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REGIONAL COOPERATION IN THE ECONOMIC, SOCIAL AND RELATED FIELDS

Summary of the economic survey of Europe, 1995

CONTENTS

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INTRODUCTION

1. Economic developments in the various parts of the region of the Economic Commission for Europe (ECE) have become increasingly divergent over the past year. In western Europe there has been a marked deterioration since the early months of 1995: economic growth in 1995 was not only lower than forecast a year ago, but the sharp deceleration through the year has led to a significant lowering of forecasts for 1996. This is an unexpected and disappointing development because it has occurred before the current upswing has had time to have much impact on persistently high levels of unemployment.

2. Economic growth has also slowed down in North America, but this was expected - indeed, looked for - after three years of robust expansion had significantly reduced the margins of spare capacity and triggered fears of overheating. The slow-down was therefore in line with the "soft landing" sought by the United States authorities, but it was more rapid than expected: GDP growth in North America last year was just over 2 per cent, compared with earlier expectations of 2¾ per cent. 1/

3. Economic performance varied considerably among the economies of eastern Europe, the Baltic States and the Commonwealth of Independent States (CIS). Eastern Europe now stands out as an area of rapid growth. On average, real GDP grew by over 5 per cent in 1995, following an average 4 per cent the year before, and official expectations are for a further acceleration in 1996. The variations are still considerable within this group of countries: output fell in Croatia and the former Yugoslav Republic of Macedonia in 1995 and rose by over 13 per cent in Albania, but in between these extremes there is a core group with growth rates of some 5-7 per cent.

4. In the Baltic States a somewhat hesitant recovery has become more firmly established in Estonia and Lithuania, where GDP grew by some 2½ per cent in 1995, but in Latvia there was a further set-back, with output falling again.

5. The deep depression of output in Russia and the other CIS countries continued last year, but the fall in output slowed considerably in a number of countries. Output actually increased in Armenia and Georgia, and there are expectations of an upturn beginning to emerge in more countries in 1996. Such a possibility, however, will very much depend on what happens in Russia with which economic links are still very close for many CIS members. Russian GDP fell by 4 per cent in 1995, but this was considerably less than expected at the beginning of the year. There are hopes that if the progress made with economic stabilization last year can be maintained, Russian output might stabilize and begin to rise in the course of 1996. But it must be stressed that the uncertainties are considerable and that the range of forecasts for 1996 include a further decline in output.

6. The gap between expectations and outcomes in 1995 underlines yet again the difficulties of making forecasts during and after a period of rapid structural change. This is true of the western market economies, where the short-term forecasting models still do not seem to have absorbed the consequences of the extensive deregulation that occurred in the 1980s or the impact on behaviour,

especially of consumers, of the experience of asset deflation that marked the last recession. But it is even more valid for those countries undergoing wholesale systemic transformation and large-scale restructuring of their economies.

7. Virtually all governmental and independent forecasts failed to anticipate the depth and length of the depression that followed the onset of the transition process in 1989 and after, 2/ and for two years running (1994 and 1995) the strength of the recovery in eastern Europe has been significantly underestimated. Most of the forecasts made for the transition economies, including those presented in this survey, are at best informed judgements and in some cases little more than working - or hopeful - assumptions. This is not surprising and, indeed, is unavoidable.

8. Short-term forecasting relies for reasonable success on the identification of a stable set of behavioural relationships operating within a stable institutional framework. But the whole point of the transition process is to change traditional modes of behaviour and transform the formal and informal infrastructures which govern economic activity. Thus, in the short-to-medium run, success for the transition process must inevitably undermine the parametric stability required for reasonably accurate forecasts.

I. WESTERN EUROPE AND NORTH AMERICA

9. The economic survey of a year ago shared a widespread judgement that the possibilities for sustained and balanced growth in western Europe were better than at any time since the 1960s. The inflationary and other shocks of the 1970s had long-lasting and severe effects on economic stability, but they had now largely worked their way through the system. In particular, inflation rates were generally at their lowest for decades, and those who feared the risks of a renewed flare-up ignored not only the margins of spare capacity in the western economies but also the structural changes that had occurred in the world economy since the early 1980s and the marked reduction in the inflationary expectations of price setters and wage earners.

