A. Economic Development in 1996

1. THE WORLD ECONOMY

1.1 Global Trends of Macroeconomic Development

1.1.1 Dynamics of Growth

The development of the world economy in 1996 was induced by some long-term trends in the dynamics of growth in individual global groupings while, at the same time, certain short-term aspects influenced the business cycle, particularly on the European continent.

The group of OECD countries recorded a relatively moderate rate of economic growth which - expressed as a year-on-year increase in gross domestic product (GDP) - reached 2.4%. Nevertheless, there were substantial differences among OECD-member states in the dynamics of their economic growth.

The economy of the United States, growing moderately from the early 1990s, recorded a growth of 2.4% in GDP year-on-year. Probably, the only remarkable deviation from this long-term trend occurred in the second quarter of 1996, when the rate of year-on-year growth almost doubled (to 4.7%). In spite of this, the Federal Reserve System decided not to raise interest rates in anticipation of a gradual decline in the rate of growth. The housing development scheme, government consumption and inventory growth were the main factors of economic growth.

The economic development in Japan in 1996, showed signs of recovery from a lengthy recession when, encouraged by low interest rates and high volumes of public investment, Japan recorded the highest rate of GDP growth (3.6%) among all G7 countries. Japan's economy was going through a phase of major structural change introduced in reaction to the process of globalisation. The economy opens up domestic markets to foreign competition and, as the domestic demand rises, imports quickly follow. Domestic producers have been quick in relocating their capacities to cover a substantial portion of the domestic demand from abroad. The ongoing process of a certain standardisation of the social and economic development in Japan indicates that the high rates of Japanese economic growth in previous decades are unlikely to recur.

The rate of growth in the countries of the European Union (EU) slowed down and the EU, as a whole, posted a 1.6% GDP growth. The slowdown in the rate of economic growth in the EU in 1996, can be attributed, apart from business cycle, to the cautious fiscal policy and a generally shared interest in meeting the Maastricht criteria for accession to the European Monetary Union.

The economies of South-East Asia maintained their generally high rate of growth, although typical of this part of the world are notable differences in the dynamics of growth in individual countries. The long-term dynamics of growth of the four "Asian tigers" (South Korea, Taiwan, Hong Kong and Singapore) slowed down (to the level of 5-7% GDP growth year-on-year), while economic growth accelerated in Indonesia, Thailand, Philippines and Vietnam (6-9% year-on-year). Following the strong economic expansion in China, which lasted several years, the rate of growth slackened in 1996, although it still approached 10%. A relatively high rate of economic growth (5-9%) was achieved, too, in the majority of Latin American countries.

The pace of growth in the transforming economies of Central and Eastern Europe slackened somewhat (approximately by 1% in CEFTA countries). This slowdown is attributable to the fact that the EU-member states, as major trading partners for CEE countries, are currently on the descending curve of the business cycle. The contraction of export opportunities and the growing domestic demand resulted in a general increase in the foreign-trade deficit (from 5% to 10% of GDP). The recession in the Russian Federation intensified further (GDP fell by 6.4% compared with a 4-% decline in 1995); the balance of trade recorded a surplus of US$ 28 billion.

1.1.2 Inflation

Price development in global terms was favourable without disturbing the longer-term trend of disinflation. The rate of 1996 inflation (expressed in terms of the consumer price index) in the OECD (28 member states, including Czech Republic, Hungary and Poland) reached 4.7% (compared with 3.0% in 1995). Without Turkey (where prices grew by 80%), inflation in OECD states averaged 3.3%. This rate of inflation is a result of two mutually contradictory phenomena: while, on one hand, inflation in the EU fell to 2.4% (from 3.3% in 1995), two of the three newly accepted and obviously 'more inflationary' economies (Poland and Hungary) recorded two-digit rates of inflation at the level of 20%.

Regarding the group of OECD countries, consumer prices grew at a relatively faster pace in the USA, where the annual rate of inflation reached 3.3%, while inflation in Japan in 1996, fluctuated around the symbolic level of 1%.

Efforts to slash the rate of inflation in the traditionally inflationary region of Latin America had various success. On the other hand, the dynamic economic growth in south-east Asia did not put excessive pressure on the growth of consumer prices. Inflation rates in the countries of the region reached acceptable levels (5-8%). A substantial reduction in inflationary pressure was achieved in China, where the annual inflation rate dropped to 6.6% (from 15.4% in 1995).

The moderate growth in consumer prices in 1996, is attributable to the relative stability of producer prices which, in EU countries, grew by less than 2%, in the USA by 2.8% and in Japan by 0.9%.

