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Economic trends, as well as risks and opportunities, for the economies in the Economic Commission for Europe region

Summary

The present report, based on information available as of December 2005, provides a summary of the assessment of main economic developments, as well as the risks and opportunities, faced by the economies in the Economic Commission for Europe (ECE) region in 2005. The deceleration of growth in the economy of the United States of America during 2005 is expected to continue into 2006, as it is increasingly challenged by a number of structural macroeconomic weaknesses, including low household savings rate, large external deficit and associated indebtedness. Sustained high prices of energy and rising interest rates also constitute important downside risks. The growth outlook for Western Europe remains lacklustre, in particular for the major economies. The recent fall of the euro against the dollar, low interest rates and favourable corporate finances provide some potential for positive impulses to growth. In contrast, growth of the economies of the new members of the European Union is expected to strengthen as a result of stronger exports and increased long-term investment. Growth in the Commonwealth of Independent States countries is expected to remain robust. It is benefiting from higher commodity prices and domestic demand expansion owing to rising wages and expansionary policies. Institutional and structural weaknesses and the need to reduce dependence on primary commodities remain key policy challenges for the region as a whole. Growth in South-East Europe is expected to remain strong but to decelerate somewhat. While increased foreign direct investment inflows would continue, more restrictive macroeconomic policies, to counter expected overheating of these economies, may marginally affect private consumption.

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Western Europe

Recovery fails to gather significant momentum in 2005

1. The recovery in Western Europe was weaker than expected in 2005. Economic growth was dampened by high oil prices, a cautious spending behaviour of private households and a moderate investment propensity in the business sector. Exports were the most dynamic demand factor. For the area as a whole (20 countries), real gross domestic product (GDP) rose by 1.5 per cent compared with the preceding year. In the euro area, average annual economic growth was only 1.3 per cent in 2005, which is significantly below the estimated growth of potential output, which is itself quite moderate at some 2 per cent. As a result, there was a further increase in the negative output gap. A direct consequence of the low growth of trend output is that new adverse shocks always risk pulling down the euro area economy to near stagnation.

2. Annual GDP growth rates of individual member countries of the euro area continued to diverge significantly in 2005 (see annex, table 1), with below average growth in Germany (0.8 per cent) and Italy (0.1 per cent) and a somewhat stronger performance (1.6 per cent) in France. These variations in growth performance can be traced back to the differential strength of domestic demand and changes in net trade. In Germany, the recovery continued to be driven by exports, on the back of strengthened international competitiveness. Domestic demand stagnated and changes in real net exports accounted for all of the increase in real GDP. In France and Italy, a deteriorated international competitiveness entailed that net exports made a negative growth contribution, which was more than offset by the rise of domestic demand (which was moderate in Italy). Outside the euro area, in the United Kingdom of Great Britain and Northern Ireland, annual economic growth slowed down to only 1.8 per cent in 2005, the lowest increase over the past 10 years. This reflects a weakening growth of all major components of final domestic demand, notably a softening expansion of private consumption due to moderating house price increases. Changes in net trade were broadly neutral to economic growth in 2005.

Moderate strengthening of the pace of economic expansion in 2006

3. Against the backdrop of a continued favourable international environment and supportive financial conditions, economic growth in Western Europe is expected to accelerate slightly in 2006. For the whole area, real GDP is forecast to increase by 1.9 per cent compared with 2005. In the euro area, the average annual growth rate of real GDP is forecast to be 1.7 per cent in 2006.

4. The strengthening economic expansion will be driven largely by an increase in fixed investment. Business spending on new equipment is expected to strengthen significantly, following surprisingly subdued growth in 2005. Business investment will be supported by strong corporate profitability, favourable financing conditions and continued robust growth of foreign demand. Construction investment is also expected to pick up somewhat. But the acceleration of investment activity will be limited by the continued moderate expansion of private consumption, the major domestic expenditure item. This largely reflects the situation in the labour markets, where minor increases in employment and wage restraint entail modest gains in labour incomes and, associated with that, real disposable incomes. Household precautionary savings will, moreover, remain high in the face of lingering labour

market risks and ongoing discussions about reforms of pension and health systems. Exports will therefore continue to be the major driver of economic activity in the euro area and Western Europe at large, supported by the ongoing robust expansion of global demand. Changes in real net exports are, however, expected to make only a small positive growth contribution in 2006.