10. The rapid recovery of output in the United States in 1992-1994 and, to a lesser extent, in the United Kingdom in 1993-1994 was actually accompanied by falling rates of inflation, despite the persistent fears of bondholders and financial markets to the contrary. In a low-inflationary environment, the expectations for western Europe in 1995 were for steady growth of about 3 per cent, to be led in the main by fixed investment and net exports. Given potential output growth of around 2 per cent a year, anticipated growth of 3 per cent also raised hopes of some reduction in unemployment or, at least, an end to further increases. The recovery of fixed investment also strengthened the prospect of lower unemployment over the longer term as capacity continued to expand.

11. But even as this favourable outlook was being formulated in the forecasts and governmental budget plans for 1995, the recovery in the western European economies was beginning to falter, and the loss of momentum gathered pace during the year. The average quarterly rate of GDP growth has been decelerating since

mid-1994, and the preliminary statistics actually show a slight fall in output in the last quarter of 1995. This sharp deceleration is not apparent from the annual averages which show GDP growth increasing from 2.5 per cent in 1994 to 2.7 per cent in 1995. Some of the smaller economies - Belgium and Switzerland - actually moved into recession in 1995 (defined as two consecutive quarters of negative growth), and this could also be the case, at least technically, for France and Germany in the first quarter of 1996 (although bad weather has played an important role in the latter two).

12. A number of factors have played a part in these developments. In general, consumer confidence has remained fairly weak throughout the recovery that began in the second half of 1993. This reflected fairly bleak prospects in the labour markets and uncertain prospects of future incomes; high levels of unemployment and the fear of unemployment have engendered a degree of economic insecurity among a much larger proportion of the labour force than used to be the case. Sectors and higher-income groups, particularly services (including government), hitherto more or less immune from periodic bouts of unemployment, are now threatened with job losses as a result of technical change and relatively weak demand or, in more fashionable language, of "downsizing". In this environment, the lagged effects on western Europe of rising interest rates in the United States during 1994 had a significant impact on consumer spending on durable goods, and this was reinforced in early 1995, despite the general easing of monetary policy, by increases in short-term interest rates in several countries as a result of turmoil in the foreign exchange markets.

13. Private consumption has also been weighed down by a number of other factors: higher taxes and social security charges and reductions in governmental transfers have dampened the growth of disposable income; and in some countries the weakness of the housing market and the persistence of negative equity in privately owned houses, as well as the continued reduction of earlier levels of indebtedness, have also discouraged spending. Private consumption grew on average by only 2 per cent in 1995, compared with annual rates of well over 3 per cent between 1986 and 1990.

14. Government spending also added little to growth, as Governments increased their efforts to lower general governmental deficits in time to meet the Maastricht criteria for convergence by the end of 1997.

15. Hopes that the recovery of fixed investment in 1994 would continue in 1995 have only been partly disappointed. The weakening of demand led to a steady cutting back of investment plans, but fixed investment still rose on average by some 4 per cent, compared with 1.6 per cent in 1994. A somewhat disturbing development, however, is that, in general, investment has been focused not on the expansion of productive capacity, which would improve the medium-term prospects for employment growth, but on cost reduction and the modernization of the capital stock. This is reflected in the much larger increase of investment in machinery and equipment (which rose some 7 per cent) as compared with construction (up 1.5 per cent). This development was partly a response to intense competition on world markets, but it is also a way to increase profits in the face of weak and uncertain prospects for the growth of demand. Thus, poor growth prospects will generally weaken investment, but the more immediate effect may be to alter the motives for investment - rationalization versus

expansion of capacity - which in turn will have longer-run implications for growth and employment.

16. The disappointment of expectations is clearly reflected in the behaviour of stock-building which played a major role in the slow-down in output growth last year. Stocks were built up rapidly in 1994 in anticipation of a sustained recovery of demand, but throughout 1995 further additions became steadily smaller in response to weak sales and, in some countries, high real interest rates. Whereas stock-building accounted, on average, for well over one third of GDP growth in 1994, last year it contributed a mere 8 per cent. This downturn in the stock cycle has occurred at an earlier stage than normal in the recovery process.