1.1.3 Unemployment

At a generally moderate rate of economic growth, the level of unemployment in OECD countries was not substantially different from that of 1995, reaching 7.8%. Unemployment in the USA slightly dipped to 5.3%. Although unemployment in Japan was low in global terms, it was relatively high (3.3%) by Japanese historical standards. Even though the rate of unemployment in the EU decreased, it still remained at a two-digit level in 1996 (10.9%).

1.2 The European Union

1.2.1 Dynamics of Growth

Economic development in the European Union in 1996 was influenced by a general effort by governments of the member states to further approximate their respective monetary and financial indicators to the convergence criteria that the Maastricht Treaty set forth for membership in the monetary union scheduled for 1999. In addition to being in the descending phase of the business cycle, the cautious financial policy of the EU-member states - oriented towards shrinking budget deficit and government debt - slowed the dynamics of their economic growth even further.

In 1996, GDP in most EU countries grew at a rate of 1.8-2%. The highest rate of GDP growth was recorded in Ireland (5.6%); the economies of Great Britain and Finland also grew fairly dynamically (2.4% and 3.0% respectively). On the other hand, the largest economies in the continental part of the EU - Germany, France, Belgium and Austria - recorded a GDP growth of around 1% year-on-year.

One of the remaining problems in the economic development of the EU-member states is the high rate of unemployment which, given the sluggish rate of economic growth, continues to exceed 10%. In 1996, Spain reported the highest rate of unemployment (22.5%). Unemployment in Ireland (13.4%), Finland (16.3%), France (11.7%) and Italy (11.8%) was higher than the EU average.

1.2.2 Heading Towards Monetary Union - Meeting the Maastricht Criteria

Following the substantial progress achieved by EU-member states in previous years in meeting the Maastricht criteria for accession to the monetary union in converging their inflation and interest rates, and in stabilising the currency exchange rates, rehabilitation of public financing was high on the agenda in 1996.

The 1996 price development in the EU was stabilised. With the exception of Greece and Italy (where inflation reached 8.3% and 3.9%, respectively), all EU members complied with the Maastricht criterion for the rate of inflation, which spanned from -0.4% (Sweden) to 3.2% (Spain).

The process of converging interest rates was also successful. Except for Portugal and Greece, where the rates of interest on government bonds fluctuated during the year between 10% and 15%, respectively (albeit with interest rates in these two countries falling as well), interest rates in the remaining EU countries moved within a narrow band, from 5.1% (Austria) to 7.67% (Great Britain). However, given the levels at which some EU countries maintained their interest rates at the beginning of 1996, only 10 EU members complied with the Maastricht criterion, because three countries reduced their interest rates substantially enough only over the course of the year.

The exchange rates within the Exchange Rate Mechanism (ERM) of the European Monetary System in 1996 remained relatively stable. This favourable development was supported by the revaluation of the US dollar versus the German Mark which, in principle, was occurring throughout the entire year. Two years after joining the EU. Finland also announced the inclusion of its currency in the ERM.

Results in the consolidation of public spending were less favourable. A number of EU countries did not manage to lower the size of their public sector deficit to desirable dimensions even in 1996. The tight criterion of 3% of GDP was met only by three countries, four had their deficit at the level of 4% and five at the level of 5% of GDP. However, the relatively vague formulation of the Maastricht criterion (which allows for short-term excesses), enables various loose interpretations of the results, whereby the public finance situation in only about a half of all EU countries can be considered satisfactory.

Similarly, the criterion of 'sufficiently convincing' reduction of government debt to the maximum level of 60% of GDP allows for a certain discretion in evaluating the results achieved in individual countries by the end of 1996. Except for Luxembourg, which is atypical because of its historically symbolic dimension of government debt, only France and Great Britain managed to dip several points below the 60% limit. Indicators slightly above 60% were recorded in Germany (61.5%) and two other countries. Government debt in six countries spanned from 70 to 80% of GDP. Greece, Italy and Belgium continue to show the highest rate of government indebtedness, which exceeds 100% of GDP.

1.3 Financial and Commodity Markets

A dominant characteristic of developments in the world financial market in 1996 was the appreciation of the US dollar against Japanese yen (from 103 JPY/US$ in December 1995 to 114 JPY/US$ in December 1996) and German mark (from 1.44 DEM/US$ in December 1995 to 1.55 DEM/US$ in December 1996). The exchange rate of the dollar was growing throughout the year. This trend slowed down in the middle of the year as markets expected Japanese interest rates to go up due to the faster-than-projected GDP growth in the first quarter. On the countrary, political uncertainty in Japan and apprehension of the impact which the increase in oil prices would have upon the Japanese economy pushed the yen down in the last quarter of 1996.

