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# Wirtschaftsentwicklung in ausgewählten mittel- und osteuropäischen Ländern 1997/98

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# Summary


## Poland

With inflation falling, Poland has recorded for more than four years the highest level of growth in the central eastern European countries (1993-1997: annual average of 5.8%). In 1997 the trend of recent years continued with an economic growth rate of 6.9%. On the strength of these figures it is safe to say that the flood catastrophe in the summer of 1997 (causing financial losses amounting to about 2% of the GDP) barely affected the country's economic upswing. The progress made in the transition process is reflected in the fact that almost two-thirds of all jobs are now to be found in the private sector.

In 1997, as in the previous year, the domestic demand components (+9%) made the leading contribution towards the increase in the GDP, but significant growth impetus also came from exports (+11.5%). The vigorous increase in investments (+21.9%), which was carried by the dynamic domestic economic situation, suggests that Poland has entered a phase of self-supporting growth and restructuring. This development is also nourished by the fact that the general environment for investments has improved in the financial market sector and that increasing amounts of foreign direct investments are flowing into Poland (influx: approximately 6.6 billion US$)

As a result of the sharp rise in investments and dynamic growth in terms of private consumption (+7%) the current account deficit has increased to 4.3 billion US$. As this deficit is moving within a relatively safe margin of 3.4% of the GDP, there is no likelihood of a currency and economic crisis like that in the Czech Republic. Nevertheless, the situation is to some extent worrying in that the growth in consumption was fed not only by higher real wages (net +6.8%) but also by increasing consumer credits. On the supply side, the dynamic growth in industrial output (+10.8%) was again the driving force behind economic growth, which was mainly achieved through an increase in productivity. While the agricultural sector stagnated, the construction industry recorded an impressive growth rate of 16%. The sustained improvement in the economic situation is also reflected in mounting corporate profits and falling unemployment (10.5%).

In 1998, Poland will probably achieve - in spite of its rather cautious macro-economic policy - a high growth rate of about 6%, with a lower rate of inflation (approximately 11%) and a small budget deficit (1.5% of the GDP). Although the current account deficit will increase, it will remain with a relatively safe margin (5-7% of the GDP). However, with all the country's economic successes, it should not be forgotten that Poland is facing major economic challenges: a cautious monetary and fiscal policy together with structural reforms and institutional adjustments will be needed in order to fulfil the conditions for membership in the EU.

## Czech Republic

Since the end of 1994, the disproportionate development of labour income and productivity had caused a rapidly rising current account deficit, with the result that the increasing overvaluation of the Czech crown led to a currency crisis in the spring of 1997. On 26th May 1997, after holding on to the fixed exchange rate anchor for many years, the parity of the Czech currency collapsed in the face of the basket of US-$ and DM.

The austerity programme introduced by the Klaus government worked together with the stability-oriented monetary policy of the central bank to keep the economic crisis within limits and already initiated what may be a reversal of the trend. The restriction of demand in 1997 led to a decrease in real GDP growth to only 1% (after 3.9% in the previous year) and a rise in the unemployment rate to 5.2%, but the current account deficit could be limited to 6.1% of GDP after 7.6% in the previous year. In order to stabilise the economy further, the present provisional government is employing a mixture of macro-economic and income policies. The budget deficit for 1998 is set at 1% of GDP; a continuing restrictive monetary policy is designed to guarantee the gradual decrease of core inflation and a stable nominal exchange rate vis-à-vis the DM; a more restrictive wage policy in the public sector is to orient the growth of incomes towards growth in productivity; reforms and privatisation in the banking sector will restore confidence in the capital market. Under these circumstances a real GDP growth of 2-2.5% is expected this year, together with a moderate decrease in core inflation to 5.5-6.5% (with a simultaneous rise in the overall inflation rate – taking into account effects of price deregulation – to approximately 11%) and a rise in the unemployment rate to 6-7%. Under these conditions the current account deficit should be forced down to below 5% of the GDP.

After increasing discrepancies within the liberal-right coalition and following the currency crisis, the government resigned on 30th November 1997, thus ending the five-and-a-half-year era of Prime Minister Klaus. This was triggered by a donation scandal in his party; in the meantime all the larger parties have been hit by similar affairs, including the opposition Social Democrats favoured so far in the public opinion polls. The party-political landscape is at present quite unstable. In the middle of December President Havel, who has since been re-elected, appointed Josef Tošovský prime minister. Tošovský, past president of the central bank, is now leading an interim government up to the early elections already scheduled for June 1998. The latest opinion polls suggest that there is hardly any chance of a government without the participation of the Social Democrats. This would certainly mean no fundamental setback for the transition to a free market or the increasing integration of the country in the world economy; the economic programme of the Social Democrats might, however, lead to a more expansive fiscal policy, and delays in the pending privatisation of the banking sector could not be ruled out.