5. In the euro area, weak growth in Germany and Italy (1.2 per cent in both cases), which account for some 45 per cent of euro area GDP, will continue to weigh on the overall economic performance of the area in 2006. In France, real GDP is forecast to increase at a somewhat stronger rate of 1.8 per cent. Growth in Germany will rely to a large extent on favourable changes in net trade, whereas in France and Italy net exports will continue to make a negative growth contribution. Outside the euro area, in the United Kingdom, economic growth is forecast to accelerate to an average annual growth rate of 2.2 per cent in 2006, which is broadly in line with trend output. Net trade is expected to make a small positive growth contribution, a pointer that growth in the United Kingdom has become more balanced than in recent years.

6. The forecast for Germany is subject to particular uncertainty because it remains to be seen what impact the agreed economic programme of the new grand coalition Government will have on business and consumer sentiment and economic activity. Only a limited growth stimulus can be expected from a €25 billion euros spending programme on innovation and investment that will be spread over a period of four years. Some stimulus to private consumption in 2006 can be expected from the likely forward bringing of expenditures in anticipation of the sharp rise in value added tax at the beginning of 2007.

Risks to the outlook are tilted to the downside

7. Risks to the outlook in Western Europe are tilted mainly to the downside. They are related to the possibility of a further pronounced rise in oil prices, a disorderly unwinding of global imbalances and an associated renewed strong appreciation of the euro, and a sharper increase in long-term interest rates in case of a more pessimistic assessment of inflation prospects in financial markets. A potential upside risk could be a stronger than expected response of business investment to rising activity levels in the presence of continued favourable financing conditions and strengthened corporate balance sheets. A sharp fall in house prices from their current elevated levels remains another major downside risk in the United Kingdom and some other Western European economies (France, Ireland and Spain).

Inflationary pressures expected to remain subdued

8. Sharply rising energy prices drove headline inflation in the euro area above the European Central Bank’s 2 per cent ceiling in 2005. But core inflation has declined, a pointer to the absence of demand pressures on non-energy product prices. Growth in labour costs has remained moderate and there are no indications of second-round effects in price and wage setting to compensate for the rise in energy prices. Inflationary expectations, as gauged from 10-year index-linked bonds, have remained stable at close to 2 per cent. Forecasts are for headline inflation to fall back below 2 per cent during 2006. The outlook for inflation is similarly favourable in the United Kingdom, where inflation moved above the Government’s central target of 2 per cent in 2005.

No significant improvements in the labour market

9. Despite the moderate rate of economic growth, employment edged up further in Western Europe in 2005. It rose by about 1 per cent in the euro area but this outcome was influenced by Government measures in some countries that aimed at boosting part-time and self-employment. The average annual unemployment rate in the euro area fell slightly to 8.6 per cent. Looking ahead, employment growth is expected to strengthen moderately in 2006 and the unemployment rate will decline somewhat further, to an annual average of 8.4 per cent.

European Central Bank maintains an accommodative policy stance

10. Monetary policy in the euro area has not changed in 2005 and the European Central Bank's main refinancing rate has been at 2 per cent since June 2003. Concerns about the potential inflationary consequences of the ample liquidity supply and possible lagged effects of the sharp rise in energy prices on price and wage setting has led the European Central Bank to step up the use of moral suasion to prevent a rise in underlying inflationary pressures and an upward shift of inflationary expectations. But the risks to the inflation outlook currently appear to be quite balanced, suggesting that there is scope for continuing the wait-and-see policy until the recovery is better established.

11. The rapid expansion in money supply in the euro area in previous years has been associated with the strong growth of private sector credit, in particular mortgages for house purchases by private households. With the major exception of Germany, low interest rates have spurred housing investment and house prices have risen to quite elevated levels. This contrasts with the relative sluggishness of private consumption and suggests that the transmission of monetary policy stimuli to private consumption via housing market dynamics is weaker in the euro area than in other economies, such as the United Kingdom or the United States of America.

12. In the United Kingdom, the stronger than anticipated economic slowdown in the first half of 2005 led the Bank of England's Monetary Policy Committee to reduce the bank lending rate in August 2005. With inflation forecast to remain close to the central target of 2 per cent and economic growth expected to return to trend in 2006, it can be assumed that interest rates will not be cut further in 2006.

