



1/2003 (8)

20 JANUARY 2003

# Global Economy

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## Global Outlook

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- **Lacklustre recovery**
- **Uncertainties undermine private and investment spending**
- **Gradual improvement in 2003, but slower than previously expected**
- **Low inflationary pressures**
- **End of monetary easing in industrialised countries**

4Q02 did not see any decisive changes in the global economy, with the lacklustre recovery in the major industrialised countries continuing. The main drivers of economic growth, i.e. private consumption in the US, and net exports in the European Union (EU) and Japan, exhibited signs of moderation. There is a high degree of uncertainty in the global economy, primarily due to geopolitical tensions, high and volatile oil prices, and depressed equity markets. The negative wealth impact of corrections in the financial markets are expected to materialise with a time lag. This, coupled with weakened confidence, makes consumption and investment spending less likely to get back on to a fast track in the near term.

In the US, evidence of weaker-than-expected profits and moderating growth in household spending has cast doubt on a stronger acceleration of growth in 1H03. The EU's largest members (Germany, Italy and France) have very weak domestic demand, giving little hope for improvement from their side. In Japan, the recovery is expected to be particularly muted and dependent to a large extent on foreign markets. Economic conditions do not bode well for a prompt pick-up in investment and household consumption. In emerging Asia, a rapid recovery has been moderated by weaker external demand and stabilising growth in manufacturing, though the outlook remains positive. The CEECs continue to perform well, with booming domestic demand – in many cases at the cost of high budget deficits. The economic situation in Latin America continues to be fragile, despite some recent financial stabilisation in Brazil and signs of a bottoming out in Argentina. The conditions in Venezuela are particularly worrisome.

The near-term outlook for the global economy relies critically on the dissipation of prevailing uncertainties, including those associated with geopolitical risks, and the prospects of higher profits. GDP forecasts for many countries (especially the US and EU) have been revised downwards again. In the longer term, however, economic performance will be largely contingent on sound macro policies, in particular structural changes that boost competitiveness and efficiency. This especially applies to the banking sector in Japan and fiscal policies and labour markets in the euro zone. Growth momentum and trade volumes in the world economy should accelerate modestly in 2003, with more vibrant growth expected only for 2004.

Inflation in many industrialised countries increased somewhat in 4Q02 on the back of higher energy prices, but the inflationary outlook is generally positive given the under-utilisation of production capacity and lacklustre growth. On the other hand, prices in many CEECs have continued to decline and inflation is expected to hit historic lows in 1Q03. In the course of 2003 prices should increase, though remain in check. Japanese deflation is expected to continue. In 2003, oil prices will be a key factor determining price developments around the world, with the obvious key risks related to a possible war in Iraq and any ensuing hikes in oil prices. If there is no war in 2003, oil prices should fall, though prices of other raw commodities are expected to increase in this eventuality.

Favourable inflation developments and weaker growth have provided space for monetary easing. Central banks in the US, euro zone and some CEECs have all cut interest rates recently. For the more advanced industrialised countries these latest reductions should end an easing cycle, while in the CEECs further monetary accommodation cannot be ruled out. In 4Q02, the euro continued to gain against the yen and the dollar. This is not expected to change much in the short term, though over the course of 2003 we should see the dollar-euro exchange rate stabilising around parity. The real appreciation of CEECs' currencies is expected to continue. Given the low inflationary outlook this will be primarily achieved via nominal appreciation. <LR>

GDP in selected countries, 1998-2004 (% change, yoy)							
	1998	1999	2000	2001	2002 <sup>e</sup>	2003 <sup>f</sup>	2004 <sup>f</sup>
OECD	2.7	3.2	3.8	0.7	1.2	2.1	2.8
USA	4.3	0.7	3.8	0.3	2.3	2.8	3.3
European Union	2.9	2.8	3.5	1.6	0.9	1.6	2.6
Euro zone	2.9	2.8	3.6	1.5	0.7	1.6	2.7
Germany	2.0	2.0	2.9	0.6	0.3	1.3	2.4
France	3.5	3.2	4.2	1.8	1.0	1.8	2.9
Italy	1.8	1.6	2.9	1.8	0.3	1.5	2.5
United Kingdom	2.9	2.4	3.1	2.0	1.5	2.2	2.5
Czech Rep.	-1.0	0.5	3.3	3.3	2.2	2.9	3.6
Hungary	4.9	4.2	5.2	3.8	3.2	3.6	4.3
Poland	4.8	4.1	4.0	1.0	1.2	2.3	3.2
Russia	-4.9	5.4	8.3	5.0	4.0	3.5	3.5
Turkey	3.9	-6.1	6.3	-9.5	6.0	4.5	4.0
Japan	-1.1	0.7	2.6	-0.3	-0.8	1.1	1.5
China	7.8	7.1	8.0	7.2	7.7	7.4	7.0

Notes: e-estimate, f – forecast

Source: OECD, IMF, statistical agencies (data); CASE, market consensus (forecast).

CPI in selected countries, 1998-2004 (% change, yoy)							
	1998	1999	2000	2001	2002 <sup>e</sup>	2003 <sup>f</sup>	2004 <sup>f</sup>
USA	1.5	2.2	3.4	2.8	1.6	1.8	1.6
Japan	0.7	-0.3	-0.7	-0.7	-1.2	-0.8	-0.3
European Union	1.8	1.2	2.5	2.5	2.4	2.0	1.8
Euro area (HICP)	1.2	1.1	2.4	2.5	2.3	1.8	1.7
United Kingdom (RPIX)	2.6	2.3	2.1	2.1	2.2	2.6	2.5
Czech Rep.	10.7	2.1	3.9	4.8	1.8	1.1	2.6
Hungary	14.2	10.0	9.8	9.2	5.3	5.2	4.3
Poland	11.6	7.3	10.1	5.5	1.9	1.2	2.1
Russia	27.8	85.7	20.8	21.6	16.0	13.0	8.0
Turkey	84.6	64.9	54.9	54.4	45.0	30.0	25.0
China	-0.8	-1.4	0.3	0.7	0.1	1.4	1.0

Notes: f – forecast

Source: OECD, ECB, IMF, statistical agencies (data); CASE, market consensus (forecast).

## Country Updates

### United States

- **Household consumption still strong, but may moderate**
- **Favourable inflation outlook**
- **Accommodative policies: a stronger fiscal boost**

3Q02 data point to a further improvement in the economic performance in the US. GDP in 3Q02 grew at a higher annual rate (3.2% yoy) than in the two previous quarters, again driven mainly by private consumption. The economic expansion was also underpinned by private investment and government spending. As imports rose and exports remained weak the trade deficit widened. Seasonally adjusted industrial production has been rising, albeit moderately, since July.