## Slovak Republic

Even though 1997 once again witnessed an impressive real growth of 6.5%, accompanied by an inflation rate of only 6.1%, the "double deficit" in current account and budget has not been decisively reduced. The budget deficit increased to 5.7% of GDP. Although the current account deficit was limited to 6.9% of GDP through import restrictions, it is still not sustainable, and export dynamics is still pending. More than three quarters of real GDP growth were due to the 14.5% rise in gross capital formation, which by now amounts to more than 38% of GDP. With only moderate increases in industrial labour productivity, the efficiency of this huge investment ratio must, however, be doubted.

The external imbalance only partly reflects an overvalued currency, but is, in fact, mainly the result of expansive fiscal and conserving structural policies responsible for both permanently high unemployment rates of 12–13% and relatively low productivity growth in industry. The conflict with the stability oriented monetary policies of the National Bank is resulting in continuously high interest rates crowding out investment by small and medium sized firms, while external indebtedness, already amounting to 56% of GDP, is growing enormously. While the Slovak crown lost about 10% against the US-$ during 1997, it had to rise by 5% against the DM, in order to stay within the fixed currency band. The limited international exposure of the Slovak foreign exchange market has helped to delay an outright devaluation so far, but the possibility of a crisis after the South-East Asian pattern can no longer be excluded.

If the conflict between fiscal and monetary policies should persist, and – not very realistically – supposing that the currency will remain relatively stable, continuously high real interest rates and planned cuts in public investment, which may not suffice to keep the budget deficit below 5% of GDP, will slow down GDP growth to about 4.5% in 1998 implying stagnating unemployment rates at around 13%. Consumer prices would go up by about 6%, the current account would be around 6% of GDP, and external indebtedness should surpass 60% of GDP. These expectations contain a considerable currency risk. If the external imbalance should lead to the hitherto avoided devaluation in the order of 10–15% against the basket of DM and US-$, which would imminently influence the solvency of banks and enterprises, all forecasts for the second half of 1998 would have to be corrected considerably to the worse.

1998 is a decisive election year: At the beginning of March, president Michal Kovác's five years term of office came to an end, parliament not as yet having been able to find a majority for a successor. As all presidential competencies have therefore passed over to government or prime minister, the already conflict-ridden domestic situation, which led to the country's being excluded from the first round of the EU's Eastern enlargement, is passing into a true democracy crisis. The parliamentary elections in October 1998 might, depending on the outcome, lead to a withdrawal from the prospectless economic policies of the present government, the difficulties of a truly fresh start in economic and structural policies should, however, not be underrated.

## Hungary

Hungary finally reached the economical turning point and for the first time since the beginning of transition registered a considerable economic growth of 4.4%. This clearly surpassed the government's forecast (+2%). Exports (+19.5%) and investments (+8.2%) were the essential growth engine, compared with which private consumption was only slowly beginning to take off. In 1998 exports and investments are again expected to generate a large GDP increase of approximately 5%, with stronger impulses also being expected from private consumption. The soundness of the growth process can be recognised in the fact that at the same time the current account deficit was forced down to approximately 2% of the GDP (1994: 10% of the GDP) due to considerable increases in exports.

Hungary's stabilisation and economic upswing are based on solid financial and real-economic foundations. In the financial area the government deficit was brought down from 9.6% in 1994 to 4.6% in 1997. For 1998 a deficit of 5% of the GDP is planned. Inflation decreased, but at approximately 18% is still on a high level. For 1998 a price increase rate of approximately 15% is expected. In real economic terms the growth process is based on large increases in productivity, which reflect the progress that has already been made in the privatisation and restructuring of the economy. It is also reflected in the high level of foreign direct investments (which are likely to be 1.8 billion US$).

## Slovenia

The Slovenian economy could not sustain the economic dynamism that had showed signs of increasing at the end of 1996. Stability-oriented monetary measures as well as the lengthy formation of a new government and the extremely late approval of the budget all contributed towards restraining growth. The fact that the growth rate of the previous year was reached again at approximately 3% and that it even accelerated again in the last months of the year is to be attributed to the increasing demand from abroad. Domestic demand remained slack. This rate of growth was not high enough, however, to reduce unemployment. The unemployment rate remained at a relatively high level (7%, according to the figures collected by the ILO, and 14%, according to official national data).