Moderate strength of recovery limits scope for fiscal consolidation

13. In the face of moderate cyclical growth forces, the aggregate fiscal policy stance in the euro area was broadly neutral in 2005. The overall actual government budget deficit edged up slightly to 2.9 per cent of GDP. Fiscal policy is expected to maintain a broadly neutral stance also in 2006. In five economies (France, Germany, Greece, Italy and Portugal), overall budget deficits are projected to remain above the 3 per cent threshold fixed in the Stability and Growth Pact. Outside the euro area, in the United Kingdom, which is at a different stage of the business cycle, the Government is expected to continue the tightening of fiscal policy started in 2005.

New European Union member States

14. Economic activity in most of the eight new European Union (EU) member States from central Europe and the Baltic region continued to be dynamic in 2005

but the pace of growth was uneven across countries (see annex, table 2). Aggregate GDP in the region grew by some 4 per cent in 2005, down from 5.4 per cent in 2004, but the lowering of average growth reflects mainly the economic slowdown in Poland, where GDP grew by slightly more than 3 per cent. The gross domestic product in the other central European economies grew between some 4 and 5 per cent but performance was mixed: compared to 2004, there was some slowdown of economic activity in Hungary and Slovenia, whereas growth picked up in the Czech Republic, reflecting new productive capacity in the foreign direct investment sector. The Baltic States remained the fastest growing of the eight new EU member States, with GDP growing by some 7 per cent on average in 2005.

15. In 2005, the expansion of economic activity in the region comprising the eight new EU member States as a whole was driven mainly by external demand, reversing the pattern of growth that had prevailed in the previous several years. This was achieved thanks to a combination of strong exports and slowing imports, largely offsetting a declining growth contribution of domestic demand, which even became negative in a number of countries. Given the continuing expansion of foreign direct investment-dominated production capacity, exports are set to remain buoyant in 2006 as well. Import growth has become less dynamic, reflecting weaker growth of consumer and investment expenditure; however, it may accelerate in 2007 if domestic demand picks up.

16. Although output growth has decelerated, the recent development of economic sentiment in the three largest central European economies (Czech Republic, Hungary, Poland) implies a favourable short-term outlook for the area comprising the eight new EU member States as a whole. Most of these economies are set to preserve or accelerate their pace of growth and, compared to 2005, the rate of aggregate GDP growth in the region as a whole should accelerate by around one half of a percentage point in 2006.

17. Labour market developments in the new EU member States were on average favourable in 2005 but the positive changes were marginal. Moderately positive rates of employment growth were accompanied by a slight decrease in the unemployment rate in most countries. This was the case in the largest economy in the region, Poland, where, for the first time in years, there was a notable decline in the rate of unemployment which, however, remains the highest among the eight new EU member States. In 2006, employment growth might slow down relative to 2005, reflecting the deceleration in the rate of output growth observed between 2004 and 2005.

18. Apart from the sharp increase in energy costs, in 2005 there was little change in domestic core inflation in the eight new EU member States: labour cost pressures were low due to the persistent weakness in labour markets and there were no policy-induced pro-inflationary side effects. The ongoing gains in labour productivity have also helped contain cost pressures and hence a rise in domestic prices. Core inflation is unlikely to accelerate in the short run in any of the eight new EU member States and may well moderate further in some of them.

19. Macroeconomic policies have been broadly supportive of growth. In most of the eight new EU member States (Hungary being the most significant exception), better than expected fiscal outcomes and low inflationary pressures have allowed the central banks to preserve accommodating monetary conditions. Fiscal deficits are likely to either decline or stagnate in 2006 throughout those countries; however,

the upcoming elections in the Czech Republic, Hungary and Slovakia may be associated with some election-driven spending hikes.

20. The growth in trade (both exports and imports) throughout the region began to taper off in mid-2005 from the more robust pattern in the previous year and the trend is probably set to continue in the short run. Nevertheless, total exports in the first nine months still grew by 15 per cent year-on-year in current euro terms, while the rate of import growth was below 10 per cent. Compared to the same period of 2004, the aggregate merchandise trade deficit of the eight new EU member States shrank by nearly a quarter in current euros. Those countries continue to attract relatively large capital inflows, including significant levels of foreign direct investment, averaging 5 per cent of their aggregate GDP.

