supplies primarily finished goods. This represents a kind of dichotomy inside Europe. There is nothing wrong with that in principle. But some CEEC governments feel unhappy about it and would like to become (again) producers of a high share of sophisticated products. Traditions play a role in this context, and the fact that those countries that produce the more sophisticated goods are also the wealthier ones.

The demand side, on foreign as well as on domestic markets, regards **finished goods produced in CEECs frequently as inferior**. Whoever can afford it, will buy western brands. Western goods are prevailing in the 'better' shops of the CEECs. On the one hand, the owners hope for more profits from selling western instead of domestic goods, on the other hand people with higher income prefer western commodities. If preferences remain that way, the still-existing producers of finished goods will not profit much from growing real incomes and the troubles with the trade balance will also increase. The situation differs, however, from country to country. For example polls conducted among Polish consumers indicate a growing reputation of domestic products. Accordingly, in Poland foreign investors increasingly retain the 'brands' of the firms taken over.

Central and Eastern European Countries have **low exchange rates** that make their nominal wages very low compared with western countries. The labour input per output unit is relatively high, but nevertheless production costs per output unit are lower than in the West. However, most companies produce no-name commodities and the prices are not much above the costs per unit of output. This contrasts sharply with the world's most successful companies, because they gained the ability to **sell large quantities at high prices**. For example, one can sell a product of a given quality at a higher price if it has the label 'Swiss made' and not 'made in Slovakia'. Some years ago this used to be the case for 'made in Japan' or 'made in China', too.

Future success depends on technical restructuring and improvements in quality and, even more so, in information about it. Three scenarios are feasible: An '**assimilation scenario**' could be as follows: the nominal exchange rate remains rather constant, wages rise proportionally with the labour productivity. The prices rise due to higher mark-ups on unit production costs, but an improving reputation on domestic and international markets enables the suppliers to sell their output even at increasing prices. Over time, differences in wages, productivity and prices disappear. Post-war *Austria* followed roughly this pattern.

In a ‘**tiger scenario**’ the nominal exchange rate would remain also constant, at least in the beginning. Productivity (quality-adjusted) might rise much faster than nominal wages. Unit production costs would fall, and the gap between them and the price could widen. If reputation increased in parallel, price rises could widen the gap even further. The products would become extremely competitive, and in the long run the country would come under revaluation pressure. *East Asian countries* are examples of such a development pattern.

In a ‘**Sisyphus scenario**’, nominal wages might increase faster than labour productivity, and reputation might stagnate at the given low level. This scenario would follow from a lack of success in attempts to restructure. Repeated devaluation would become unavoidable, and thus the relation between domestic and foreign wages – and domestic and foreign prices as well – might remain constant over time. In each scenario the GDP may be growing, but in the ‘Sisyphus case’ growth might be hampered by instabilities and an unfavourable commodity structure in exports. A modernization by means of western investment goods is rather risky, if repeated devaluation keeps the price level down. The new equipment may often not comply with the price of the output it will produce. This scenario reminds one of countries like *Mexico*. One should perhaps add that if international agreements are impeding devaluation, the Sisyphus scenario results in mass bankruptcies of companies. Something like this happened in *Eastern Germany*.

The second phase of transition, the ‘**real restructuring’**, relies on management decisions. Policy can however support the development. Programmes of industrial and structural policies have in the meantime become en vogue (Slovenia plays a pioneer role). At the same time, macroeconomic policies have not lost their significance. The companies’ prosperity results from profits per unit of output multiplied by the output quantities sold. Macroeconomic policy can influence the latter.

The **conditions for restructuring have improved**, as GDP is now growing in the CEECs. State revenues are rising and budget problems are less severe. Fiscal and monetary policies tend to be much less restrictive than before, partly also because the claim for financial discipline of the state leads to a rather pro-cyclical behaviour of the governments. The inflation problem is serious but slowly abating in most countries and monetary constraints are less draconian than in the first years of transition. It is likely that eastern Europe will be the more dynamic part of the continent in the years to come. GDP growth means also growth of profits, and internal financing of investment projects becomes easier.

Western prosperity was an engine for CEEC growth, but now it seems that domestic demand, especially investment, is promoting home-made prosperity. For countries growing faster than others, **the balance of payments is always a potential constraint and can turn into a major obstacle to further development**. The probability for this is the higher, the weaker a country's microeconomic foundation is.