Despite a further liberalisation and adjustment of administrative prices, the inflation rate remained just short of double figures at the same level as in the previous year. The central bank successfully steered against the upward trend in prices, without the influx of short term foreign capital becoming a serious danger. It seems that the budget deficit which loomed in the course of the year itself could be avoided. Since the monetary and interest policy must bear the large part of the stability policy, the central bank does not yet wish to do without administrative restrictions on the short-term movement of capital. The treaty of association with the EC still permits these measures for some time. The high real interest rates in Slovenia are not primarily due, however, to the restrictive monetary policy. Slovenia has to cope with considerable institutional shortcomings, which could possibly endanger its good position among the transition countries. Although the reorganisation of the banking sector is making some progress, there is still a lack of sufficient competition. Thus the interest spread in Slovenia is extremely high and hampers the restructuring process and the growth of the economy. The transition of social property has largely been completed. At the same time, however, the state's share of property increased even further. The privatisation of this property has still to be started and must take place as quickly as possible. Since insider privatisation has dominated so far, the Slovenian economy is wrestling with substantial corporate governance problems, which impair the productivity of the economy. Only the rapid development of a secondary capital market can provide a quick remedy. The waiting periods for the sale of the shares must be cut and foreign capital more strongly involved.

Slovenia continues to record a balanced current account. Tourism is developing strongly and is compensating for the deficits in the balance of trade. The foreign indebtedness does not constitute any problem despite the assumption of part of ex-Yugoslavia's debts. To a minor extent, Slovenia is in fact a creditor nation. Since direct investments have also begun to increase after being rather meagre, the foreign trade flank is largely secure. With its small domestic indebtedness and the low budget deficit, Slovenia has the best chances of resisting turbulence from the international financial markets. This also justifies Romania's entry into the first group of candidates for admission to the EC. The Slovenian government also wants to lower inflation before any possible admission date to such an extent that it even satisfies all the Maastricht criteria. For 1998 a slight increase in growth is expected together with a largely balanced national budget and balanced foreign trade and payments. Without the expected acceleration of institutional reforms, this target could, however, be put in jeopardy. These reforms must therefore be stepped up.

## Romania

In 1997 the Romanian economy suffered a heavy setback, which is to be attributed essentially to the lasting effect of the previous government's omissions in terms of law and order and delayed reforms. But the political climate deteriorated in 1997 too as a result of disputes within the government coalition and this obstructed the restructuring process. The effects of the environmental legacy and more recent delays in restructuring resulted in the GDP falling by a real 6.6%, while inflation rose to an annual average of 154.8%, which was due in particular to the sharp increase in the first quarter.

The new, more reformist government coalition under Prime Minister Ciorbea, which has the majority in parliament and the senate, had set itself the goal of launching a radical reform programme in order to take Romania as quickly as possible up to the level of the advanced transition countries in both economic and political terms and thus to secure its entry to the EC and NATO in the first extension phase. In February 1997 the new government introduced landmark measures involving the liberalisation of the foreign exchange market, the deregulation of prices and extensive cancellations of subsidies. As an indication of its recognition of Romania's new economic policy, the IMF resumed in April 1997 its co-operation, which it had suspended in April 1996, and signed a new stand-by agreement (431 million US$ to 5 layers). The implementation programme introduced by the government in February, however, proved to be more difficult than expected because of internal political resistance and concessions. The process of restructuring and privatisation fell short of expectations despite the initial progress that was made. After some initial turbulence, a restrictive monetary and fiscal policy improved the stability of prices and the exchange rate by the middle of the year. Towards the end of the year, however, a relaxing of the monetary and fiscal policy led to inflation increasing again. Unemployment reached a year-end position of 8.8% because of the closure of many desolate state enterprises and the strong downward economic trend and will probably continue to rise in 1998 in view of the pending restructuring measures.

The bouquet of laws, which was passed in January 1998 in an extraordinary parliamentary sitting (concerning privatisation, foreign investments, the purchase of real estate and banks), is designed to give new impetus to the reform process, which almost came to a standstill. An indispensable condition for this, however, is a rapid solution to the present government crisis. The budget prepared in co-operation with the IMF sees for 1998 a continuation of the austerity programme, with the focus of economic policy being laid on the restructuring of further state enterprises and the creation of a stable legal framework as a means of creating the conditions for economic recovery. The National Commission for Prognosis reckons with positive figures in 1999 after zero growth in the current year.

## Bulgaria

After the massive political and economic crisis in 1996, which reached its peak in the spring 1997, Bulgaria is now on the road towards stability. The new government under Prime Minister Kostov, in office since the early elections on 27th April 1997, managed to create a broad political consensus for a consistent programme of stabilisation and reform with the support of the IMF. The central features of the new government programme are the accelerated continuation of economic reforms, including the privatisation of banks and enterprises, the desired entry of Bulgaria to the EC and NATO, the improvement of the investment climate as well as the fight against corruption and organised crime.

The greatest success in the past year was the stabilisation of the financial situation. With the introduction of a Currency Board on 1st July1997 the Bulgarian currency was bound to the DM at a fixed rate of 1000 leva for 1 DM. Through the financial discipline implied in the introduction of the Currency Board it was possible to break through the devaluation-inflation spiral within a short time and reduce inflation to a monthly rate of between 0.5% and 1.5% by the end of the year. By means of a strict budgetary policy, it was possible to reduce the budget deficit even below the target to 3.9% of the GDP, but this was achieved at a considerable cost to the economy, however.

