A. The External Economic Environment

1. THE WORLD ECONOMY

1.1 Global Trends

Forecasts for the development of the world economy in 1997 held that the year concerned would see the continuation of the long-term trend of global growth and general relative stability. In principle, the forecasts proved correct: the increase in real global output (GDP) reached 3% and the global rate of consumer-price inflation 4.2%. Within the major regions of the world economy, however, there occurred some marked deviations from the forecasts, including several unexpected events.

A marked deviation from the forecasts, positively influencing the advancement of the world economy, was recorded primarily in the development of the US economy, where the rate of growth further accelerated in contrast with the expected slowdown, as the top of the business cycle was supposed to have been reached in 1996. On the contrary, the rate of economic growth in Japan failed to accelerate in 1997, despite the signs of recovery from recession during the previous year. The long-term relative stability of the basic trends of development in the individual centres of the world economy and their contributions to the process of globalisation, was disturbed by the financial crisis that hit the countries of East Asia during the second half of 1997. In 1997, the development of the world economy was more or less unaffected by this event. The consequences of the crisis may, however, spread to other regions in the area if not the rest of the world.

In 1997, economic development on the European continent was determined by the generally favourable situation in overseas areas, and by the process of European integration. Within the European Union, which is already standing on the threshold of the final phase of preparation for monetary union, the fulfilment of the Maastricht criteria of financial stability in the individual member states remained the centre of attention. In terms of wider differentiation among the associated countries of Central and Eastern Europe, their positions in respect of prospects for serious talks about accession to the European Union have clarified.

The CEFTA group of Central European countries, except the Czech Republic and Rumania, achieved a higher rate of growth in output than western European economies. However, the rate of price inflation was higher than in western Europe, though in countries with two-digit inflation in the long run (Poland, Hungary), a certain reduction was achieved. Owing to the favourable climate in the area of external demand, the deficits in the balance of payment current accounts of these countries were usually lower than the previous year's figures. For the first time since the split of the former USSR, the Russian economy recorded a slight growth in output in 1997.

The favourable economic development in advanced industrial countries was also supported by moderate price developments on the world's leading commodity markets. First of all, a continuous fall was recorded in the price of crude oil, the stocks of which were replenished in Europe and the USA after a marked decline in 1996. At the end of December 1997, the price of crude oil (Brent - North Sea Oil) stood at US$ 16.92 per barrel, that is 27.4% less than the figure recorded in December 1996.

There was a moderate rise in world prices of other commodities; the aggregate increase reaching roughly 2%. This increase was due mainly to a rise in the level of food prices, while the prices of non-food raw materials showed a tendency to fall. Therefore, despite an appreciation in the value of the dollar, the prices of fuels and raw materials imported into the main centres of final production had no significant effects on the level of consumer prices on domestic markets.

In 1997, the trend that determined the development of international foreign exchange markets was the strengthening of the dollar against all major currencies - the German mark and other currencies within the European exchange rate mechanism, as well as against the British pound and the Japanese yen. The strong exchange rates of the US dollar and the British pound were supported by the fast rate of economic growth and macroeconomic stability in these countries. The weakening of the yen was associated, among other things, with the low level of economic activity in Japan and the unlikelihood of a substantial change. The East Asian crisis gave rise to a certain depreciation in the value of the dollar against western European currencies during the last months of the year; at the same time, the exchange rate of the yen against the dollar further deteriorated owing to the more intense impact of the crisis on the Japanese yen.

The development of share prices on the stock markets of advanced economies (excepting Japan), marked by several years of steady growth, had a more volatile character in 1997. The first half of the year saw fluctuations accompanied by a sharp fall in prices due to tighter monetary policy in the USA, and by their rapid recovery due to the continued expansion of the American economy. During the second half of the year, a marked impact on international share prices was caused by the East Asian financial crisis. The share prices on East Asian stock markets fell by an average of 40% compared with the previous peak recorded in 1997; less significant decreases were recorded in shares prices on the stock markets of major industrial countries: from 8% in the USA to 21% in Japan (from 11% to 17% in the three leading countries of western Europe). Marked price fluctuations were also recorded on the stock markets of some transforming economies.