21. The principal downside risks to the outlook include a delayed recovery in the euro zone and significantly higher than expected energy prices. The most pressing policy challenges facing the larger new EU member States in central Europe are to achieve sustainable fiscal consolidation and to continue with the implementation of structural reforms for job-rich growth.

South-East Europe

22. Vibrant growth prevailed in South-East Europe in 2005, with aggregate GDP increasing by some 5 per cent (see annex, table 3). The EU accession candidates in South-East Europe (Bulgaria, Croatia and Romania) continued to benefit from rising investor and consumer confidence, reflected in solid flow of inward foreign direct investment, continuing restructuring and expansion of export-oriented productive capacity and improving financial intermediation. Economic consolidation gained momentum in the remaining part of South-East Europe, combining successful post-conflict reconstruction and restructuring and further macroeconomic stabilization.

23. Growth in South-East Europe continued to be mostly driven by domestic demand in 2005. The robust domestic demand (both private consumption and fixed investment) reflects improving expectations supported by an ongoing credit boom. Notably, the surge in domestic demand has been exclusively driven by the private sector while public spending has been less dynamic. No major changes in the overall macroeconomic situation are expected in 2006 and aggregate output in South-East Europe should continue to grow at a relatively high pace.

24. In the first nine months of the year, year-on-year, total South-East European exports increased by a fifth in dollar value and import growth was even stronger. As a result, trade deficits continued to widen in most economies, except in the republic of Serbia, within Serbia and Montenegro,[1] and in the former Yugoslav Republic of Macedonia. However, export performance may weaken in the short run if Western European demand fails to gain momentum and if currencies continue to appreciate in some of these economies.

25. The downside to the present pattern of growth is the prevailing large current-account deficits, which continued to widen in 2005 in several South-East European economies (Bosnia and Herzegovina, Bulgaria, Romania, the republic of Serbia, within Serbia and Montenegro,[1] and the former Yugoslav Republic of Macedonia),

[1] Within Serbia and Montenegro, the republic of Serbia and the republic of Montenegro compile separate current-account balances as they use different currencies.

for the most part reflecting the dynamics of the merchandise trade deficits. Several factors have contributed to the widening of these deficits, including ongoing surge in domestic demand (which is outpacing output); insufficient level of domestic savings; rising energy prices (which have pushed up the merchandise trade deficits); and, in some cases, inflows of speculative capital and/or increased private foreign borrowing. Nevertheless, foreign direct investment inflows continued to increase into the region, especially for the EU accession countries.

26. The policy response to these deficits is complicated, especially when different factors are at play simultaneously. Thus, trying to dampen domestic demand through higher interest rates may induce even larger inflows of speculative capital, and vice versa. The authorities resorted in 2005 to various types of credit restrictions and tighter bank regulations in an attempt to cool down the credit boom and foreign borrowing although further liberalization of the capital account has been the ongoing longer-run trend, especially for the EU accession countries.

27. The labour markets in the EU accession candidates benefited in 2005 from the expansion of economic activity in 2004 and some progress in labour market reforms, and this is likely to continue in 2006. The rest of the South-East European subregion was characterized by very high unemployment and persistently feeble employment growth. The ongoing enterprise restructuring and the structural nature of unemployment suggest no major improvement in the labour market situation in those countries in 2006.

28. In most of the South-East European economies, disinflation continued in 2005, reflecting a further tightening of the macroeconomic stances and low levels of domestic cost pressures. Growing competition in local markets has prevented the passing of demand pressures onto domestic prices. These effects are likely to carry on in 2006 and therefore the pressures on core inflation should remain relatively subdued.

29. The main risks to the outlook in South-East Europe are related to the excessive reliance on domestic demand as a source of growth. While the imminent risks of macroeconomic destabilization in these economies remain low, policy should target a shift towards export-led growth which, in turn, should help reduce the external imbalances. As monetary policy so far has not produced satisfactory outcomes, the authorities may resort to further fiscal restraint in their attempt to curb these deficits and this may have negative implications for economic activity and growth.