Together with the structural reforms that were introduced, this created the basis for a turnaround in the current year. Due to rising investments and the further liberalisation of foreign and domestic trade, the Bulgarian government expects the GDP to grow by 4% in the current year (1997: -7.4%), with inflation being reduced further to 16% by the end of 1998 (1997: 578%). In the wake of an invigorated economy and attractive investments there will be an expansion in the granting of credits and the interest level will rise. Increasing imports of capital goods will probably lead for the first time in years to an albeit not too large deficit in the balance of payments. The expected further increase in foreign direct and portfolio investments as well as loans from international financial sources will contribute to a further growth of foreign exchange reserves.

In view of the limits set by the Currency Board regime, the consolidation strategy can only be maintained in the medium term if simultaneous improvements are achieved on the supply side. In particular, the restructuring and privatisation of loss-generating state enterprises must be stepped up and the strong influence of the state must be reduced in some areas, particularly in the agricultural sector. The most necessary step is the creation of a stable legal system in order to create a solid basis for the development of private investments. The maintenance of the political consensus for a consistent reform policy will become increasingly difficult in 1998 in view of the growing conflict over corruption and organized crime.

## Croatia

After the peaceful reintegration of East Slavonia as well as further progress in the implementation of the peace treaty of Dayton, there was a further distinct improvement in the prospects for durable peace. The Croatian economy, which had already registered a remarkable surge in 1997, profited from this too. With an estimated growth of 6.5%, the upswing seen in 1996 (+4,3%) continued with vigour. Despite a somewhat relaxed monetary and fiscal policy, inflation was kept down to 3.6% again, a very low rate compared with that of other reform countries.

On the supply side, the construction industry is booming and tourism continues to expand, both contributing to the rise of the GDP. In addition, for the first time since the acquisition of independence, industrial output accelerated strongly (+6.8%). It is worth noting that, due to restructuring, traditionally strong branches like textiles and the furniture industry recorded high growth rates again after the dramatic losses in 1996. Overall, industrial productivity rose by 11.9%. Employment in the industrial sector fell by 5% and was not able to contribute towards reducing the pressure on the labour market situation.

As far as demand was concerned, economic growth was promoted by a sharp increase in domestic consumption. There was a distinct increase in both private consumption (due to rising real income) and investments. The budget deficit rose to 2.3% of the GDP, which is still far below the Maastricht criteria Croatia is using as an orientation mark. On account of the sharp increase in imported goods, the current account deficit rose to roughly 9% of the GDP for the year 1997 as a whole, although this was also partially due to the revaluation of the dollar. (Long-term) capital influx and mounting direct investments meant that the deficit could be financed without any problem. The foreign indebtedness rose only moderately to date and is below 30% of the GDP.

For 1998 a more restrictive monetary and fiscal policy (with a planned budget deficit of 1.6% of the GDP) is intended with the aim of generally curbing demand. An export-oriented economic policy is intended to contribute to reducing the trade deficit. Devaluation for the purpose of improving the current account is categorically rejected by the central bank, in order to let no doubt arise as to the stability policy. On the contrary, competitiveness is to be increased by improving the conditions of supply, above all by reducing the high wage costs as well as by accelerating the structural reforms (privatisation). Mounting receipts from tourism and direct foreign investments will promote growth in 1998 too. Due to the necessarily more restrictive policy devised with the aim of cutting the deficit in the current account, the growth rate will be – at an estimated 5% – somewhat lower than in 1997.

## Bosnia-Herzegovina

Economic development in Bosnia-Herzegovina was marked in 1997 by opposing tendencies in the Bosnian-Croatian Federation on the one hand and the Serbian Republic on the other. In the Federation, the GDP increased in 1997 by 37%, compared with 55% in 1996, which was clearly above the increase of 19.2% quoted by the statistical office of the Serbian Republic, a figure that experts even regard as being too high. There are no figures available on the GDP in the Serbian Republic in 1997. According to the latest estimates, however, the Serbian Republic has again achieved a rate of growth that is way below that reached in the Federation. On account of the high rates of growth in recent years, the Federation has already recovered about 50% of its economic performance from before the war. The Serbian Republic has a long way to go in that respect. The economic recovery in the Bosnian-Croatian Federation is led by the industrial sector. About one third of the enterprises have started production again, and in October 1997 output was about 50% higher than the annual average of 1996. The Serbian Republic has just about reached half of this growth rate.

The upswing in the Federation has been sustained to date by the financial aid of the international community of states, which under the leadership and with the financial co-operation of the World Bank and the IMF is financing the projects involved in the rebuilding of the country. In 1997 1.4 billion US$ reached Bosnia-Herzegovina; in 1998 a further 1.1 billion US$ is expected. After the election of Dodik, who is considered a moderate, to the head of government in the Serbian Republic, the World Bank started providing financial aid there too. This nurtures the hope that economic recovery will now speed up in the Serbian Republic too. It is also expected that a single economic area will – however gradually – come into being. But this was still a long way off in 1997. All the important decisions affecting the entire state had to be made by the High Commissioner for Bosnia, the ex-Foreign Minister of Spain. He had at his disposal, among other things, a joint currency, the convertible mark, which will be valid for eighteen months at first and is bound to the DM at a ratio of 1:1.