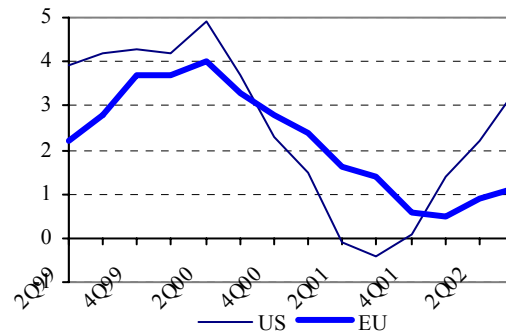


After almost a year of very low inflation, the CPI increased in October and November to 2.0% and 2.2%, respectively, mainly due to higher energy prices and a weaker dollar. Stronger inflationary pressures were also reflected in the PPI. In October and November, producer prices in the manufacturing sector increased in annual terms for the first time in 12 months. However, the persistent under-utilisation of resources should moderate price growth in the near future.

Given the recent loose monetary stance and large fiscal stimulus (the latter is expected to continue in 2003), the outlook for the US economy is positive. However, most forecasting institutions have revised downwards their GDP projections for this year and recovery is expected to be moderate. Growth in fact had been expected to slow already in 4Q02 and to remain below potential for a longer period than earlier expected. The strength of the economy in the medium term will primarily depend on investment. Higher business confidence and profits will be key factors determining any revival. A sustained and fast rise in productivity bodes well for company profitability. In addition, the gradual elimination of inventory overhangs should bolster investment. In due course, household consumption (which has so far proved very resilient) should also contribute more significantly to economic growth. Higher expansion in personal expenditures will depend to a large extent on a clarification of the current geopolitical uncertainties and a strengthening of consumer confidence, as well as on a moderation of the negative wealth effects from the stock market declines observed recently. 2004 should see further firming of growth momentum.

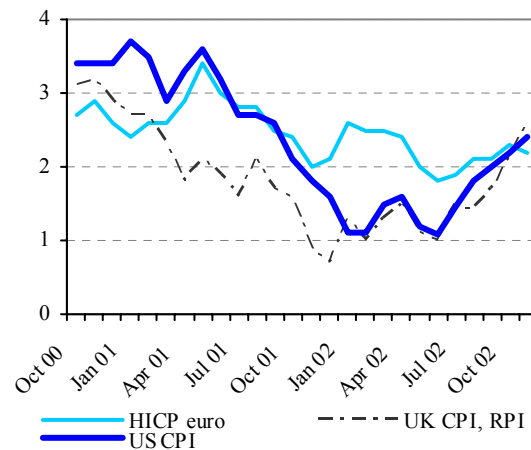
In the face of sub-par growth expectations in the near term, policy makers decided to increase accommodative policy measures. On the monetary policy side interest rates were cut in December (see *Central Bank Watch*), and on the fiscal side another stimulus package is envisaged. The Bush administration unveiled in mid-January a US\$670 billion package aiming at boosting the economy and creating new jobs. The package comprises measures to abolish taxes on dividends and faster income tax cuts.

**US and EU GDP growth, 1999-2002  
(% change, yoy)**



Source: FedStats, Eurostat

**World inflation, 2000-2002 (% change, yoy)**



Source: Eurostat, Bureau of Labor Statistics, National Statistics

## European Union

- **Lacklustre domestic demand**
- **Weak confidence**
- **Downward revision of forecasts**

Growth in the euro zone gathered some momentum in the most recent quarters, though very slowly. In 3Q02, GDP increased by 1.1% yoy in the EU15 and 0.8% yoy in the eurozone. With very sluggish domestic demand, net exports remain the main contributor to economic growth. In the first three quarters of 2002, fixed investment contracted and household consumption was stagnant. Disappointing domestic demand is largely down to the pessimistic moods among enterprises and households, difficult financing conditions, geopolitical uncertainty and generally weak global activity. According to European Commission

indicators of economic sentiment, confidence in manufacturing industry and among consumers declined in 4Q02 in comparison to previous months.

On the basis of currently available data, 4Q02 is not expected to have seen much improvement on the previous quarter. Poor economic growth in the EU stems from the sub-par performances of its largest countries, in particular Germany, Italy and France. The UK has weathered the global downturn better, growing at a reasonable rate.

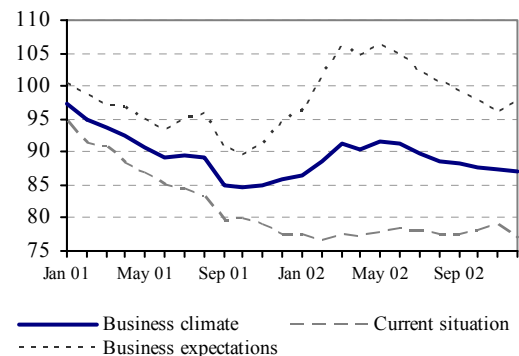
Inflationary pressures in the EU and the euro zone increased at the end of 2002. After a mid-year inflation fall, prices kept on rising. In October, the HICP in the euro zone was 2.3% and stayed at 2.2% in November and December (flash estimate). Producer prices also rose. In September, the PPI in the euro zone increased for the first time since 3Q01 (in manufacturing prices started rising in July). These trends were maintained in 4Q02. Inflation in the euro zone is expected to pick up at the beginning of 2003 due to recent higher oil prices and increases in indirect taxes and administered prices planned in some countries. The ECB sees this increase as temporary and estimates that inflation will moderate in 2003, falling below the bank's target of 2%. How oil prices and labour costs pan out over the 12-month horizon will be crucial for lowering inflation. A stronger euro and subdued economic activity have so far helped to keep inflation in check.

As far as the outlook for the EU is concerned, there is still plenty of uncertainty over the timing of any upswing. The hesitant pace of economic growth and subdued confidence are expected to last throughout 1H03, with a firming of growth momentum at the end of 2003 and in 2004. On the one hand, falling inflation should boost household income (and in turn consumption), and on the other, stronger external demand should drive up exports. These developments and lower interest rates are expected to bolster investment. As domestic demand picks up, imports will grow at a faster pace. Consequently, the contribution of net exports is expected to go from positive in 2002 to neutral and then to negative in 2003 and 2004.

The emergence of critical opinions on the EU's Stability and Growth Pact, and an apparent

loosening of fiscal discipline in some member countries, inclined the European Commission and the Governing Council of the ECB to come out with statements re-endorsing the key principles of the pact and underscoring its importance for price and general economic stability. The statements said the pact is growth-promoting and not growth-hampering, and encouraged governments to pursue growth-oriented consolidation policies that strengthen their economies' productive forces. In addition, the European Commission put forward a proposal to improve the implementation and interpretation of the Stability and Growth Pact.

**Ifo business climate index, 2001-2002**



Source: Ifo Institute for Economic Research

### Germany

Economic activity in Germany in 3Q02 recorded a slight improvement over previous quarters. The annual rate of GDP growth amounted to 0.9% yoy, with net exports remaining the main driving force, though imports increased for the first time since 2Q01. Unlike in the two previous quarters, household consumption did not contract, though there was no significant upswing. As business sentiment and financing conditions deteriorated and the outlook remained poor, 3Q02 investment recorded another fall, if at a slower pace. The Ifo indicator of business confidence has fallen consistently since its spring 2002 highs. In December, it reached levels not observed since the beginning of 2002. Stock market prices also fell, with the DAX hitting a six-year low in mid-October. In addition, rising unemployment (10.1% in November) impacted on household sentiment and is not very encouraging for higher spending. Against this background, GDP growth in 2002 is expected to reach roughly 0.4%.