17. Domestic activity in western Europe continued to be supported by export growth in 1995, although the net effect was smaller than in 1994 because of a slow-down in intra-western European trade. Apart from the general weakening of demand, the exchange rate turbulence of early 1995 probably had a net contractionary effect on intra-trade in the second half of the year. Nevertheless, the region has continued to benefit from the strong global demand for investment goods and from the rapid growth of imports into the transition economies, most of which originate in western Europe, and the developing countries.

18. The weakening of activity in western Europe is of course a particularly worrying development, given the limited progress in reducing unemployment.

19. There was a small increase (0.6 per cent) in the level of western European employment in 1995 after falling by nearly 3½ per cent between 1991 and 1994. But the improvement was small, largely concentrated in the smaller economies, and seems to have slowed in the second half of the year. The weaker rate of job creation in western Europe contrasts sharply with the much more buoyant expansion in North America (increases of 3 per cent and nearly 2 per cent in 1994 and 1995). Although much stress has been given to the greater labour market "flexibility" in the United States as an explanation of this difference in the rates of job creation, the major factor in recent years seems more likely to be the considerable difference in rates of economic growth.

20. The unemployment rate in western Europe in 1995 averaged 10.5 per cent, slightly below its peak of 10.9 per cent in 1994 but still above the recession year of 1993. In several countries the rate would have been higher without early retirement schemes and other measures designed to encourage withdrawals from the labour force. There was some reduction in the extent of unemployment among young people in 1995, partly because of special labour market programmes in a number of countries (especially in France), but in general youth unemployment rates remain very high - 20 per cent or more in many countries - and constitute a major social problem and a tragic waste of resources.

21. In the United States the unemployment rate has been fairly stable at about 5.6 per cent since late 1994, but this is still below the rate of 6 per cent which has long been held to be the minimum consistent with non-accelerating inflation (the so-called NAIRU). However, although a probable reason for the Federal Reserve raising interest rates in early 1994 was concern that

unemployment was falling towards 6 per cent, inflation has not accelerated and has remained fairly subdued, at less than 3 per cent. This suggests that the unemployment rate consistent with stable inflation has fallen. In other words, there is room for unemployment to fall further without triggering a rise in the inflation rate. This also appears to be the case in western Europe. Consumer price inflation in western Europe, which also averaged less than 3 per cent throughout 1995, is not much higher than in the United States, and in France and Germany, it is significantly lower. Inflationary pressures and expectations remain low partly because of the weak prospects for demand but also because of the changes in economic structure and behaviour mentioned above.

22. The short-run economic outlook for western Europe is not very encouraging. Since the autumn, forecasts for GDP growth have been steadily lowered; business and consumer confidence have continued to fall, and current indicators such as order books, stocks and output expectations suggest little, if any, growth in the first quarter of 1996. Weaker growth - or even falling output - in France and Germany is bound to affect the other European economies because of their close integration. It now seems probable that economic growth will slow down in virtually every economy and, at best, western European GDP could rise by 1.5 per cent in 1996. This compares with actual growth of 2.7 per cent in 1995 and forecasts last autumn of a roughly similar rate for 1996. In North America real GDP growth is expected to be little changed from last year (around 2 per cent), while a long-awaited recovery in Japan is forecast to materialize with an increase in GDP of 2 per cent.

23. Expectations of a better outcome in western Europe are now focused on the likelihood of an acceleration in the growth of output in the second half of the year. The reasons for expecting such a rebound include the end of the stock adjustment process and the delayed response of consumer spending to lower interest rates. However, if GDP levels remain more or less unchanged in the first half of the year, an annual rate of over 4 per cent would be needed in the second half to produce a growth rate of 1.5 per cent for 1996 as a whole. Such an acceleration is not very likely, which means that if activity fails to pick up before mid-year, even the 1.5 per cent may prove to be optimistic.

24. This subdued outlook for growth in western Europe implies that, on the basis of present policies, a renewed rise in unemployment in 1996 will be unavoidable. However, the only likely change in economic policies at present is a further and perhaps faster rate of reduction in interest rates. Fiscal policy is currently constrained by the determined efforts of many European Governments to meet the convergence criteria of the Maastricht Treaty. There appears to be little room for manoeuvre here, although further efforts might be made to shift the composition of governmental expenditure in favour of items which have a positive effect on private consumption and fixed investment, as well as more active labour market policies.