1.2 Overseas Developments

In 1997, the US economy entered the eighth year of steady growth marked by a noteworthy year-on-year increase of 3.8% in GDP, pushing the rate of unemployment down to 4.7%. The high rate of expansion was achieved at an annual inflation rate of 1.7% and under conditions of relatively high central bank rates maintained already for two years in expecting the top phase of the business cycle. Paradoxically, the East Asian crisis seemed to have a stabilising influence on the American economy: as a result of a several percent's fall in the Dow Jones index at the end of October, it was not necessary to take measures to prevent the economy from being overheated at the end of the year.

In the long run, the dynamics of economic growth have been supported mostly by domestic consumer and investment demand. Thanks to the effects of technological innovations in the most progressive segments of the economy on the level of productivity in the individual sectors, however, the high export performance of the American economy has been maintained, despite the strengthening of the US dollar during the past two years. In principle, the non-inflationary development of the economy was a reflection of the high level of trust on the part of the American society in the continuation of the ongoing trend of prosperity.

In foreign trade, the increased volume of exports was exceeded by an even higher volume of imports, resulting in a trade deficit of roughly 2% of GDP. The year-on-year increase in American imports (approx. 20%) acted as a 'locomotive' of economic revival in other regions of the world, particularly in the countries of Latin America. Furthermore, the efforts of the American administration focused on the further liberalisation of international trade and extension of the free trade zone of NAFTA (including USA, Mexico, and Canada) to the countries of Latin America.

After a promising acceleration during the previous year, the Japanese economy returned to the phase of slow growth in 1997, which has been a characteristic feature

of development during the 90ies. The 1.7% year-on-year growth in GDP has confirmed the opinion that the extensive structural changes and internationalising processes implemented in the Japanese economy and society according to the western style of industrial civilisation precludes the possibility of a return to the high rate of growth that characterised previous decades. The main factor that caused a slowdown in the rate of expansion was the fall in domestic demand in the area of consumption as well as investment. Although the discount rate was maintained at an extremely low level (0.5%), the confidence of entrepreneurs has weakened. In the sector of foreign trade, the growth in exports was not fast enough to compensate for the fall in domestic demand, despite the export promoting effects of the yen's exchange rate depreciation. During the last months of the year, however, the consequences of the financial crisis in East Asian countries became apparent. The decline in imports into these countries caused huge losses for the Japanese economy, as more than 40% of Japan's total exports is directed towards this region. With regard to the close connection between the Japanese economy and the economies of newly industrialised countries in south-east Asia, however, the financial crisis in these countries has had a far more serious impact on Japan, particularly the country's financial system, where large brokerage houses and banks have failed for bankruptcy.

The East Asian financial crisis, which erupted during the summer of 1997, hit four countries - Thailand, the Philippines, Malaysia, and Indonesia. The crisis was basically of a regional nature, as it had resulted from the weaknesses of the unified Asian model of development based on the export oriented Japanese example. At times of shortage of internal resources, it was financed from foreign credits and led to the accumulation of large amounts of foreign, especially short-term debt. The growing competition among these countries and the worsening of their export possibilities resulted in marked trade-balance deficits. Despite a growth in economic imbalances, the national currencies of these countries remained pegged to the US dollar, which led to disproportionate overvaluation of their exchange rates. Speculations against these currencies during the summer of 1997, forced the affected countries to devalue their currencies significantly (approx. 40%). The monetary crisis resulted in an abrupt fall in share prices on stock markets. Due to currency devaluation, unprepared commercial banks became practically unable to repay foreign credits denominated in dollars. This, together with a depreciation in share capital, endangered the functioning of the banking system as a whole.

Despite the regional character of the crisis, it is necessary to take into account - with regard to its potential impact on the world economy - the fact that the high rate of devaluation significantly increased the competitiveness of the affected countries on the world markets, putting producers from other countries at a disadvantage, as reflected in the case of Japan already in 1997. The international dimensions of possible negative impacts on the global economy, which might arise from the inability to localise the possible consequences of the crisis, is confirmed by the large amounts of capital injections, which will be provided to this region by international financial institutions.