2003 should see better economic performance, though any recovery should remain sluggish, depending to a large extent on stronger exports. World trade volumes are expected to gain momentum this year and as exports and private consumption strengthen and capacity utilisation increases there should be scope for higher fixed investment. Germany is unlikely to see above-potential growth – over 2% – any earlier than 2004, when private spending should be on a firmer footing on the back of rising employment.

Germany's forced budget consolidation – due to a breaching of Growth and Stability Pact rules – could be a drag on growth in the coming years. In 2002, the budget deficit is estimated to have reached 3.7% of GDP – well above the 3% limit. The already introduced consolidation measures (lower spending and higher revenues) will not be enough to bring the deficit below 3% and reach a balanced budget by 2006. Most fiscal adjustment in Germany, as such, still awaits.

#### UK

Annual GDP growth in the UK accelerated to 2.1% in 3Q02, a level not seen since 3Q01. Although household consumption remained the main driver of growth, its momentum abated. Consumption is underpinned by higher incomes due to soaring housing prices. This factor also contributed to sustained expansion in the construction sector. For the first time in many quarters industrial production rose. On the other hand, contraction in investment and net exports impacted negatively on GDP growth. 2002 as a whole should see economic growth at around 1.5%, which makes the UK one of the fastest growing industrialised countries. In October and November inflationary pressures increased, with the RPIX rising to 2.3% and 2.8% (1.4% and 1.6% for the HICP), largely due to higher house prices and increased car sales. The outlook for 2003 and 2004 is favourable, though dependent to a large extent on the external environment. On the domestic front, house price developments pose some risks to household consumption. Any sharp decline here may dent household incomes considerably – and in turn personal expenditures. This could impact on growth rates in the current year. <LR>

## Central and Eastern Europe

- **EU and NATO enlargement on track**
- **Strong growth in 2002 and positive outlook for 2003**
- **Inflation down, budget deficits up**

The conclusion of EU accession negotiations for eight CEECs and invitations to join NATO for seven countries in the region clearly dominated the political events in 4Q02. Both impacted visibly on economic development, in particular on exchange rates (see *Exchange Rates*). NATO – and perhaps more so EU – enlargement will clearly continue to exert a major impact on economic policy, the investment climate and trade flows in the next few years. While these processes represent a major success after more than a decade of transformation and provide a favourable environment for sustainable development in the long run, they also pose new challenges. The ways countries in the region tackle these challenges and cope with arising problems will ultimately determine their levels of affluence and quality of life on the one side and their position within the enlarged EU on the other.

Generally, 2002 was a good year for the region. Growth remained surprisingly resilient to the EU slowdown (with Poland an exception). Forecasts for 2003 are mostly positive, with the two largest economies (Poland and the Czech Republic) expected to improve on last year's results and no major worsening (in some countries improvements) expected for other economies. The region entered 2003 with low inflation (with the exception of Romania), and in many cases all-time lows were recorded. In general, falling food prices and strengthening currencies were the factors behind this. No major risks to inflationary dynamics are foreseen for 2003. On the other hand, the fiscal position remains difficult in several countries and public finance reforms are pending. Lowering budget deficits without hampering economic growth may prove difficult in the face of weak external demand, higher expenditure related to EU enlargement and various political factors.

#### The Czech Republic

3Q02 saw a moderation of growth momentum in the Czech Republic. Annual GDP growth was lower than in the two previous quarters (1.5% yoy vs. 2.8% and 1.9%). This is to some extent

attributable to the direct and indirect havoc brought by the August floods. The disaster caused not only contraction in output, but also impacted negatively on the tourist industry. Household consumption and changes in inventories were the main factors behind economic expansion. As tourism-related revenues fell, external demand remained weak and the koruna strong (see *Exchange rates*), thus widening the trade deficit markedly. The current account deficit reached a record high of 1.68 million euros in 3Q02 (vs. 0.83 million euros in 3Q01). Disinflation was sustained, and in November the CPI reached all-time low of 0.5%. Despite this, wages kept on rising at a fast pace – in 3Q02 they rose by 6.7% yoy in real terms, undermining Czech competitiveness. Nonetheless, inflationary pressures should remain in check in 2003. At the beginning of 2003, deflation may even be seen due to the strong koruna, low food prices and stable administratively controlled prices. However, over the year the CPI is expected to increase. The budget deficit is estimated at over 6.0% of GDP in 2002. The government plans to reform fiscal policy in some areas in order to curb the budget deficit. The authorities want to cut CIT rates, for example, increase excise tax on tobacco and spirits and introduce tighter discipline on social welfare spending. In 2003 and 2004, growth momentum should further strengthen, though the improvement is expected to be moderate, especially this year.

### **Hungary**

In 3Q02, GDP growth in Hungary accelerated to 3.5% yoy. This was driven by still robust household consumption (around 8% yoy for the first three quarters of 2002). On the other hand, fixed investments and exports geared down somewhat. Weaker investment activity was especially evident in the private sector. Unemployment remained broadly stable, though wages kept on rising – on average by nearly 20% yoy in nominal terms. Taking into account recent increases in inflation, this is still a huge jump in real wages. At the end of the year prices rose in comparison to 3Q02, but the CPI remained below 5% in October (4.9%) and November (4.8%). Robust household consumption and waning exports caused the current account deficit to widen, amounting to 2.7 billion euros in January-October (vs. a 0.8 billion euro deficit in the corresponding period of 2001). The government is largely responsible for booming private consumption and the higher current account deficit

due to its wages policy and generous spending. The 2002 budget deficit is expected to have reached 9% of GDP. The 2003 budget envisages some consolidation, but very modest and weakly linked to structural reforms in public finances. The persistently high budget deficit therefore still poses risks to the economy.

### **Poland**

In 3Q02, GDP increased by 1.6% yoy and 2002 as a whole should see growth of 1.2%. Household consumption continues to expand by over 3% yoy and investment to decline – though at a slower rate. In 4Q02, industrial production rose for the second quarter in a row. Construction, however, surprised on the downside and the contraction in this sector is now deeper-than-previously-anticipated. 1Q03 should see weaker economic activity in some sectors of the economy, though GDP growth should be above 2%. In particular, we anticipate slower growth in household consumption, industrial production and higher unemployment. The deterioration on the labour markets can be largely attributed to seasonal factors. In general, the economic situation in 2003 should improve on the back of higher investment and stronger exports. The latter will be crucial in balancing out growing imports due to stronger domestic demand. In 2003 as a whole, GDP should increase by 2.3%. 4Q02 saw strong disinflation, which should continue in 1Q03 and over 2003 as a whole. The CPI is expected to reach an all-time low of 0.4% yoy in January. The fiscal situation remains difficult, though revised government budget statistics do not indicate any significant problems in implementing the 2002 budget.