Commonwealth of Independent States

30. The pace of economic expansion in the Commonwealth of Independent States (CIS) slowed down somewhat in 2005, after two years of exceptionally strong growth: aggregate GDP increased by slightly more than 6 per cent in 2005, after having grown by 7.6 per cent in 2003 and 8.1 per cent in 2004 (see annex, table 4). That outcome reflects a moderation of growth in the two largest economies, the Russian Federation, and in particular Ukraine, where the slowdown was particularly pronounced. The smaller economies fared better, with the notable exception of Kyrgyzstan.

31. External factors were generally supportive in 2005, with oil and gas prices reaching new highs, but there were adverse developments as well. Softer steel prices

and sharply lower cotton prices exerted a negative influence on the economies specializing in these commodities. Domestic demand remained the main driver of economic expansion in the CIS. Robust consumer demand played a key role while fixed investment was less dynamic in some of the largest economies, including the Russian Federation. Imports were strong, fostered by robust domestic demand and the ongoing appreciation of real exchange rates. A temporary slowdown in the growth of oil production in the Russian Federation triggered by production bottlenecks reduced export growth despite a favourable price environment. This coincided with a sharp deterioration of export performance in the second largest CIS economy, Ukraine, resulting in an overall increase of the negative contribution of net external demand to GDP growth in the CIS.

32. The pace of economic activity in the CIS as a whole should remain broadly unchanged in 2006. Robust domestic demand, progress in economic restructuring and recovered oil shipments should allow the Russian Federation's economy to preserve its dynamism in 2006. The development of the hydrocarbons sector in the other two main producers, Azerbaijan and Kazakhstan, will continue to fuel sustained investment and output growth, even under less favourable price conditions. The slowdown in Ukraine, which contributed significantly to the lower rate of aggregate GDP growth in the CIS in 2005, is expected to come to an end; the improvement in the business climate and a recovery of steel prices should allow for faster growth in 2006.

33. The relatively fast economic expansion in 2005 (as well as in the previous several years) was mostly achieved owing to strong output performance in sectors that are not labour-intensive. Moreover, similar to other emerging market economies in the region, the labour markets in the CIS are characterized by a lagged response to changes in the aggregate output dynamics, suggesting a relatively high degree of labour hoarding. Therefore, there was only limited amelioration of the labour market situation, even in countries that experienced high rates of economic growth. In the oil-exporting countries, employment increased only marginally compared to the rate of output growth, while unemployment rates did not decrease significantly. The other CIS countries achieved even lower rates of employment expansion. The prospects for a perceptible improvement of the situation in the labour markets hinge upon the growth performance in labour-intensive sectors (such as services) and the facilitation of intraregional labour mobility through the establishment of an adequate legal framework and social policies.

34. In most CIS countries, inflation accelerated further in 2005, underpinned by the generally expansionary stance of fiscal policies and the pro-inflationary effect of fast-rising household incomes and energy costs. In many CIS economies, the official year-end target rates for 2005 are expected to be overshot, in particular in the Russian Federation and Ukraine. Industrial producer prices rose even faster, in particular in Kazakhstan and the Russian Federation. Given the inherent inertia, a further rise in inflation in the CIS cannot be excluded in the short run. Taming the inflationary pressures would require a more comprehensive policy approach and a major policy effort towards fiscal consolidation.

35. Macroeconomic policies were generally supportive to growth in 2005, with an ongoing pro-cyclical loosening in fiscal policy and expansionary monetary policy in commodity exporters. The strength of oil prices has exacerbated the old dilemma faced by monetary authorities in the oil-exporting CIS countries, as they attempt to

moderate the pace of real exchange rate appreciation in the presence of strong inflationary pressures. A higher degree of exchange rate flexibility may be required to prevent inflation from becoming entrenched. The rapid credit expansion and growing foreign liabilities in the private sector are further risks that need to be appropriately monitored.

36. Merchandise exports from the CIS continued to expand rapidly during 2005 for the energy and commodity exporters, in particular the Russian Federation, Kazakhstan and Azerbaijan. Robust domestic demand pushed up the value of imports as well, but at somewhat slower rates. Trade with non-CIS partners was expanding much more rapidly than intra-CIS trade. Most energy and commodity exporters achieved significant merchandise and current account surpluses and sizeable increases in their foreign exchange reserves. Those trends should persist into 2006 as long as there are no dramatic declines in world energy prices. The remaining CIS countries are likely to continue to rely on external finance in order to cover moderately sized current-account deficits.