25. But a significant reduction of unemployment, which is the major economic and social problem now facing western Europe, will not occur without a considerably higher rate of economic growth than that currently in prospect. Labour market policies do have an important role to play in reducing the costs to enterprises of hiring new staff and by increasing the employability of the young and the long-term unemployed with better education and training. But

these efforts will have little effect if the demand for labour is constrained by weak growth prospects. Fears that lowering unemployment will trigger more inflation are exaggerated; there is growing evidence that there is significant scope for reducing unemployment without raising inflation. Moreover, the risks of inflation have to be balanced against the risks to social and political stability of increasing numbers of disenchanted and marginalized people excluded from the social integration achieved through stable employment.

26. There is always of course the possibility of unforeseen events that, as noted above, can upset any forecast. Stronger growth in the rest of the world could boost western European exports with positive multiplier effects on intra-European trade. But many of the risks are still on the downside: tighter monetary policy in the United States could check the fall in European interest rates, as could increasing uncertainty about the future of European integration.

II. EASTERN EUROPE, THE BALTIC STATES AND THE COMMONWEALTH OF INDEPENDENT STATES

27. Economic performance in the countries of eastern Europe, the Baltic area and the CIS in the past year has been very varied, and the differences among them are becoming increasingly marked. In eastern Europe, there is a core group of economies, mainly the members (Czech Republic, Hungary, Poland, Slovakia and, from the beginning of January 1996, Slovenia) of the Central European Free Trade Agreement (CEFTA), which have made considerable progress in the transition from central planning to a market economy and, excepting Hungary, have achieved GDP growth rates of 5-7 per cent in the past year (or past two years in Poland and Slovenia). Among the other eastern European countries, Albania has been growing rapidly, and Romania's GDP growth improved sharply in 1995, bringing it into the range of the CEFTA group. There has also been some recovery of GDP growth in Yugoslavia following the success of the February 1994 programme to end hyperinflation. But performance has been much weaker in Bulgaria, and in Croatia and the former Yugoslav Republic of Macedonia (and, almost certainly, in Bosnia and Herzegovina, for which no data are available), GDP continued to fall. Thus, within eastern Europe it is largely the more developed CEFTA countries which are pulling ahead of the economies of south-eastern Europe.

28. The performance of the Baltic States still lags behind that of most of eastern Europe, a reflection of their later start in the process of systemic transformation and the more difficult conditions in which they began their reforms, not the least of which have been the problems of adjusting their economic relations with the countries of the CIS. Nevertheless, a modest rate of recovery is now under way in Lithuania (since 1994) and in Estonia (since last year); but in Latvia there was a further set back in 1995 (GDP appears to have fallen), partly because of a major crisis in the banking sector.

29. The various members of the CIS display considerable variation in performance, with GDP increasing in Armenia and Georgia (by 5.2 and 2.4 per cent, respectively) and continuing to fall elsewhere, by as much as 12 per cent or more in Azerbaijan, Tajikistan and Ukraine. But for most CIS members the drop in output was much smaller than in 1994. This was most conspicuous in Russia, the dominant economy in the CIS, where GDP fell by some

4 per cent in 1995, against earlier forecasts of 9 per cent and a decline of nearly 13 per cent in 1994. In aggregate, GDP in the CIS probably fell by some 5 per cent in 1995, compared with 15 per cent the year before.

30. The recovery in eastern Europe has been based to a very large extent on the revival of industry. Although the development of the service sector is one of the most important and conspicuous aspects of the transition process, its weight in the economies of eastern Europe is still relatively small. Industry, on the other hand, was excessively large in the eastern economies before 1989, and although parts of the capital stock may be economically redundant, it still had the capacity to recover sooner and more quickly than other sectors. On average, industrial production rose more than 7 per cent in eastern Europe last year (and nearly 6 per cent in 1994), and in several countries by more than 9 per cent. In contrast it continued to fall in most of the CIS and in the Baltic States (although there was some recovery in Lithuania in the second half of 1995).