The CSO outlined changes in the methodology for national accounts, stemming from standardisation of Polish and EU procedures (ESA95). They apply primarily to the pricing of central and local government transactions (now on the accrual basis), pricing of investment (now based on market prices), as well as to a different definition of institutional sectors. Unfortunately, the data recalculated according to the new methodology is available only from 2000. Methodological changes do not affect real changes in the overall GDP, but have impacted significantly on nominal values and real growth of some GDP components (both on the demand and supply sides).



### **Bulgaria**

Growth momentum was maintained, with 3Q02 noting 4.5% yoy growth. Stock building and investment expenditures provided a positive stimulus. In 3Q02, exports recovered while imports remained restrained. Tourism revenues surprised on the upside. Consumer expenditure was stable in 2002 and the prospects for 2003 depend *inter alia* on future fiscal policy plans (mainly tax cuts) and political stability. Developments on the political stage should be watched carefully, as the problems of the ruling coalition could potentially derail the reform programme. In 2002, two large privatisations were blocked by court rulings, and as a result the inflow of FDI was very low. 2003 should bring an improvement in this area. Relations with the IMF cooled somewhat following a dispute over the 2003 budget, but the impact of this disagreement is not expected to be significant. Credit for the private sector boomed on the back of falling interest rates. Inflation dropped sharply to around 3% at end-year.

### **Romania**

GDP growth remained solid in 3Q02 at 4.7% yoy, but is expected to have moderated in 4Q02 due to relatively tight fiscal and monetary policies. The current account deficit exceeded 5% of GDP in 2002 and will likely remain above 4% in 2003. However, there should not be any problems with financing, given the strong remittances from Romanians working abroad and FDI inflows. In 2002, exports continued to expand strongly. In particular, Romania managed to increase its exports to the EU. Fiscal policy remained in check in 2002, though further fiscal consolidation in 2003 and beyond remains a difficult task facing the government. Balancing expenditures related to EU preparations against social needs is especially challenging. The restructuring and privatisation of large state-owned enterprises remains a related and equally difficult task, given widespread public opposition in this area. Slow but stable disinflation continued, with the CPI falling to 17.8% yoy in December. In the near-term, monetary policy will face new challenges. This is linked to real appreciation pressures, stemming mainly from the nearing prospect of EU accession.

### **Slovakia**

Slovakia recorded strong growth in 2002, with GDP expanding by 4.3% yoy in 3Q02 and annual growth

estimated at 4% for 2002 as a whole. Strong domestic consumption, supported by a real wage increase resulting from pre-election policies, was the main growth driver. An austerity package, involving expenditure cuts and increases in some taxes and administrative prices, is expected to lower the budget deficit considerably in 2003. The current account deficit is also expected to narrow, from around 8% of GDP in 2002. In 2H02, the koruna underwent strong appreciation pressure underpinned by a significant lessening of political risk (largely due to expectations that Slovakia will be invited to join NATO and the EU). The central bank responded with forex interventions and a substantial interest rate cut (150 basis points), but these actions had little long-term impact. The market consensus is that the koruna will appreciate further in 2003. The CPI is expected to increase significantly in early 2003 on the back of administrative price increases, but this should not be a major concern for monetary policy.

### **Baltic States**

The Baltic States' economies continued to grow very strongly. In 3Q02, GDP expanded by 6.7% yoy in Estonia, 6.8% in Lithuania, and 7.4% in Latvia. Exports performed relatively well, given the weakness in the EU. However, as imports surged even more, current account deficits widened. This indicator should be watched, especially in Estonia, where the deficit is expected to remain at around 10% of GDP this year, i.e. close to its 2002 level. Fiscal policies remain in check, with budget deficits in 2003 forecast at 1% of GDP in Estonia (due to the introduction of pension reform) and 1.5-1.8% of GDP in Latvia and Lithuania. <LR&WP>

### **CIS**

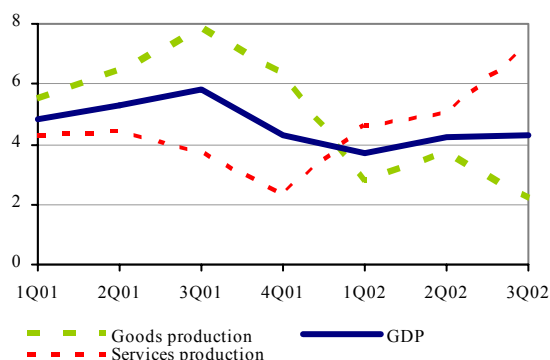
- **Stable moderate growth in Russia and Ukraine**
- **Development outlook mixed – eroding competitiveness**
- **Oil prices underpin boom in the CIS oil sector**

### **Russia**

Strong domestic demand, in particular domestic consumption, continued to support growth in Russia in 3Q02. GDP expanded by 4.3% yoy in 3Q02, i.e. slightly stronger than in 1H02. Growth

momentum is also expected to have remained solid during the last months of 2002. Gross output in the five major sectors of the economy (the best available proxy for GDP) increased by 3.9% yoy in January–November, unchanged from the first three quarters. However, aggregated data hides substantial differences in performance across sectors. The services sector saw stronger expansion, while industrial production slowed in October and November, after recording relatively strong growth in 3Q02. Our estimate for 2002 GDP growth is 4%. In 2003, we expect economic growth to average around 3.5%, underpinned mainly by household consumption and high energy exports. The competitiveness of the non-oil production sector remains the key factor for long-term development prospects and continuation of structural reforms is of vital importance. In this respect, a weak investment record of 2002 raises concerns. While the positive effects of the reforms implemented in the last 3 years are becoming evident, we see political risks to the transformation processes in 2003 linked to the election timetable.

**Real GDP and output components,  
(% change yoy)**



Source: Goskomstat

The fuel industry continued its strong expansion and, given oil price developments, this is likely to continue for some time. The performance of sectors producing consumer goods, in particular food products and light industry, worsened visibly in October and November. Strong domestic demand and import surge appear to indicate a waning of competitiveness of these sectors.

According to preliminary data, oil and oil products exports contributed to the upsurge in total exports. In 4Q02, exports amounted to nearly US\$30 billion, an almost 20% rise in annual terms. As a result, in

2002 as a whole, total exports increased by 4.4% yoy. Non-energy exports also increased (2% in 2002). At the same time, imports surged by 15% yoy in 4Q02 and by 13% in 2002. The share of non-CIS countries continued to increase in both exports and imports, though imports from CIS started to grow in annual terms in 2H02, following a period of rapid decline. The surge in exports in 4Q02 increased the current account surplus. For the year as a whole it stood at nearly US\$32 billion, only marginally lower than in 2001 – US\$34.8 billion. In 2003, export dynamics will hinge on oil price developments and imports are expected to continue to see steady growth.

The CPI stood at 15.1% yoy in December, i.e. only slightly lower than the 18.6% recorded at end-2001. The December figure was precisely in line with our expectations. We anticipate that prices will continue to expand at a two-digit rate for the whole 2003, reaching around 12% by year-end.