For the transition countries, the **balance of payments is the principal headache most of the time**. In a recent study commissioned by the Austrian Federal Chancellery, the Vienna Institute for Comparative Economic Studies (WIIW) tries to evaluate that constraint for different countries in more detail. Traditionally, economists focus on the trade balance, while the other items in the balance of payments are permanently increasing their significance. A surplus on the balance of services can compensate a deficit on the trade balance. Also, in the last few months the different items of the capital balance have played an increasing role – especially the inflow of FDI, of portfolio investment and of short-term capital. The latter feeds the fear of a Mexican-type crisis. The mentioned WIIW study starts from **demand elasticities** (relative to prices and income) which differ for western goods (CEEC imports) and CEEC goods (exports). The individual CEECs differ in the commodity composition of their foreign trade flows, and the study tries to incorporate the impact this fact may exert on elasticities. The individual countries have different approaches to service and capital flows. Also, they follow diverging strategies in their exchange rate policy.

The WIIW study considers three different cases: an **approximately complete EU integration** of the CEECs, a **perpetuation of the present state of integration**, and a **tendency towards 'disintegration'** in the sense of a strengthening of barriers. The WIIW study comes to the conclusion that **the degree of integration has a positive impact on the long-term average of CEEC growth rates**. The positive influence on the growth path, e.g. by way of attracting more FDI, should overcompensate the negative influences. (Less flexibility in the exchange rate policy or fewer instruments for manipulating balance-of-payments flows may have a negative impact.)

The WIIW study gives estimated growth rates for three periods: 1993 to 1998, 1993 to 2003 and 1993 to 2008 (see WIIW-figure 1). These rates, however, are **not forecasts, but rather the upper limits of growth rates** set by microeconomic shortcomings which surface as balance-of-payments constraints. Due to gradual improvements, growth rates become higher over time, and east-west integration exerts a positive influence in this respect. The study is a first attempt to approach crucial problems and can be gradually improved as information increases.

WIIW-Table 1

The Vienna Institute's Outlook for 1995 to 1997

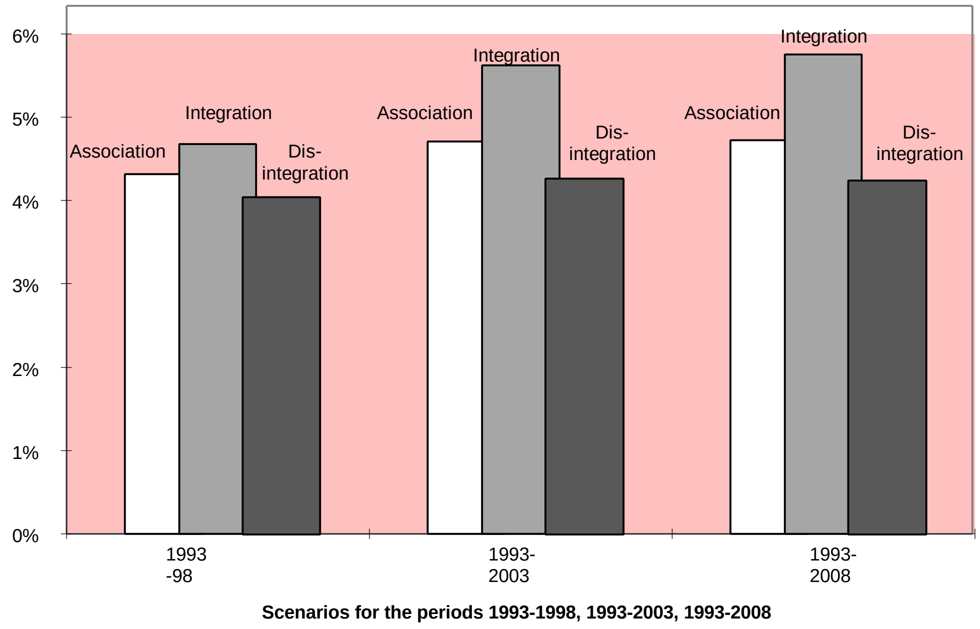
	GDP change in % against previous year				Consumer prices change in % against previous year			
	1994	1995	1996 forecast	1997	1994	1995	1996 forecast	1997
Czech Republic	2.6	4.9	5.5	5.5	10.0	9.1	8.2	8.3
Hungary	2.9	2	2.5	4	18.8	28.2	22	15
Poland	5.2	6.5	5.5	5	32.2	29	20	15
Slovak Republic	4.8	6.6	5	5	13.4	9.9	9	8
Slovenia	5.5	4	5	6	19.8	12.6	9	7
CEEC-5	4.2	5.3	5	5	.	.	.	.
Bulgaria	1.4	3	3.5	4	96.2	62	35	30
Romania	4.0	4.5	4	5	136.8	32	35	30
CEEC-7	4.0	5.0	5	5	.	.	.	.
Croatia	0.8	0	.	.	97.6	2	.	.
Russia	-15.0	-4	0	4	300	200	60	40
Ukraine	-23.0	-11	-1	4	891	360	90	45