1.3 Western Europe

Owing to the favourable economic situation in other parts of the world, economic development in western Europe in 1997 was characterised by a faster than expected rate of growth. The year-on-year increase in GDP reached 2.6% (compared with 2% in 1996) in western Europe due mainly to extended possibilities for export provided by growing domestic demand in the USA and numerous developing countries. The export performance of western European economies was also supported by the development of exchange rates of the dollar and the Japanese yen against the German mark and other European currencies. The marked appreciation of the dollar

(and, during the first half of the year, of the yen too) contributed to the strengthening of price competitiveness of western European production.

In 1997, a characteristic feature of the entrepreneurial climate in western Europe was the persisting business cycle disharmony between Great Britain and continental Europe. For several years, the British economy has experienced the most dynamic growth among western European countries, and has been functioning in Europe - as the USA in the world - as the locomotive of growth. As the rate of GDP growth reached 3.5% in 1997 (i.e. almost the same pace as the US economy), the utilisation of production capacities in Great Britain reached a level exceeding the long-term standard and thus domestic demand stimulated the export performance of other western European countries as well. This was also supported by the high exchange rate of the British pound against other western European currencies.

In the other three major European economies (Germany, France, and Italy), the ascending phase of the cycle that began in 1996 stabilised over the course of 1997, due mainly to the above-mentioned favourable conditions for export. The rate of year-on-year growth in GDP reached 2.3% in France, 2.4% in Germany, and 1.0% in Italy. In small countries, the GDP growth reached an average of 3.2% with relatively big differences between the individual countries. A steadily high, but falling rate of GDP growth was recorded in Ireland (7.5%) and Turkey (5.2%). In most western European countries, the ascending phase of the business cycle is indirectly indicated by the dynamics of growth in industrial production, which exceeded the rate of GDP growth in 1997. The only exception was Great Britain, where industrial production was stagnant on a year-on-year basis.

Although the rate of economic growth created favourable conditions for a rise in the level of employment, employers in most countries chose another approach, such as contracts for part-time or flexible working hours. A marked increase in the number of jobs was recorded only in Great Britain and in some small countries; however, this was offset by the continued fall in the level of employment in Germany. Changes in employment did not cause, even indirectly, any substantial decrease in the average rate of unemployment, which remained at the level of previous years, i.e. roughly 10%. Although there were marked differences between the individual countries, the problem of high unemployment was most serious in Finland, France, Germany, Italy, and Spain.

In western Europe, as in overseas countries, the ongoing economic cycle continued under conditions of relative price stability: the annual rate of consumer-price inflation fell below the level of 2% over the entire region. Among the four leading western European economies, a higher rate of inflation was only recorded in Great Britain (2.9%), which can be attributed to a marked increase in domestic demand. In other countries, however, the weak consumer demand, idle production capacity, and the slow increase in wages had a downward effect on the rate of price inflation. Though the strong dollar exerted a pressure on the prices of imported commodities, the effect of this pressure on the level of consumer prices was in fact negligible under conditions of fierce competition. The trend of non-inflationary acceleration in economic growth was also supported by the favourable development of labour productivity, which acted, in combination with the moderate wage increase, as a brake on the growth of unit labour costs.

1.4 Meeting the Maastricht Criteria in EU Countries

The ascending phase of the business cycle in Western Europe created favourable conditions for the member states of the European Union, which subordinated their economic and monetary policies in 1997 to the process of fiscal stabilisation corresponding to the Maastricht criteria for accession to the European

Monetary Union. Fiscal policy remained restrictive and was aimed at bringing the annual budget deficits down to the 3% level of GDP and further improving the ratio of overall government debt towards the 60% mark of GDP.