The nominal dollar-rouble exchange rate remained very stable in 4Q02, as had been the case in previous quarters. In 2002, the rouble depreciated against the dollar in nominal terms by around 5%. As of December it depreciated slightly on an annual basis also in real effective terms, largely due to the strengthening of the euro against the dollar in 2H02. The CBR is expected to seek to manage the exchange rate in order to avoid an excessive real appreciation of the rouble. At the same time, the bank said it wanted to limit inflation (to 10-12% at end-2003). Any more ambitious inflation plan is not feasible given the contradictory policy targets. On a positive note, the recent reintroduction of several monetary policy instruments (e.g. currency swaps, repo and reversed repo deals) that were suspended after the 1998 financial crisis, is worth mentioning.

The fiscal situation remains confident. 2003 budget projections look realistic and there should be no problems meeting debt payments this year of US\$15-17 billion. In view of these developments, and strong economic growth, Standard&Poor's recently upgraded Russia's sovereign rating. According to CBR data, Russia's total debt remained constant in 2002 at around US\$150 billion, 98% denominated in foreign currencies.

December saw two large privatisation deals in the oil industry. A 6% stake in Lukoil was sold for



US\$0.77 billion and a 75% stake in Slavneft was acquired for US\$1.86 billion by two other Russian oil producing companies. The latter price turned out below previous expectations. Several new investment projects in oil and gas sectors are currently being discussed. All require the involvement (and financing) of foreign partners and 2003 may be a test year of Russia's policy towards FDI in this sector.

#### **Ukraine and other CIS countries**

Ukraine's GDP expanded by 3.5% yoy in 3Q02, by 3.8% yoy in October and by 4.2% yoy in November. Full year growth is estimated at around 4%. The major contributions came most likely from a surge in consumption following the almost 20% rise in real incomes in January-October 2002, and from net exports. A positive merchandise trade balance was registered for the first 10 months of 2002. Ukraine's industrial output grew by 7% in 2002.

The *hryvnia* exchange rate was broadly stable throughout 2002, depreciating by less than 1% yoy against the dollar for the full year. It is expected that the *hryvnia* will slightly depreciate in 2003.

CPI deflation was observed at end-2002; for the first time in Ukraine's post-1990 history. Despite continuous growth in the CPI in 4Q02 on the monthly basis, consumer prices fell by 0.6% yoy in December, which was still the result of low prices for agricultural commodities in summer 2002. The higher prices of products from the mining sector pushed the PPI to 5.7% yoy in December.

In the last months of 2002, the central bank slightly tightened the money emission, though the monetary base still grew by 33.6% yoy in December. However, given the NBU's actions in November, when it extended refinancing loans to commercial banks, it is likely that such actions will be repeated, leading to a rapid growth in domestic liquidity in 2003. The recent change in NBU president, which took place amid internal political tension, brings further risks to Ukraine's monetary policy.

The approved draft budget for 2003, with artificially inflated revenue projections, is also a warning signal. Unexpected deflation, moderate growth and the slow-down in privatisation caused the underperformance of budget revenues in 2002,

resulting in turn in expenditures cuts and higher domestic borrowing.

The appointment of a new prime minister in November 2002 indicates that implementation of any coherent reform program before the 2004 presidential elections is unlikely.

Most other CIS economies maintained strong growth in 3Q02. Official data for the first three quarters point to annual growth rates in a range of 9% to 11% in Kazakhstan, Azerbaijan, Armenia and Tajikistan. Inflation rates remained within low single digits, with the exception of Belarus and Russia. Given the high international oil prices, the growth outlook for 2003, in particular for energy exporters, remains positive. <MJ&WP>

#### **Turkey**

- **Very strong economic expansion in 2002**
- **Fiscal problems expected in 2003**
- **The biggest risk factor – US military action in Iraq**

The Turkish economy expanded by 7.9% yoy in 3Q02, after an 8.8% yoy jump in 2Q02. This was the result of strong domestic demand and solid growth of exports. There are signs that GDP continued to expand further in 4Q02. Industrial production rose by nearly 12% in October and 9% in November, and capacity utilisation figures implied strong domestic and export demand.

Fiscal data for 4Q02 suggest that the budget target for the year as a whole was probably not met. Moreover, there may be problems in 2003 attaining the primary surplus target of 6.5% of GDP. Some of the planned spending cuts proposed by the government in order to achieve the 2003 target may be impossible to execute in the short-term. However, it is still expected that Turkey will receive the next IMF credit tranche of US\$1.6 billion in 1Q03.

The central concern is Turkey's huge debt burden. Even assuming that real activity will be on an upward path (around 5% GDP growth in 2003), Turkey's gross external debt will amount to nearly 90% of GDP in 2003, and debt servicing will be at 17% of GDP this year. This makes Turkey heavily dependent on international financing.

An improvement in market sentiment allowed for a faster-than-planned decline in inflation. The CPI rose by 29.7% yoy in December, well below the 35% target. It is expected that CPI inflation will stay above 20% at the end of 2003.

The unexpected outcome of the November 2002 elections – the moderate-Islamic party winning an absolute majority, hence no need to form a coalition – brings hope for essential structural reforms. The biggest risk factor is connected with the possibility of US military action in Iraq. The war would have adverse effects on tourism and the economy would suffer from higher oil prices. The potential war might have been among factors behind the 9% depreciation of the Turkish lira against the dollar in December. <MJ>

## Asia

- **Export demand – the only factor underpinning growth in Japan**
- **China maintains buoyant economic expansion**
- **Optimistic forecasts for other Asian economies**

Asian economies performed better than expected in 3Q02, and although a temporary deceleration of rates of growth is expected in 4Q02, prospects for 2003 remain favourable. 3Q02 growth rates were in the range of 4-6%, with Indonesia, Malaysia, and Philippines at the lower end and Korea and Thailand at the higher end. Exports gave a strong growth impulse. 2002 was marked by moderate inflation across the Asia-Pacific countries, with the exception of Korea, where rising costs of housing pushed the CPI up. 2003 growth forecasts for the region (outside of Japan) are generally positive, with Asian industrialised and the largest ASEAN countries expanding by 3.5-6%.

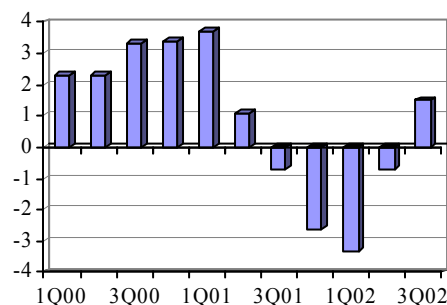
The Chinese economy grew by 8% in 2002, according to preliminary estimates. Growth remained firm in 4Q02 and was broadly based. Monthly data indicate the positive contribution of household consumption, exports (particularly of textiles and electronics), as well as public and private investment. It is expected that in 2003 economic growth will stay high, at over 7%.