31. The recovery of eastern European industry has been accompanied by large annual gains in productivity (10-16 per cent in many cases in 1995). These partly reflect the usual increases which occur when spare capacity is brought back into use in response to a recovery of aggregate demand. But for these economies this also signals that a significant part of the existing capital stock still has economic potential and that enterprises are responding to market incentives to exploit it. (In this context it should also be noted that the evidence in some countries is that, although the private sector is playing a leading role in this process, the recovery is not confined to private enterprises.) Productivity gains are also due to general improvements in efficiency, resulting from the restructuring of output, the shedding of redundant labour, and the adoption of new production methods, often in conjunction with investment in new and more up-to-date machinery and equipment. Assessing the relative importance of these various factors is a matter for further research, but it seems reasonable to assume that the supply-side improvements in industry, albeit far from complete, were an important precondition for many of the eastern European countries being able to take advantage of the new opportunities for rapid export growth to the markets of western Europe.

32. National accounts data for 1995 are still preliminary and in many respects incomplete, especially with respect to net trade, but the general picture is that domestic demand was the driving force behind the growth of output in eastern Europe last year - and behind the continuing fall in Russia and the other CIS States. Private consumption, supported by rising real incomes, has been picking up in a number of countries (Czech Republic, Poland, Romania, Slovakia), especially those where productivity growth has been relatively high. But austerity programmes and incomes policies have held consumption back in Bulgaria, Croatia and Hungary. In Russia, however, falling real wages are the major factor behind falling private consumption (-7 per cent in 1995).

33. Although it is difficult to make precise statements about the contribution of the various components of domestic demand to overall growth (because of the often large statistical discrepancies in the national accounts), it does appear that fixed investment is now playing an increasingly important role in the economic recovery of eastern Europe. This is especially so in those countries

where most progress has been made towards restoring macroeconomic stability, with institutional reforms, and more generally, in providing investors with greater confidence in economic and political stability. Fixed investment last year rose by some 13 per cent in Romania, 15 per cent in the Czech Republic, 19 per cent in Poland and 22 per cent in Slovakia. It probably rose in double digits in Slovenia as well. This investment boom, which was already under way in 1994, is partly making up for a previous neglect of maintenance and replacement, but all new investment is likely to play a role in increasing productive efficiency, whether or not it is intended to expand productive capacity. In contrast with eastern Europe, the recovery of fixed investment in the Baltic States is still weak and hesitant, while in Russia capital formation has continued to fall.

34. In strictly national accounting terms, the real trade balance probably subtracted from GDP growth in 1995, with the volume change of imports outstripping that of exports. (The ECE secretariat estimates that the volume of eastern European exports rose 10-12 per cent last year and imports by 13-15 per cent.) But this ignores the dynamic effects of larger volumes of trade on productive efficiency via an improved division of labour resulting from the extension of export markets and the enhancement of production technology through imports of capital goods.

35. Another important development in the transition economies in 1995 was a sharp decline in rates of inflation, and in many cases by much more than was expected a year ago. In 5 of the 11 eastern European countries for which the data are available, the year-on-year rate of increase in consumer prices in late 1995 was in single digits. There was also a marked fall in the rate of inflation in Russia and the other CIS States in 1995. But despite the fall in rates of inflation - Tajikistan and Yugoslavia were the only countries to go against this general movement - the actual rates still remain very high, especially in the CIS countries but also in some of the eastern European countries. In Hungary, Poland, Romania and the Baltic States, annual inflation is proving to be "sticky", in a range of some 25-40 per cent (and even higher in Bulgaria).

36. These rates, although still influenced by periodic changes in administered prices, appear to be more deeply rooted in the structure of these economies and relatively less amenable to standard stabilization policy. Nevertheless, the current rate of inflation in Poland (28 per cent) does not, for example, appear to be a serious constraint at the moment on fixed investment which, together with further institutional reforms, can be expected to weaken the sources of this inertial or structural inflation. The deceleration of inflation in 1995 in eastern Europe was clearly helped by, among other factors, the rise in output and productivity which more than absorbed the increase in unit labour costs.