According to official figures, unemployment in the Federation is around 85% and just over 70% in the Serbian Republic. Even if these figures are too high, they demonstrate quite clearly the most urgent task at present: the creation of jobs. Privatisation, which is to be launched in 1998 both in the Federation and in the Serbian Republic, is intended to secure economic growth in the long term and create profitable jobs. However, the privatisation law that had only just been passed in 1997 in the Serbian Republic was withdrawn again by the new government under pressure from the World Bank. Whether privatisation will really begin this year, therefore, appears to be rather questionable. In the Bosnian-Croatian Federation, however, a start is to be made in May with the privatisation of enterprises and the banks. Shares can be purchased by means of coupons which have been issued to the public free of charge. This means that privatisation is not expected to generate any receipts for the time being. Foreign capital will not play a role until a later point in time either. As a result it is very probable that the ensuing structures will not contribute much to the reorganisation of the enterprises.

## Yugoslavia

In 1997 the Yugoslavian economy suffered from the "external wall of sanctions", which continues to isolate the country from the international financial markets. Although official statistics claim that economic growth reached 7.5%, experts estimate that the GDP only increased by 4%. The development in industrial output was the major disappointment. After a good start, it lost much of its verve in the course of the year and only arrived at an annual average increase of 6%. This is to be attributed in the main to the totally insufficient volume in investment activity. The capital stock is run-down as a result of the UN embargo and there is a correspondingly large need for investments. The only means the factories have at their disposal to restore and extend the capital stock is their cash flow, but in the majority of cases the enterprises' cash flow is negative. And foreign direct investments only make a small contribution to renewing the capital stock. According to official statistics over 300 million US$ were invested by foreigners (not including the sale of the Telekom) but two large German investments accounted for about 100 million DM of this alone The government expects a growth rate of 10% in 1998, but this is based on the understanding that the outer wall of sanctions is lifted. As this is improbable and new sanctions are even being discussed and preferential treatment cancelled, this target is very unlikely to be achieved. The actual growth rate is more like to be between 3% and 5%.

The budget deficit in 1997 is supposed to have been in the range of 10% of the GDP. It was "financed" by the non-payment of wages and pensions. With an official unemployment rate of 26% and a concealed rate of a further 15% to 20%, about a quarter of the population are living below the subsistence minimum.

Economic growth in 1997 was fed as in the previous year by imports, which led to a new record deficit of 2.43 billion US$ in the balance of trade. A deficit of this order is not sustainable for a country that has no foreign currency reserves and no access to the world capital markets. On 1st April 1998 therefore the government gave in to pressure from the central bank and devalued the dinar by just under 82%. The new parity to the DM is 6 dinars to one DM, after 3.3:1; at the same time the DM was recognised as an official means of payment. Devaluation will again accelerate the rise in prices considerably in 1998 after a state of relative stability had been reached in 1997 with an inflation rate of 18.5%. But the devaluation of the dinar will not be sufficient to fortify the competitive strength of the economy to any decisive degree. Consequently, even before the end of 1997, the government announced the next step, which would take the form of comprehensive privatisation. Enterprises in state or co-operative ownership still provide 90% of the jobs and produce about two-thirds of the GDP. Within the space of two years 80% of the state enterprises are to be privatised. It is very doubtful, however, whether the required structural changes can be achieved by means of privatisation. On the one hand, privatisation usually turns out to be nothing but insider privatisation on familiar lines. And on the other, privatisation is not obligatory but is up to the discretion of the enterprise concerned. And in particular it does not provide the enterprises with the crucially important access to new capital.

## Macedonia

The economic recovery that began in Macedonia the year before continued in 1997. The GDP growth rate was almost twice as high as in the previous year and reached 3%. A further acceleration is expected in the current year, with the growth rate reaching about 5%. As in the previous year public investments and the positive development of industrial output were the driving forces behind the upswing. And it is public investments that will make the decisive contribution to the economic situation in the foreseeable future. This means that the dependence on financial aid from the international financial institutions and other foreign creditors will be maintained, since the volume of domestic savings is by no means large enough to finance the high gross investments.

The progressing deterioration in the balance of trade and payments had reached disquieting proportions in the first half year of 1997 and finally made a devaluation of the Macedonian denar inescapable. Devaluation came in July at 16.1% with the agreement of the IMF and was accompanied by wage controls and a stricter monetary and fiscal policy. In the second half of the year inflation began to accelerate but remained – at an estimated 7-8% – within the range expected a year ago. The state budget was also remarkably stable. In spite of an unforeseeable shortfall in receipts, the deficit was kept down to 1.5%. A slightly increased budget deficit of about 2% is expected in 1998 because the government has since adopted a more active labour market policy.