In India, GDP expanded by 5.8% yoy in 3Q02 on the back of strong exports and investment. Consumption was already constrained by a fall in farm incomes, resulting from drought. The significant slowdown in consumption due to the drought is expected to have extended into 4Q02 and early 2003. However, November foreign trade and investment data suggest that these factors will compensate the deterioration of consumption, and keep industrial production rising.

## Japan

Japanese GDP rose slightly in 3Q02, by 1.5% yoy. Export demand was the key engine, followed by private consumption, with the build-up of inventories also positively contributing to growth. However, there are signals that domestic activity in the last quarter of 2002 was weaker. Retail sales fell in October and November, as did disposable household income, indicating weak consumption. In addition, enterprises reduced their inventories during the first two months of 4Q02, and there was no good news on fixed investments, at least in October.

**Real GDP, % change yoy**



Source: Bank of Japan.

Exports were undeniably strong in October and November, and were the only hope for positive growth in 4Q02. Exports of goods increased by 14% yoy in October (imports by only 3% yoy), and customs trade figures for November also suggest good results.

CPI deflation continued in October (-0.9% yoy) and November (-0.4% yoy), as lower wages held down consumer demand. At the same time, wholesale prices recorded very small increases on a yearly basis. The monetary base rose by 20% yoy in



October and by 22% yoy in November. Bank lending continued to shrink on an annual basis (-4%).

The budget approved for the new fiscal year (starting in April 2003) indicates a slight ease in Japan's fiscal policy stance. The government said it wanted to keep general expenditures at a level roughly equal to this year's. However, as a moderate contraction in economic activity (and hence shrinkage in tax revenues) is anticipated, a record bond issuance is planned. <MJ>

## Latin America

- **Bad results of 2002 – some hope for 2003**
- **Political stability key to growth prospects**

After disappointing results in 2002, the outlook for 2003 improved slightly during the last quarter. Most importantly, conditions firmed in Brazil and Argentina. Venezuela remains the most difficult case, though the fallout of political tensions there should be limited to the oil market (see *Commodities* section). Foreign demand is seen as a key driving force for growth in all the major economies of the region. The recently more stable political scene has been crucial for improvements in Brazil's and Argentina's outlook. At the same time, politics will remain a major risk factor in 2003 and any renewed tensions would have a negative impact on economic activity. The importance of political stability and sound macroeconomic policies is visible in international borrowing data. In 2002, Latin American borrowing roughly halved – in stark contrast to other emerging markets, where an upsurge was observed. Investors are, however, still distinguishing risks in the region and in early January Chile and Mexico placed large issuances at very low spreads.

One year after the crisis broke out some relatively positive news from Argentina, with activity in the real sector appearing to have bottomed out at last. So far, the rebound has been concentrated in the tradables sectors. Despite very tough financing conditions, in November and December industrial production increased on an annual basis for the first time since mid-2000. CPI inflation stabilised at low levels in 4Q02, in December at 41% yoy, well below expectations formulated from 1H02. While

these positive developments owe much to the relative political stability in recent months, nothing can be taken for granted in 2003. Political stability, realistic economic policies and reform plans are needed to assure stable growth over the longer-term. Difficult negotiations on defaulted debt will probably start only after April's presidential elections. Relations with the IMF will remain vital, given the amount of money Argentina is scheduled to pay to the Fund this year.

Fears of policy weakening in Brazil after the election of a new president diminished somewhat after his and his government's declarations that they would pursue responsible macroeconomic policies, though it remains to be seen the extent to which the new team will be able to achieve any real success in this area. The earlier heavy depreciation of the *real* resulted in increased competitiveness and in recent months Brazil's external position improved visibly, with strong export gains. GDP growth is expected to strengthen only moderately this year from around 1.5% in 2002. A strong rebound is unlikely given the need to tighten monetary policy in response to the rise in inflation. In 4Q02, the CPI rose above 10% yoy – the worst figures since 1995.

Mexico's real sector performance will be largely determined by developments in the US. 2003 should see stronger growth performance, despite the expected tight monetary policy aimed at bringing down inflation (which reached 5.7% yoy in December 2002). 4Q02 saw a softening of growth momentum, with the GDP figure for 2002 estimated at around 1.1%. <WP>

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## Central Banks Watch

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- **Further easing in the US, euro zone and CEECs in 4Q02...**
- **... but could be the end of easing phase in industrialised countries**

In the face of weaker-than-expected economic data and fears about muted expansion in the US, the FOMC decided to cut its interest rates by 50 basis points in November 2002. As a result the federal funds rate amounted to 1.25% and the discount rate

to 0.75%. Given the slack in the labour and product markets, fears about inflationary pressures were thought less important than fears about the pace of economic recovery. FOMC members clearly see a deflationary scenario as unlikely, unless a severe demand shock hits the economy. Given expected economic developments in 2003 and the current very low level of interest rates, there are unlikely to be changes in monetary policy in 1H03, and in the latter part of 2003 a rise in interest rates could be expected, with the precise timing and scale depending on growth and price performance.

The ECB also decided on more accommodative monetary policy. In December, it lowered interest rates by 50 basis points. The minimum bid rate on the main refinancing operations was brought down to 2.75%. This, the ECB said, was because of the low inflationary risk due to subdued economic growth and uncertain outlook for further expansion. The decision was made in spite of M3 growth of 7.1%, i.e. above the reference value. In December, it was also decided that the M3 reference value would remain unchanged at 4.5% for the next year. Given still high inflation in the euro zone, no further cuts in interest rates should be expected in the coming months. To the contrary, by the end of 2003 a tightening of monetary policy will probably take place – contingent on the pace of economic expansion and inflation behaviour.

In contrast to monetary policy decisions in the US and euro zone, the Bank of England left its interest rates unchanged in 4Q02: interest rate have remained unchanged at 4.0% for over a year. The risks of higher inflation were weighed against growth prospects. Given the UK's robust household consumption, as well as extensive household borrowing and soaring housing prices, rising inflationary pressures are looming. Against this background, a cut in interest rates is unlikely in the near term. Only a prolonged contraction in domestic investment and a weak global economy are likely to increase the chances for easing monetary policy.