The development of US$/DEM exchange rate was not that straightforward. The dollar appreciated mainly in the first half of the year (in May, DEM recorded its 16-month low at 1.54 DEM/US$), then it started to fall and hit 1.48 DEM/US$ in August only to pick up in the last months of the year. The depreciation of the mark against the dollar in 1996 was due to the unfavourable economic situation in Germany. The growth failed to accelerate despite supportive interventions by the German Bundesbank that, in April, lowered the discount and Lombard rates to 2.5% and 4.5% respectively (i.e. by 0.5 percentage points), and, in August decreased its REPO rate too, from 3.3% to 3.0%.

Prices on the world commodity exchanges in 1996 declined. The aggregate dollar index, reflecting all traded items, reached 106.9 (1990 = 100%) and, in year-on-year terms, the decline was 3.2%.

Contrary to commodities, oil prices on the world market increased. The high level of demand for oil products pushed the prices of oil up and, as a consequence, oil companies used oil from stocks which, in the USA alone, fell at the end of September to the lowest level in the past 20 years. The price of oil (Brent) reached US$ 24.55 per barrel (against US$ 18.45 from the beginning of January) and decreased only slightly to US$ 24.13 per barrel towards the end of the year. The price growth reached an average of 21.2% year-on-year (from US$ 17.05 to US$ 21.66 per barrel). The price of Ural oil followed the development of Brent and grew by 20.9% to US$ 19.99 per barrel (from US$ 17.66 in December 1995, to US$ 23.30 in December 1996).

1.4 World Trade

For quite some time, world trade has been growing at a faster rate than the world output. In 1996, the volume of world trade grew by 6.9%, with the dynamics of growth lower in the industrialised countries (5.4%) and the participation of the developing and transforming economies (a 10.4% growth in volume) in the international exchange of goods becoming more intensive.

Compared with 1995, the overall dynamics of growth in international trade slightly slackened. This was due both to the slowdown in economic growth in Europe and the reduction in the volume of exports by the newly industrialised nations of south-east Asia caused by the unfavourable impacts which the weakened yen had upon their import and export conditions. On the other hand, the global trend towards international specialisation and further liberalisation of trade helped to keep the volume of world trade high in 1996.

2. ECONOMIC DEVELOPMENT OF TRANSITION ECONOMIES OF CENTRAL EUROPE

The development in the CEFTA group of countries in 1996, i.e. in the seventh year of their economic reform, was characterised by a continued revival, although at a slower pace than in the previous year. Domestic consumption increased at a faster rate than the growth in domestic output and thus the consumer and investment demand had to be covered from sources abroad, which, in turn, created a deficit in the balance of payments. Positive aspects include the gradual decrease in the rate of inflation and a slight decrease in the rate of unemployment.

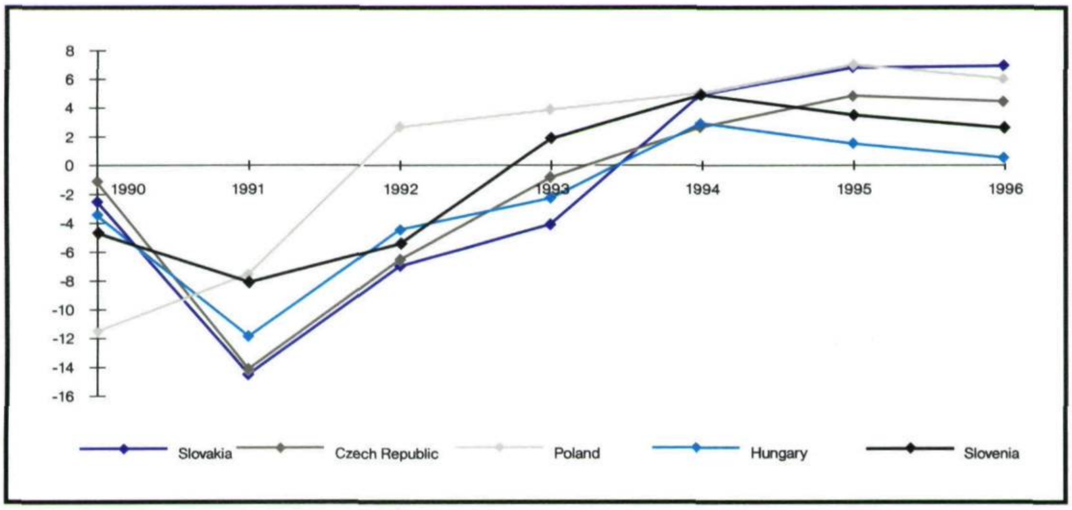
In 1996, CEFTA member countries took another step towards becoming more involved in wider international groupings. Following the admission of the Czech Republic to OECD in the previous year, Hungary and Poland became members in 1996. The association agreement between Slovenia and the European Union was also signed in 1996 to take effect in 1997.