37. The strong growth of output in eastern Europe has led to a marked slow-down in the fall of employment levels, and in a few countries (Albania, Bulgaria, Czech Republic, and Poland in 1994; Slovakia in 1995) they have started to increase. Most of the new jobs are in the private sector, particularly in services, and there are a few signs - in Poland, for example - that new jobs created in the private sector may be starting to exceed the number lost in the public sector. The share of the private sector in total employment now ranges

from some 36 per cent in Bulgaria to some 60 per cent in Poland. There has also been some decline since early 1994 in the number of people unemployed, but unemployment rates still remain very high: the average rate in eastern Europe at the end of 1995 was about 13 per cent, with most countries in a range of between 9 per cent (Romania) and 18 per cent (Croatia). Outside this range were the Czech Republic (3 per cent) and Yugoslavia and the former Yugoslav Republic of Macedonia, where the rates were exceptionally high.

38. In the Baltic States employment has continued to fall, although less rapidly than in 1994; unemployment remained more or less unchanged in Estonia and Latvia but rose sharply in Lithuania. In Russia and the other CIS States employment has continued to fall and unemployment to rise.

39. Unemployment rates in the CIS are still much lower than in eastern Europe (an average 5.4 per cent against 13 per cent at the end of 1995). This reflects partly problems of statistics but more importantly the slow pace of enterprise reform in Russia and other CIS countries and an incentive structure which does not encourage the adjustment of employment levels in large enterprises.

40. In general there can be little doubt that unemployment is now a major and growing problem in nearly all the transition economies. In the CIS countries the unemployment statistics are still subject to many qualifications, but in general the evidence suggests that actual unemployment is usually much higher than that reflected in the figures for "registered unemployment". Also, the unemployment problem in the transition economies shares features with that in western Europe: first, the unemployment rate for young people is roughly double the average rate (26-40 per cent out of the total unemployed in eastern Europe are young people below the age of 25), and secondly, the number of long-term unemployed people (those without work for more than a year) has continued to grow rapidly, despite the growth of output and the fall in total unemployment. By the third quarter of 1995, the long-term unemployed accounted for nearly half of all the unemployed in eastern Europe.

41. Unemployment is an increasingly painful experience in the transition economies as traditional safety nets have been weakened under the pressures to reduce public expenditure and with the aim of making labour markets more "flexible". Eligibility rules for unemployment benefits have been tightened, and the period of entitlement and the ratio of benefits to average wages reduced. In 1995, the duration of benefits in eastern Europe varied between 6 and 12 months, while the proportion of the unemployed entitled to receive benefits varied from 22 per cent in Slovenia to 58 per cent in Poland. The ratio of unemployment benefits to average wages, the "replacement ratio", ranged from 27 per cent in Slovakia to 37 per cent in Albania. In general, the conditions for the unemployed are much worse in the CIS countries than in eastern Europe.

42. The foreign trade of the transition economies continued to expand rapidly in the first three quarters of 1995, in both value and volume. In eastern Europe and the Baltic States, imports outstripped exports as a result of the recovery of domestic demand, and there was a sharp deterioration in their trade deficits - from $7 billion to $13 billion in eastern Europe and from $0.6 billion to $0.9 billion for the Baltic States. In contrast, both the value

and volume of exports from Russia and the other CIS States grew much faster than their imports, and their trade surpluses increased considerably - from nearly $15 billion to $22 billion for Russia and from $1.5 billion to $3.5 billion for the other CIS States.

43. Western Europe is now the major trading partner of most of the transition economies, taking some 50-70 per cent of their exports and accounting for a similar proportion of imports. But a more recent development has been the strengthening of trade among the transition economies themselves, with the notable exception of intra-CIS trade, the volume of which has probably continued to fall.

44. The rising trade deficits in eastern Europe were the main reason for the general deterioration in their current account balances: in aggregate, the current deficit almost doubled, to $8.8 billion. Exports of goods and services continued to grow - by some 28 per cent on average, in value terms - but imports rose by about one third. Merchandise imports grew especially rapidly and most of the eastern European countries were in deficit on merchandise trade, but this was offset to a significant extent by the growing surplus on invisibles ($4 billion). In contrast the current account surplus of Russia increased to $10 billion in the first three quarters of 1995, all of the improvement (over the same period in 1994) being due to increased merchandise exports.