The situation on the labour market became more tense in 1997. The employed work force declined again for the seventh year in sequence. The fact that the unemployment rate has not reached 50% is largely due to the agricultural sector, in which many families live in a self-sufficient economy and are waiting as hidden reserves for the economic recovery to reach the labour market. Nevertheless the increase in productivity that has been sustained for some years now made it possible for real wages to be increased in 1997 for the first time in three years.

Economic stability will continue to be overshadowed by the unstable political situation in the region. The UN have already taken precautionary measures aimed at preventing the unrest in Kosova from spreading to Macedonia. Nevertheless, any worsening of the crisis in Kosova would certainly be a major obstacle in the progress of this newly born economic recovery.

## Albania

Albania's economic development in 1997 was marked by the large-scale disintegration of law and order at the beginning of the year when enormous numbers of weapons got into the hands of the population. This situation was triggered by the collapse of the pyramid schemes, which had shot out of the ground like mushrooms in 1996 and which the old government had refrained from interfering with despite the warnings of the international financial organisations. This unrest (losses through the pyramid schemes and the vandalism of capital stock) is estimated to have caused an overall financial loss to the national economy of approximately 2/3 of the 1996 GDP. The political damage is no less dramatic.

This turbulence put a sudden end to the promising beginnings of economic stabilisation and growth. Destabilising economic errors dating back to the time before the election could no longer be reversed and they were dramatically reinforced in their effect. According to latest estimates the GDP sank by approximately 8%. There was a sharp decline in investments. Real income fell dramatically. Albania hence reinforced its reputation again as the poorhouse of Europe. Public revenue dropped over-proportionally and the budget deficit grew. Under these circumstances it is to be considered a success that the inflation rate could be kept down to approximately 40%. Although agriculture's enormously large share of about 60% in the GDP ensures an extensive self-sufficient economy and has to some extent provided a retreat for the increasing number of unemployed workers, international assistance again had to be made available to supply the population. The flexible exchange-rate system prevented the drain of central bank reserves, which had a stabilising effect. After the formation of a new government and the stabilisation measures it introduced in co-operation with the IMF and the World Bank, the dramatic fall of the currency in the first half of the year could to some degree be corrected again.

If the government succeeds in maintaining political stability in spite of the difficult domestic situation and the unrest on the country's borders, conditions may be expected to improve in 1998.

The GDP is estimated to increase at a high rate of 12%. It should be possible to reduce the inflation rate by about a half. With receipts increasing, the budget deficit will decrease somewhat and the exchange rate will probably recover a little further. Since all of this will take place on very low level and before the background of the extremely negative development in 1996, these prognoses do not give any cause for euphoria. But they do represent a silver lining on the horizon, which is only very weak, however, and can easily be obscured again by any clouds of political unrest that may ascend.

## Ukraine

The Ukrainian economy again failed to accomplish the change in trend that was hoped for in 1997. Although overall economic stability appears to have been achieved to a large degree at the beginning of 1998, there continues to be major shortcomings in the progress made in structural transition. Thanks to the strict monetary policy adopted by the central bank, inflation (consumer prices) was forced down to only 10.1% in 1997 (December to December basis). This, together with the practically stable exchange rate of the grivna, ensured that Ukraine was able to qualify for Article 8 of the IWF statute (currency account convertibility of the national currency).

In spite of these positive signs, the transition crisis in the Ukraine is far from having been overcome, however. In the real sector there was a slowing down of the GDP decrease (-3.2% in relation to the previous year compared with –10% in 1996), but the anticipated positive values were not reached. Growth in production was achieved above all by the export-oriented, energy-intensive basic industries of fuel and metallurgy, which preserved the extremely high energy intensity of the Ukrainian economy. Political quarrelling continued to hinder privatisation. An unstable legal framework, enormous bureaucratic obstacles for business activities and wrong decisions in terms of allocating resources crippled the establishment and development of enterprises and curbed the influx of foreign investments. Both in terms of the structural transition policy itself and in terms of overcoming of the transition crisis, Ukraine therefore fell back onto one of the last places among the Eastern European transition countries.

The evident deficits in the structural reforms are not only an obstacle to the real economy but also jeopardise the overall economic stability again. The over-proportional drop in tax receipts, in conjunction with a renewed relaxation of the policy on public administration expenditure, led to a rise in the budget deficit (6.7% of the GDP), which was distinctly higher than the target of 5.5% set by the government. An increasing domestic indebtedness, increasing wage and pension arrears as well as the unbalanced debt policy adopted by the government all increased the budgetary risks. The extremely short-term financing of the budget deficits again restricted the leeway for the interest and exchange rate policy and increased the pressure on the national currency. The central bank had to make substantial increases in interest to secure the announced exchange rate margin. The access of the private economy to the capital market was made considerably more difficult as a result, which reduced the prospects of growth accordingly.