2.1 Development of Gross Domestic Product

The transforming economies of Central Europe in 1996 recorded a GDP growth lower than in the year before. From among these countries, Slovakia and Poland maintained the highest dynamics of growth.

The rate of growth slackened slightly in the Czech Republic and Slovenia. As a consequence of stabilisation measures adopted in 1995, Hungary managed to maintain its rate of economic growth only at a minimum level.

Development of real GDP - change against previous year ***(%)***



2.2 Price Developments

Except for Hungary, the rate of inflation in CEFTA countries is going gradually down. In 1996, the most moderate rate of growth in consumer prices was recorded in Slovakia, the Czech Republic and Slovenia, with year-on-year inflation reaching single-digit levels. As for Poland and Hungary, their economic growth was accompanied by inflation of 20% and 24% respectively.

Macroeconomic results in the CEFTA group of countries

	Slovakia	Czech Republic	Poland	Hungary	Slovenia
Index of GDP growth (%)					
1994	4.9	2.6	5.2	2.9	4.9
1995	6.8	4.8	7.0	1.5	3.5
1996	6.9	4.4	6.0	0.5	2.6
Consumer Price Index (%)					
1994	**13.4**	10.0	32.2	18.8	19.8
1995	9.9	9.1	27.8	28.2	12.6
1996	5.8	8.8	19.9	23.6	9.7
Unemployment rate (%)					
1994	14.8	3.2	16.0	10.9	**14.2**
1995	13.1	2.9	14.9	10.9	14.5
1996	12.8	3.5	13.6	10.7	14.4
Balance of payments current account (% of GDP)					
1994	4.7	-0.1	-1.1	-9.9	3.7
1995	3.7	-2.9	-2.0	-6.3	-0.0
1996	-7.3	-7.1	-0.4	-3.2	-1.3
Budget balance (% of GDP)					
1994	-5.2	1.0	-2.7	-7.3	-0.2
1995	-1.6	0.6	-2.6	-2.4	-0.0
1996	-4.4	-0.1	-2.8	-3.8	0.0

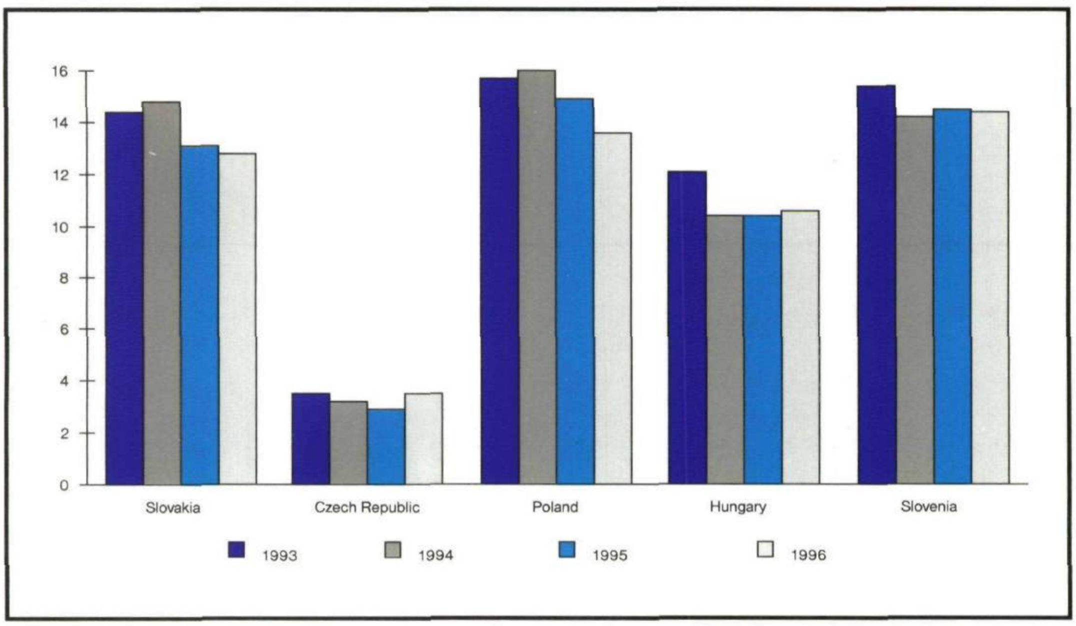
2.3 State Budget

Only Slovenia closed 1996 with a balanced government budget. After several years of budget surpluses, the Czech Republic reported a deficit of 0.1% of GDP, the deficit in Poland neared 3% and deficits in Hungary and Slovakia reached 3.8% and 4.4% of GDP respectively.