45. A remarkable feature of developments in 1995 was a tripling of net capital flows into eastern Europe, from $10.6 billion in 1994 to just over $31 billion. This was far more than required to finance the current account deficits, and there were consequently very large additions to foreign currency reserves in most countries. However, most of the funds (nearly 90 per cent) went to just three countries - the Czech Republic, Hungary and Poland. Since most of the funds were private capital, this distribution seems to confirm the view that foreign investors are attracted to economies when reforms and stabilization policies are in place and credible and when the prospects for growth seem reasonably firm. Such large inflows of foreign capital may create problems for domestic monetary control and there is an additional risk of sudden and disruptive outflows of short-term capital. However, the inflows into eastern Europe consist of a wide range of types of capital, from foreign direct investment (FDI), through portfolio investment to medium- and long-term bank credits. Short-term obligations appear to be a small proportion of the total and easily covered by reserves.

46. The outlook for the transition economies in 1996 is as always subject to the many uncertainties mentioned at the beginning of this section, but official expectations, largely formulated before the extent of the slow-down in western Europe became clear, point to a further strengthening of the recovery in eastern Europe to perhaps an average growth rate of some 6 per cent in GDP. Within this aggregate there is some slow-down in those countries with the highest growth rates in 1995 - Czech Republic, Poland, Romania and Slovakia - but except in Romania, this is fairly marginal, with growth rates remaining in the 5-6 per cent range. However, in the countries that lagged in 1995, Governments expect growth to pick up, particularly in Croatia, the former Yugoslav Republic of Macedonia and Yugoslavia. All countries in the region of south-eastern Europe should gain from the suspension of economic sanctions against Yugoslavia

and the improved outlook for security in the area; the former Yugoslav Republic of Macedonia will also benefit from the ending of the Greek embargo on its transit trade. The outlook for Bosnia and Herzegovina is especially uncertain, but if the World Bank reconstruction programme goes ahead, $1 billion of external financing should be available in 1996 as the programme gets under way.

47. Apart from the uncertainties of the reform process itself, an important element of risk in the outlook for 1996 derives from the increasing ties between the eastern and western parts of Europe. Eastern Europe is now very dependent on western Europe as an export market - nearly two thirds of all its exports now go to developed market economies, which for eastern Europe largely means western Europe. Eastern Europe is therefore more vulnerable to a slow-down in western European import demand, and the signs of a deceleration in the growth of industrial production in several eastern European economies in the second half of 1995 may be a sign of such dependence. The high growth countries in 1995 were generally those which have been most successful in raising the share of their exports going to western Europe; the slow-down in their growth rates in 1996 may therefore be greater than currently expected.

48. Similar considerations apply to the Baltic States, where output is expected to grow in 1996, but much less strongly than in the rest of eastern Europe. Exports of the Baltic States to western Europe have been growing rapidly and now account for probably just over 50 per cent of the total. They too will be vulnerable to a more severe slow-down in western Europe.

49. The outlook for Russia and the other CIS States still remains very uncertain. Considerable progress was made in 1995 with stabilizing the Russian economy, and the increasing optimism about the possibility of a return to growth in 1996 seemed to be supported by a recovery of industrial output in the summer and early autumn. But this improvement was checked towards the end of the year, and the decline resumed in the early months of 1996. Nevertheless, the Russian authorities have reached an agreement with the International Monetary Fund (IMF) on a medium-term strategy and on economic policies for 1996, and this has led to the approval by the IMF of an extended fund facility of $10.2 billion over three years. The new strategy continues the stabilization policies pursued in 1995 but also includes a number of important structural reforms. The success of these policies will largely depend on political developments, but the availability of considerable IMF funding, subject to conditionality and close monitoring, may help to keep them on track, despite increasing popular protests against reforms in the run-up to the presidential elections in June. The projected growth rate for 1996 in the medium-term strategy is 2.3 per cent, but none of the variant forecasts made by the Ministry of the Economy, published in January, show positive GDP growth in 1996.

Notes

1/ The recent comprehensive revision of the United States' national accounts does not allow direct comparisons between earlier forecasts prepared for 1995 and the actual outcome. The growth rate of 2¾ per cent is derived from a rough pro rata adjustment of the OECD forecast published in December 1994.

2/ But see Economic Commission for Europe, Economic Survey of Europe in 1991-1992 (United Nations publication, Sales No. E.92/II.E.1).