During consolidation of budget deficits, significant progress took place in 1997: in Greece only, the budget deficit exceeded 3% of GDP. The other countries all met the Maastricht criteria, even Germany, where the issue of public finances became rather complicated for a few years after the country's reunification. The criterion of an 'adequately convincing' reduction in government debt was followed by all countries; however, only four countries managed to lower the level below 60% of GDP (Luxembourg, France, Great Britain, and Finland). In 1997, the most indebted countries of the European Union were Belgium, Greece, and Italy, where the ratio of government debt to GDP continued to exceed 100%.

Due to the tight fiscal policy, the process of convergence was successful in all indicators of monetary stability, which consequently created conditions for further financial consolidation during the last year of preparation for the monetary union.

The average 12-month rate of inflation in EU countries remained below the level of 2%, with the exception of Greece. The Maastricht convergence criterion for inflation, representing 2.7% (the average of the three lowest annual rates of inflation plus 1.5%), was met by all countries with the exception of Greece.

In 1997, noteworthy results were achieved in the approximation of interest rates in EU member states. After the marked progress made by the individual countries in this area in 1996, an additional factor that supported the advancement of this process was the decision of the German central bank to raise repo rates by 0.3%, i.e. to 3.3% in October 1997. This increase, representing a response - within the policy of fine tuning - to the long-term weakness of the German mark against the US dollar, was immediately followed by the central banks of countries with low interest rates (Austria, Belgium, Denmark, France, and Holland), which slightly raised their official interest rates as well. This mitigated demands on monetary policy in countries with high short-term interest rates, where the process of convergence required a reduction in the level of interest rates. Due to the close dependence of short-term interest rates on national monetary policies, however, short-term interest rates in numerous EU member states (Italy, Portugal, Spain, Ireland) remained several percentage points above the level of the 'lowest' rates in Germany and France in 1997.

Fulfilment of the Maastricht criteria by EU member states

	Inflation [1/]	Budget deficit /GDP	Government debt /GDP	Long-term interest rates
Germany	1.4	-2.7	61.3	5.6
France	1.2	-3.0	58.0	5.5
Italy	1.8	-2.7	121.6	6.7
Belgium	1.4	-2.1	122.2	5.7
Holland	1.8	-1.4	72.1	5.5
Luxembourg	1.4	1.7	6.7	5.6
Ireland	1.2	0.9	66.3	6.2
Austria	1.1	-2.5	66.1	5.6
Finland	1.3	-0.9	55.8	5.9
Spain	1.8	-2.6	68.8	6.3
Portugal	1.8	-2.5	62.0	6.2
Greece	5.2	-4.0	108.7	9.8
Great Britain	1.8	-1.9	53.4	7.0
Denmark	1.9	0.7	65.1	6.2
Sweden	1.9	-0.8	76.6	6.5

1/Annual average

Source: EMI

In contrast with short-term interest rates (which are not subject to the Maastricht criteria of convergence and the necessity of their approximation is dictated by the logic of a unified monetary policy and identical interest rates within the area of the

monetary union), the process of convergence in the development of long-term interest rates saw very convincing results in 1997. The range of yields earned on 10-year government bonds narrowed in general to 0.5% from the relevant 'benchmark' long-term interest rate in Germany (5.6%). The marked and effective pressure exerted in order to lower the level of long-term interest rates in some countries (especially in Italy, Spain, and Portugal) was supported by the consolidation of public finances and the low rate of inflation. This was, however, connected with the continuing hopes for the wider membership of the planned monetary union. From this point of view, it is notable that long-term interest rates in Great Britain, Denmark, Sweden, and Greece, i.e. countries that have declined to join the monetary union in the first round, remained 1.5% to 2.0% above the mentioned level even in 1997. The Maastricht criterion for long-term interest rates (the average rate on 10-year government bonds in three countries with the lowest rates of inflation, increased by 2%, i.e. 7.8%) was fulfilled by all countries with the exception of Greece.

In 1997, the European exchange rate mechanism functioned in a reliable manner: the exchange rates of most western European currencies against the German mark were relatively stable, and their fluctuations in relation to third currencies, or depreciation against the American dollar and the British pound, did not deviate in principle from the fluctuation of the German mark.