2.4 Labour Market

The proportions in the rates of unemployment among individual countries remained unchanged again in 1996. Unemployment grew slightly in the Czech Republic and Hungary (with the lowest unemployment in this group of countries), while other countries reported decreases.

Development of unemployment rates ***(%)***



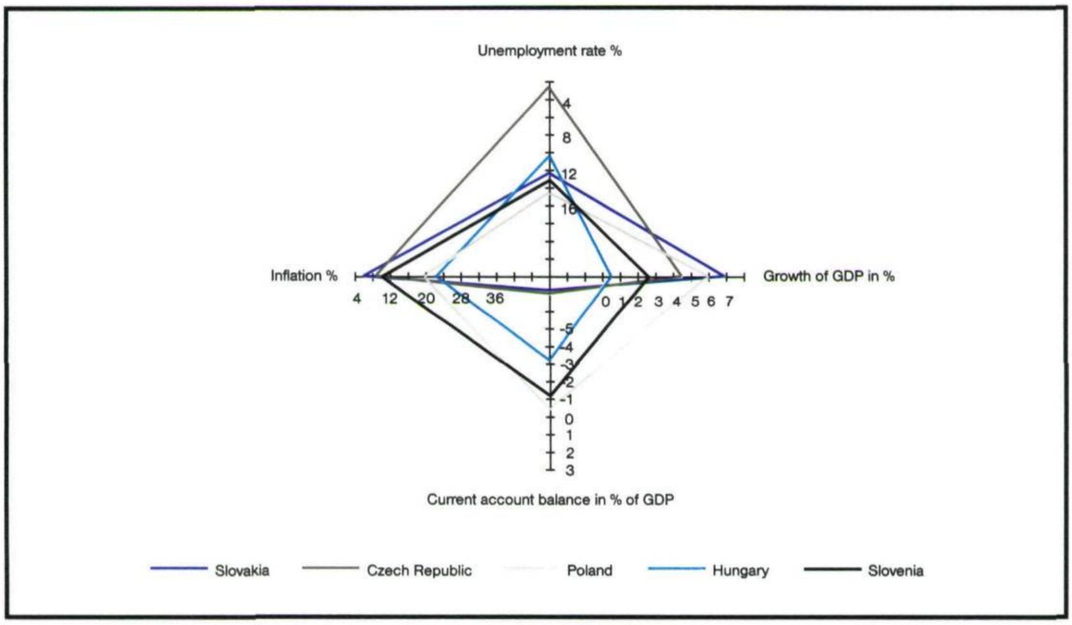
2.5 Foreign Trade

Imbalance between the rates of growth in exports and imports is a long-term problem in CEFTA countries. The size of the 1996 trade balance deficit in individual countries reached a level that, in all CEFTA countries, resulted in a deficit in the current account of the balance of payments.

This problem indicates that the pace of restructuring at corporate level is not sufficient. The gradual opening up of economies and orientation of their trading towards developed market economies also played a role in this and increased the sensitivity of these countries to the course of the business cycle in developed economies.

The diagram below, called 'magic quadrangle,' illustrates the results of interaction between government economic policy and monetary policy in the fields of GDP growth, labour market, price developments and the current account of the balance of payments in 1996. Values of individual indicators are shown on the four axes of the diagram; the further from the intersection, the more favourable the indicators are. The larger the size of the quadrangle, the better the results.

Basic macroeconomic indicators for 1996



Looking at the results, it is obvious that none of the five countries experienced balanced development in all four areas. Slovenia and the Czech Republic were most successful in bringing the rate of inflation down. However, economic growth driven by the domestic demand was, to a large extent, fuelled by using foreign resources which was reflected in a substantial increase in the deficit in the current account of the balance of payments. Polish economic growth continued to be accompanied by a high rate of inflation and a fairly high level of unemployment. Slovenia recorded single-digit inflation. However, the economy grew at a slower pace than in previous years and unemployment is still high. Hungary had the lowest dynamics of real GDP growth and the highest rate of inflation. However, the development of the current account of the balance of payments is gradually improving.