4Q02 also saw monetary easing in some CEECs. The Czech National Bank lowered interest rates by 25 basis points down to 2.75% (the 2-week repo rate) in November. The CNB in its latest announcement advocated early entry into the euro zone and concluded that, given appropriate fiscal

consolidation, 2007 would be the ideal accession date. Given the low levels of interest rates and projections of higher inflation and growth in the course of 2003, the November cut should end the easing phase. However, if growth surprises on the downside, more easing is possible. The Hungarian National Bank faced the dilemma of whether to fight forint appreciation or adhere to inflation targeting. So far, it seems the former goal has won out. Interest rates were cut on two occasions, in November and December, by 50 basis points each time and the bank intervened directly on the market in mid-January. Consequently, the central bank's base rate dropped from 9.5% to 8.5%. In November, the HNB decided to increase the interest rate on mandatory reserves from 5.25% to 5.75%, effective from 1 January 2003. This measure was aimed at reducing income loss to the banking sector and improving banks' competitiveness. Against the background of loose fiscal policy and risks of higher inflation (due to demand and wage cost push factors), the HNB should not cut interest rates in the near future. In Poland, low inflationary pressure made room for further monetary easing in 4Q02. In October, interest rates were cut by 50 basis points and in November by 25 basis points. As a result, the 28-day minimum repo rate dropped to 6.75%. Given subdued price developments and no interest rate change in December, we anticipate more fine-tuning monetary easing of around 25 basis points in January and February. Further easing in the course of the year cannot be ruled out. <LR>

Central Bank	Official interest rate	Current	Last change
US	Federal funds	1.25	6 Nov 02
Japan	Overnight call	0.01	19 Mar 01
ECB	Refi	2.75	5 Dec 02
England	Repo	4.00	8 Nov 01
Czech Rep.	2-week repo	2.75	31 Oct 02
Hungary	2-week repo	8.50	17 Dec 02
Poland	28-day intervention	6.75	27 Nov 02

Source: Central banks

## Exchange Rates

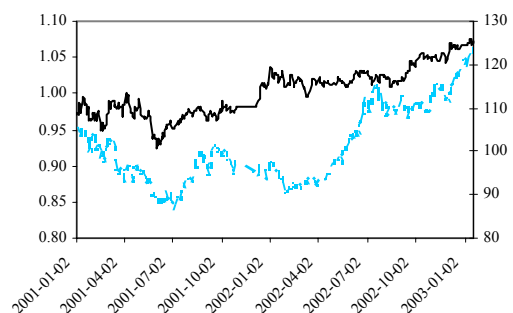
- **Strengthening of the euro**
- **Real appreciation of CEECs' currencies to continue**

After some stabilisation of the dollar-euro exchange rate in September and October, the euro started to appreciate in December and early January 2003, also gaining strongly against the yen. Consequently, the euro appreciated in nominal effective and real effective terms. This trend should continue in the short term, though the dollar-euro exchange rate is expected to stabilise around parity in the latter part of 2003. Given the prospect of a more muted recovery in Japan this year and the aim of the Japanese authorities to keep the yen weak, the Japanese currency should depreciate against other major currencies in 2003 and 2004.

The real appreciation of CEEC currencies continued in 4Q02. The Czech koruna appreciated yoy in nominal and real terms, though not as sharply as in 1H02. The Hungarian forint also

continued to appreciate on annual, nominal terms. On the other hand, the Polish zloty lost yoy against the euro, but gained against the dollar. The real appreciation in the CEECs is expected to continue. This will to some extent be related to approaching EU membership. Given the low inflationary outlook in the CEECs real appreciation will be primarily achieved via nominal appreciation. <LR>

**Euro exchange rates against US\$ and Yen, Jan 2001-Jan 2003**



— Yen per EUR (right scale) — US\$ per EUR (left scale)  
Source: ECB.

**Euro exchange rate vs. dollar and yen, 1998-2004**

	1998	1999	2000	2001	2002	2003f	2004f
Dollar	1.121	1.066	0.924	0.896	0.945	0.999	1.004
Yen	146.4	121.3	99.5	108.7	118.1	130.0	120.0

Note: f – forecasts

Source: data – ECB, forecast – CASE, market consensus

## Commodity Prices

- **Record high oil and gold prices**
- **Base metals prices up in 4Q02**
- **Low cereal production drives prices up**

### Oil

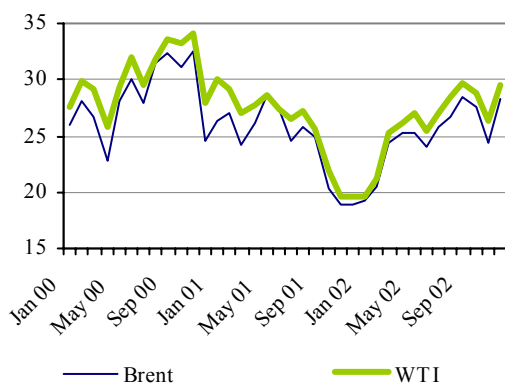
4Q02 again saw very high price volatility driven by geopolitical uncertainties (the looming war with Iraq and the general strike in Venezuela which started in December), as well as by anaemic economic growth in the world economy. The average Brent price stayed just below US\$27 per

barrel in 4Q02, largely unchanged from 3Q02, but this obscures a downside correction in prices in November to the monthly average of US\$24.3, followed by a rally to well above US\$28 in December. In early January, Brent trading was jittery within the US\$29-31 range. One should not expect oil prices to fall substantially below US\$28 per barrel in 1Q02 given that the uncertainty surrounding Iraq is unlikely to diminish. Moreover, in Venezuela oil output dropped by around 80% from the 3.1 million b/d produced before the strike began. Given technological constraints, the recovery of oil production levels will take months to recover even after the political dispute is

resolved, so Venezuelan oil will not be supplied to the market in 1Q03.

On the demand side, the International Energy Agency revised upwards its 2002 global demand growth estimates to 390 kb/d, but this was mainly attributable to gains in China. OECD oil stocks continued on a downward trend in 4Q02 with forward demand cover reduced to 52 days as of October 2002, levels unseen since 2000. The 2002 demand growth forecast remains at 1.04 mb/d, concentrated on the US and East Asia. Still, it is the supply side that will determine market conditions, as has been the case in the last two years. It is likely that OPEC will manage to increase its average annual production for the first time since 2000. In mid-January, the cartel announced a 1.5 mb/d rise in production to compensate for the loss of Venezuelan oil. Among non OPEC producers, the strongest gains are likely to be observed in the FSU region, which is likely to surpass the 10 mb/d level for the first time since 1991. <WP>

#### World oil prices, 2000-2002 (US\$ per barrel)



Source: US Energy Information Administration

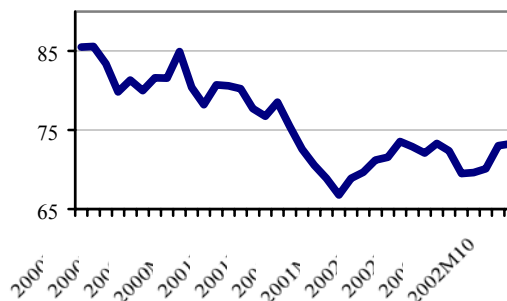
#### Metals

The IMF base metal price index increased in 4Q02, regaining losses from the previous quarter. The index consists of information about prices for aluminium, copper, iron ore, and also nickel, zinc, uranium, tin and lead. Sudden rises in the prices for basic metals are not expected, as these commodities depend on the overall economic situation.

Steel prices continued to fall in 4Q02, and after reaching a peak in the early summer of 2002, in December 2002 were already back to their spring levels. The trends observed in recent months are caused by expanding supply and still weak end-user

demand. It is commonly agreed that after the US-EU steel war ended the steel market would return to being a buyers' market as of the beginning of 2003.