The failure of the Ukrainian economic policy on structural transition, which alone can generate consistent incentives for growth, increased the country's transition costs enormously. This problem has not yet been overcome, as can be seen in the political controversy over the tax reform bill, which had already been submitted to parliament as early as February 1997, and the economic programme and its insufficient implementation. The country will not be able to find its feet unless the government passes and enforces reforms and measures for the short-term prevention of fiscal policy risks and as rapid and efficient a structural reform as possible. The parliamentary elections on 29th March 1998 do not appear to have established a condition for consistent reform on the part of government and parliament. In the run-up to the elections the government's economic programme for 1998 was adopted: it involves a modest growth rate of the Ukrainian GDP of 0.5% over 1997; inflation is to be maintained at 12%. The budget for 1998 adopted on 30th December 1997 takes the necessary improvement in the budgetary situation into account and is based on the assumption of a reduction in the deficit to 3.3% of the GDP. The continuation of the transition policy requires the support of the IMF, however, as well as the supply of additional of foreign governmental loans (at present the 542 million US$ stand-by agreement is being realised). The inadequacies in the implementation of the reform measures led to the loss of a large portion of the expected and assured credits in 1997. The continuation of international support therefore depends upon a consistent, rational and straightforward transition policy and its implementation, without which Ukraine would continue to drop behind among the countries in transition.

## Moldova

Moldova, which was often called the IMF's model pupil in the CIS, fell back substantially due to increasing differences between government and parliament on the procedure for political decision-making. Nevertheless, in 1997, the Moldovan government was able to book the first successes of its transition policy. The real gross domestic product rose in 1997 for the first time. The 11% growth in agricultural production compensated for the continuing decline in industrial production. The government's stability programme produced further successes, even if the still relatively high budget deficit could not be brought down exactly to the target set by the IMF. Nevertheless inflation continued to fall and the exchange rate of the Moldovan leu remained stable. The foreign trade imbalance continues to cause concern. The 1997 balance of trade closed with a new negative record and the foreign indebtedness continues to increase. These factors, together with a rising domestic indebtedness, are the central problems for procedural policy in Moldova. The main reasons for this development in the real economy are the continuing decline in industrial production, the low investment level with the additional draining of capital, and the expanding shadow economy. The foreign trade imbalance is due to structural weaknesses. The continued high dependence on energy imports coupled with the simultaneously weak position of the country's exports on the international markets substantially impairs the national economy in view of the major significance of foreign trade.

There is still no sign of a political reconciliation between Moldova and the renegade region of Transnistria – despite the signing of a memorandum in the summer. A third of the country's industrial production is accounted for by Transnistria, which before its separation from Moldova (1992) was the more highly developed part of the country in terms of industry. The transition crisis that already existed was further intensified by the civil war and the subsequent division of the economic area. Since the division, Transnistria in particular is in a miserable economic situation. But Moldova too is suffering from the loss of major parts of the industry and from the obstructions on important trade routes.

For the first quarter of 1998 a further slight growth in production was predicted, but there has been no real recovery in industrial output. It is not yet certain whether after the parliamentary elections of 22nd March 1998 the political parties, which delayed the transition process by their inability to make compromises in the past year, will find their way back to a common basis for accelerating the process of transition. This would be, among other things, however, an important condition for a change in the budgetary policy, without which no stronger positive impetus for the economy can be expected.

## Armenia

Armenia's economic dynamism slackened in 1997. In the first nine months of the year the GDP increased by only 2.9%. In this period agricultural production fell by 5% as a result of unfavourable weather conditions and industrial growth too was no more than 0.5%. On the other hand, the construction industry and trade as well as the other service sectors including the state sector developed into motors for growth, which was reflected in corresponding structural shifts in the national economy.

The successes that had been achieved in terms of stabilisation in 1996 could not be sustained. Although in the first nine months of the year the rate of inflation fell further to an average of 10.9% in relation to the same period in the previous year, it accelerated in the course of the year from 4.5% in the first quarter to over 20% in the third. The budget deficit was reduced to 4.9% of the GDP in the first three quarters of 1997 as a result of an improvement in the tax system and tax administration as well as cuts in expenditure and since the increase in the money supply was also further reduced, it is difficult to identify any monetary lapses that might be responsible for this inflationary development. The lowering of interest rates since the end of 1996 does not appear to have led to a expansion of the money supply either . The main reasons for the inflation are therefore to be found in the sharp increase in administrative prices, which is to be considered a positive sign in makro-economic terms, and the rise in incomes.