	Unemployment rate in %, end of period				Current account in USD mn			
	1994	1995	1996 forecast	1997	1994	1995	1996 forecast	1997
Czech Republic	3.2	2.9	3.3	3.8	-50	-1400	-2200	-2200
Hungary	10.9	10	10	10	-3911	-2200	-2000	-1500
Poland	16.0	15	14	14	-944	-2500	-3500	-4000
Slovak Republic	14.8	13	14	14	712	130	0	-300
Slovenia	14.2	14.5	14	13	459	50	100	100
CEEC-5	12.9	.	.	.	-3734	-5920	-7600	-7900
Bulgaria	12.8	11	10.5	10	157	200	-200	-200
Romania	10.9	9	10	10	-428	-1300	-1000	-1000
CEEC-7	12.4	.	.	.	-4005	-7020	-8800	-9100
Croatia	17.0	17	.	.	103	-1600	.	.
Russia	2.2	3.2	5	8	4836	8000	6000	5000
Ukraine	0.3	0.45	2	9	-3000	-5500	.	.

Source: WIIW
(January 1996)

WIIW Figure 1:

CEE-5: GDP Growth Rates for Periods Starting 1993, weighted averages



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Comments

This paper, as other forecasts of development in eastern Europe do, raises new questions. The first question arising from the forecast is the difference between the past expectations on development in Central Eastern European Countries (CEECs) and the currently observed development. The study presented, as well as other recent forecasts, notes better than expected growth and a much slower progress in the structural changes. Obviously, slow restructuring is seen in low FDI and ”slow privatization”. This question arises also when Rutger points out Slovakia - with high growth rates and slow privatization - as a ”puzzling case” (page 7).

In fact, eastern European countries chose quite different policies and reached different success in structural changes. Currently, the growth rates reached in eastern European countries show only low correlation with our understanding of success in restructuring and transition.

The next questions concern economic policy applied in eastern Europe, for example ”fiscal and monetary policies remain restrictive, but is it really the case?” (page 6). These questions lead us to forecast further growth improvement in 1996 and a slight edging down of growth in the long term. In this forecast this is mainly expressed in the description of the Polish economy: ”The main debate ... is how long will the economy sustain a 5 to 6 % growth rate” (page 13).

This picture seems to be generally accepted. The result of such development is that ”catching up with European Union per capita income levels will still take several decades even at the current growth rates” (page 3). Nevertheless, the catching up that represents one motivation of this paper could be discussed in more detail including comparisons of CEECs and lower-income member states.

According to the forecast, the growth in 1996 and 1997 will be based on increased investment rising at two-digit growth rates (13.8 % and 12.4 % in average for associated countries in 1996 and 1997 respectively) contrary to the export-led growth in 1994 (decline in growth rates from 11.4 % in 1994 to below 10 % in the following years in associated countries). However, the contribution of external demand remains significant. The forecast of the development in the Czech Republic (page 4) represents in this respect the most optimistic scenario: very strong demand for imported investment goods in 1995 already extends production capacities in 1996 and allows for increased exports and a lower trade

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deficit. However, such a scenario seems to be too optimistic, because investment is unlikely to have such a strong impact on production or even on exports within this short period.

The development of exports, imports, and trade balance will have crucial importance for growth and macroeconomic stability in eastern Europe. This forecast assumes many factors that will influence trade balance:

1. recovery of world demand;
2. productivity growth and quality effects;
3. exchange rate appreciation (or at least pressure) in real terms in all countries (in 1996, the real exchange rates will appreciate by two-digit rates in the Czech Republic, Poland, and Slovakia);
4. real wage growth;
5. growth of investment (the majority of investment goods is imported in nearly all countries)
6. growth of consumption;
7. reduction of protectionist measures (in Hungary, Poland and Slovakia) and
8. diversion of production from exports to the domestic market (for the Czech Republic, page 6).

Only the first two factors allow for increased exports. However, the prospects of the main trade partners of CEECs are already slightly worse than at the beginning of their growth period. Therefore, productivity growth and quality effects will have a crucial importance for future export growth.

On the other hand, Rutger mentioned six factors that either increase imports or lower exports (or both) and hence increase the trade deficit. However, the forecasted trade deficits as a share of GDP (in the six associated countries) decline between 1995 and 1997 by 0.5 percentage points. This is a possible inconsistency in the forecast.

The financing of current account deficits will be another problem, although the forecasts of trade deficits show them as remaining low. In this respect, Rutger assumes inflows of long-term and also short-term capital (in Poland). However, the high share of the short-term capital inflows in the economy is likely to put pressure on national governments to undertake policy changes in order to avoid a Mexico-type liquidity crisis. This may contradict the assumption of no policy changes.

WIIW-Table 1

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