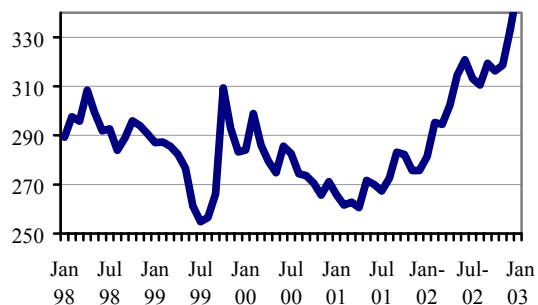
#### IMF metal price index, 2000-2002



Note: New composite index with changed weights.  
Source: IMF

Fears of military action in Iraq drove up gold prices further throughout late 2002. In early January, prices hit 6-year highs of US\$350 per ounce. However, additional increases are unlikely.

#### Gold prices, 1998-2003 (US\$ per troy ounce)



Note: January data for the beginning of the month only.  
Source: Pacific FX Database.

#### Agricultural commodities

The new IMF composite food price index increased in 4Q02, mainly as a result of rises in prices for cereals, oils and sugar. When looking at 2002 as a whole, the situation was different during the first half of the year – with food prices at a relatively low level, and in 2H02, when food prices grew. End-year higher prices for wheat and maize stem from lower production of these crops in the southern hemisphere. It is estimated that in 2002 the total cereal production was the lowest since 1995. FAO's estimate a small increase in cereal production in 2003, and hence a moderate fall in their prices.



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Cotton prices increased to levels unseen since 2000, as a result of rising demand and tighter world supply. China increased imports, while at the same time there was an unanticipated decrease in cotton production in the southern hemisphere, a decline in offers from Uzbekistan, and political tensions

mounting in West Africa. In 2003, cotton production is expected to be on a downward path in most of the major producing countries. <MJ>

## Statistical Appendix

	1999	2000	2001	4Q01	1Q02	2Q02	3Q02	Oct	Nov	Dec
<b>GDP, % yoy change</b>										
US	4.1	3.8	0.3	0.1	1.4	2.2	3.3			
Japan	0.7	2.6	-0.3	-2.7	-3.1	-0.8	1.3			
EU	2.8	3.5	1.6	0.6	0.5	0.9	1.1			
UK	2.4	3.1	2.0	1.6	1.1	1.5	2.1			
Euro-zone	2.8	3.6	1.5	0.5	0.3	0.7	0.8			
Germany	2.0	2.9	0.6	0.1	-0.2	-0.1	0.4			
France	3.2	4.2	1.8	0.3	0.5	1.0	0.8			
Czech Rep.	0.5	3.3	3.3	2.6	2.8	1.9	1.5			
Hungary	4.2	5.2	3.8	3.3	2.9	3.1	3.5			
Poland	4.1	4.0	1.0	0.2	0.4	0.8	1.6			
Russia	5.4	9.0	5.0	4.3	3.7	4.2	4.3			
Turkey (GNP)	-6.1	6.3	-9.5	-12.3	0.2	9.4	7.8			
<b>CPI, % change yoy</b>										
US	2.1	3.4	2.8	1.8	1.2	1.3	1.6	2.0	2.2	
Japan	-0.3	-0.7	-0.7	-1.0	-1.4	-0.9	-0.8	-0.9	-0.4	
EU15	1.2	2.5	2.5	2.0	2.2	1.9	1.9	2.1	2.1	
UK (HICP)	1.3	0.8	1.2	1.0	1.5	0.9	1.0	1.4	1.6	
Euro-zone (HICP)	1.1	2.4	2.5	2.2	2.6	2.1	2.0	2.3	2.2	
Germany (HICP)	0.6	2.1	2.4	1.7	2.0	1.1	1.0	1.3	1.0	
France (HICP)	0.6	1.8	1.8	1.5	2.2	1.7	1.7	1.9	2.1	
Czech Rep.	2.1	3.9	4.8	4.3	3.7	2.3	0.7	0.6	0.5	0.6
Hungary	10.0	9.8	9.2	7.2	6.2	5.5	4.6	4.9	4.8	4.8
Poland	7.3	10.1	5.5	3.7	3.4	2.1	1.3	1.1	0.9	0.8
Russia	85.7	20.8	21.6	18.9	18.0	15.8	15.1	15.0	15.2	15.1
Turkey	64.9	54.9	54.4	67.5	70.3	47.0	39.5	34.4	31.8	29.8
<b>Short-term interest rate, %</b>										
US	5.33	6.46	3.69	2.06	1.82	1.83	1.76	1.73	1.39	1.34
Japan	0.25	0.25	0.12	0.04	0.12	0.04	0.04	0.03	0.05	0.04
UK	5.45	6.11	4.97	4.09	4.01	4.10	3.95	3.9	3.91	
Euro-zone	2.97	4.39	4.26	3.44	3.36	3.45	3.36	3.26	3.12	
Czech Rep.	6.85	5.37	5.17	5.0	4.4	3.9	3.1	2.8	2.8	2.6
Hungary	14.7	11.0	10.8	10.2	8.7	8.6	9.4			
Poland	13.14	16.62	14.85	12.08	9.92	9.24	7.96	7.05		
Russia	23.0	12.8	10.0	11.1	14.2	12.9	11.5	10.5		
Turkey	70.0	183.2	59.0	59.0	54.73	48	46			
<b>Unemployment rate, %</b>										
OECD	6.7	6.3	6.5	6.8	6.8	6.9	7.0	7.0	7.0	
US	4.2	4.0	4.8	5.6	5.6	5.9	5.7	5.7	6.0	
Japan	4.7	4.7	5.0	5.4	5.3	5.3	5.4	5.5	5.3	
EU	8.7	7.8	7.4	7.4	7.5	7.5	7.6	7.7	7.7	
UK	5.9	5.4	5.0	5.1	5.1	5.1	5.2			
Euro-zone	9.4	8.5	8.0	8.0	8.1	8.2	8.3	8.4	8.4	
Germany	8.4	7.7	7.7	7.9	8.0	8.2	8.3	8.3	8.4	
France	10.7	9.3	8.5	8.5	8.6	8.7	8.8	8.8	8.8	
Czech Rep.	8.8	8.9	8.2	8.0	7.6	7.1	7.2			
Hungary	7.1	6.5	5.8	5.8	5.8	5.6	6.0			
Poland	..	16.1	18.2	19.0	19.0	19.7	20.9			
Russia	12.4	9.9	8.7	8.7	8.2	7.7	7.6	7.1	7.0	
Turkey	7.6	6.6	8.5	10.6	11.8	9.6				

Notes: 1. GDP growth rates- seasonally adjusted.  
 2. Short term interest rates generally refer to 3-month interbank rates or Treasury rates (overnight rate for Turkey).  
 3. Standardised unemployment rate is presented with exceptions of Russia and Turkey.

Sources: OECD, Eurostat, countries' statistical agencies and central banks.



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All analyses are based on data and information available until 15 January 2003. Additional information is available upon request. Please contact CASE at [global.economy@case.com.pl](mailto:global.economy@case.com.pl).  
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