Incomes continued to rise substantially, but at only 25 US$ a month they are still extremely low and are among the lowest in the successor states of the Soviet Union. At the same time unemployment is rising too. Even the official statistics quote an increase of 1.5 percentage points to 10.5% in the first three quarters, but these statistics do not include all unemployed persons, which can clearly be seen in the increase in the number of people employed in agricultural households.

The foreign trade situation is also unsatisfactory. The cancellation of the supply contract with DeBeers led to considerable losses of exports. The current account deficit increased again to 28% of the GDP and the foreign indebtedness rose in the first nine months of the year by 200 million US$ compared with the corresponding period in the previous year. The foreign indebtedness is now almost 50% of the GDP. On the other hand, the heavy influx of foreign capital also led to an increase in foreign currency reserves of almost 10 million US$, although foreign direct investments have hardly any significance in this respect. A substantial source of foreign currency was the large volume of money transferred into the country by Armenians working abroad, which is estimated to be some 40 million US$ per month.

The tax and banking reforms and privatisation were continued. It is not possible to judge exactly to what extent the positive stimulus these generated for, among other things, the influx of urgently needed foreign investments was overshadowed by political problems (including the Karabach conflict).

## Azerbaijan

It is still difficult to estimate what effect the Armenian president's resignation will have on the now ten-year-old conflict between Azerbaijan and Armenia, and this puts an immense burden on Azerbaijan's economic policy in view of the important decisions to be made in the country's energy sector. Since the economy is dependent on energy production to a considerable degree, the decisions on production rights and transportation routes have an enormous significance. Both are affected to a considerable extent, however, by political factors. In particular, there are several alternatives for the pipeline routes under discussion, which all involve enormous political risks. The solutions to these questions will have a crucial influence on the country's economic development in the coming years.

After an impressive growth rate of 5.5% was achieved in 1997, further acceleration up to 7% may be expected in 1998. This will depend entirely on oil production and oil exports, which also have a positive effect on the services sector and the construction industry. The agricultural sector, which still produces about a quarter of the GDP, likewise contributed to the acceleration of growth in 1997. The development of the processing industry (with a 0.5% increase in 1997) is still dragging behind. This is influenced very negatively by the sluggishness in the restructuring and privatisation of enterprises .

In terms of the inflation rate, substantial progress was also achieved in the area of macro-economic stabilisation . The annual inflation rate was reduced to 4%. The central bank succeeded in largely neutralising the influx of foreign capital into the oil industry but it could not avoid a slight revaluation pressure being put on the manat.

If the dependence on the oil industry is to be kept within reasonable bounds and if broad sections of the largely impoverished population are to have a share in the prosperity expected from the energy industry, greater progress must be made in restructuring the other sectors of the economy. The first steps in accelerating privatisation were taken in mid-1997. Small-scale privatisation was largely concluded with the selling of altogether 12,000 enterprises towards the end of the year. At the same time, after quite some hesitation, a start was made on the process of privatising medium and large enterprises.

In the presidential elections coming up probably in the autumn, the acting president, Alijew, is given good chances of winning. This would seem to guarantee a continuation of the established reform programme and a further positive development of the economy.

## Georgia

The recovery of the Georgian economy continued in 1997 and two-figure growth rates are forecast in1998 for the third time in succession. Growth is taking place at a low level, however, since the overall collapse brought by the civil war and the secession of Abhazia are still having a lasting effect. The radical reform programme introduced by President Eduard Shevardnadze and supported by the IMF and the World Bank thus continues to be successful. The inflation rate was reduced further (to 8%) by the tight monetary policy and the exchange rate of the lari remained stable. The lowering of the budget deficit (to 3.4% of the GDP) made drastic savings necessary, however, since receipts did not achieve the planned level despite the tax reform – part of the reform package was postponed to the beginning of 1998. An improvement can only be expected if the still extremely low tax rate can be raised. The national indebtedness was kept down to the level of the previous year (30% of the GDP) and further rescheduling agreements were made. The rising foreign trade deficit and higher expenditure for the social budget will further increase the debt. Important economic goals are therefore the improvement of the tax rate and a lowering of the foreign trade deficit by strengthening the country's own energy sector.

The structural changes within the economy are strengthening trade and the transportation and traffic sector. Georgia's particular significance as a transit country offers further opportunities for development in these sectors, especially in connection with the building of new oil pipelines and the TRAEA route. Investments in this sector are therefore being transacted and/or promoted by international credit organisations and multinational enterprises. The serious de-industrialisation of the country continues to cause concern: this is due among other things to the poor utilisation of capacity and the sluggish privatisation of medium-size and large enterprises. In the past year an attempt was made to combat a further loss in the significance of industry by means of extensive privatisation. However, the necessary restructuring process involves the danger of rising unemployment and a deterioration in the social situation. Whether the reform course will continue to be successful depends not least on the peaceful solution of smouldering ethno-territorial conflicts and on the person of the president himself – who in February 1998 escaped what was already the second attempt on his life.