37. The management of the oil resources boom has been reasonably prudent and the stabilization funds function efficiently. In the Russian Federation, the expansionary effect of high oil prices in 2005 was significantly reduced by changes in the taxation system. However, the ongoing shift towards fiscal easing increases the vulnerability of public finances to external shocks. Plans for further fiscal expansion are under way in a number of economies, including the Russian Federation, with the declared goal of providing further impulse to economic activity. However, given the generally low domestic supply responsiveness, a significant part of this stimulus is likely to leak into higher imports.

38. The short-term outlook for the CIS economies remains generally positive as a possible weakening of oil prices is likely to be moderate and have limited consequences. The main challenge faced both by commodity exporters and the rest of the CIS economies is to create appropriate conditions for increased business investment, which is necessary to address the erosion of competitiveness posed by appreciating exchange rates and to broaden the basis of economic expansion beyond the narrow basis defined by specialization in a handful of commodities.

Annex

Table 1
Annual changes in real GDP in Western Europe, 2004-2006
(Percentage change over the previous year)

	2004	*2005*	*2006*
Austria	2.4	1.9	2.1
Belgium	2.6	1.4	1.8
Finland	3.6	2.1	2.9
France	2.3	1.6	1.8
Germany	1.6	0.8	1.2
Greece	4.7	3.2	2.9
Ireland	4.5	4.7	4.6
Italy	1.2	0.1	1.2
Luxembourg	4.5	4.2	4.4
Netherlands	1.7	0.6	1.8
Portugal	1.2	0.9	1.4
Spain	3.1	3.3	3.1
Euro area	2.1	1.3	1.7
Denmark	2.1	2.4	2.2
Sweden	3.6	2.5	2.9
United Kingdom	3.2	1.8	2.2
EU-15	2.3	1.4	1.9
Norway	2.9	3.7	2.8
Switzerland	2.1	1.2	1.7
Western Europe-17	**2.3**	**1.5**	**1.9**

Table 2
Annual changes in real GDP in the eight new EU member States, 2003-2006
(Percentage change over the previous year)

	2003	*2004*	*2005*	*2006*
Czech Republic	3.2	4.4	4.8	4.4
Estonia	6.7	7.8	7.1	6.5
Hungary	2.9	4.6	3.9	3.9
Latvia	7.2	8.3	8.5	6.6
Lithuania	10.5	7.0	7.0	5.6
Poland	3.8	5.4	3.1	4.3
Slovakia	4.5	5.5	5.5	5.4
Slovenia	2.5	4.2	3.9	3.9
New EU member States	**3.9**	**5.3**	**4.1**	**4.5**

Table 3
Annual changes in real GDP in South-East Europe, 2003-2006
(Percentage change over the previous year)

	2003	*2004*	*2005*	*2006*
Albania	5.7	5.9	6.0	6.0
Bosnia and Herzegovina	3.2	4.0	5.5	5.0
Bulgaria	4.5	5.6	5.5	5.2
Croatia	4.3	3.8	4.0	4.5
Romania	5.2	8.3	5.0	5.5
Serbia and Montenegro	2.1	8.0	5.3	5.0
The former Yugoslav Republic of Macedonia	2.8	2.9	4.2	4.0
South-East Europe	**4.5**	**6.9**	**5.0**	**5.2**

Table 4
Annual changes in real GDP in the Commonwealth of Independent States, 2003-2006
(Percentage change over the previous year)

	2003	*2004*	*2005*	*2006*
Armenia	14.0	10.1	10.0	8.0
Azerbaijan	11.2	10.2	23.0	15.0
Belarus	7.0	11.0	8.5	7.5
Georgia	11.1	6.2	7.0	6.0
Kazakhstan	9.3	9.4	8.8	8.3
Kyrgyzstan	7.0	7.1	1.0	5.0
Republic of Moldova	6.6	7.3	8.0	6.5
Russian Federation	7.3	7.2	5.9	5.8
Tajikistan	10.2	10.6	5.5	8.0
Turkmenistan	3.3	4.5	5.0	5.0
Ukraine	9.6	12.1	3.0	6.0
Uzbekistan	4.4	7.7	7.0	7.0
CIS	**7.6**	**8.1**	**6.2**	**6.3**