The lasting pressure of the appreciation of the US dollar against western European currencies was conditioned mostly by interest rate differentials in groups of both long-term and short-term financial assets in favour of assets denominated in dollars (for comparison: short-term interest rates in the USA in 1997 were roughly 2.5% above the level of interest rates in Germany; long-term rates on 10-year government bonds were roughly 0.5% higher in the USA than in Germany). The upward trend in the value of the dollar was also supported by continued uncertainty about the ultimate composition of the European Monetary Union (both in terms of time and the number of member states). During the last quarter, however, the exchange rate of the dollar weakened owing to the effects of the monetary crisis in south-east Asia and the consequences of monetary policy tightening in Germany.

The strong exchange rate of the British pound against continental EU currencies was maintained principally for the same reasons as against the American dollar, i.e. interest rate differentials, while the differential achieved from assets denominated in British pounds was still higher than in the case of dollar assets. A moderate fall in the exchange rates of the pound and the dollar was recorded in autumn.

2. ECONOMIC DEVELOPMENT IN CENTRAL EUROPEAN TRANSITION ECONOMIES

For the transition economies of Central and Eastern Europe, the year 1997 was significant as the first year of positive economic growth since the beginning of economic transformation. This development was due mainly to the achievement of the bottom of recession in Russia and the turn into a moderate growth (GDP grew by 0.4% after a 2.8% decline in 1996). The monetary upsets and natural disasters that took place during 1997, indicate that the stability of the reform economies under review is still very fragile and sensitive to external factors.

In CEFTA countries, economic growth showed signs of revival and stabilisation as early as the years 1992 to 1994; however, the level of GDP recorded at the beginning of transformation (in 1989) was reached only in Poland. Of the other member states, Slovenia came closest to this level. However, even Slovenia - the country with the strongest economic potential within the CEFTA group - has reached only 91% of the level of Greece in terms of GDP per capita in purchasing power parity.

For countries interested in joining the EU, it is vitally important, apart from approaching the level of advanced economies, to make structural changes with a view to adopting to the competitive pressure and market forces acting within the Union. An equally important task is to create adequate institutional mechanisms complying with the principles of democracy and the practical implementation of the 'acquis communautaire'. According to the opinion of the European Commission submitted to the European Parliament in July 1997, the following countries are best prepared to meet these criteria: Hungary, Poland, the Czech Republic, Slovenia, and Estonia.

Macroeconomic results of CEFTA countries

	Slovakia	CR	Hungary	Poland	Slovenia	Rumania
Index of GDP growth						
1994	4.9	2.6	2.9	5.2	5.3	3.9
1995	6.8	4.8	1.5	7.0	4.1	7.1
1996	6.9	3.9	0.8	6.0	3.1	4.1
1997	6.5	1.0	3.1	6.9	3.2	-6.6
Consumer Price Index (average for the period)						
1994	13.4	10.0	18.8	32.2	19.8	136.8
1995	9.9	9.1	28.2	27.8	12.6	32.2
1996	5.8	8.8	23.6	19.9	9.7	38.7
1997	6.1	8.5	18.0	14.9	9.1	154.9
Unemployment rate (end-of-period figures)						
1994	14.8	3.2	10.9	16.0	14.2	10.9
1995	13.1	2.9	10.9	14.9	14.5	9.5
1996	12.8	3.5	10.7	13.6	14.4	6.3
1997	12.5	5.2	10.1	10.5	14.8	8.8
Balance of payments current account (% of GDP)						
1994	4.7	-0.1	-9.9	-1.1	3.7	-1.7
1995	3.7	-2.9	-6.3	-2.0	-0.0	-3.9
1996	-7.3	-7.1	-3.2	-0.4	-1.3	-6.9
1997	-6.9	-7.8	-2.1	-4.4	0.4	-5.0
State budget surplus / deficit (% of GDP)						
1994	-5.2	1.0	-7.3	-2.7	-0.2	-4.1
1995	-1.6	0.6	-2.4	-2.6	-0.0	-3.3
1996	-4.4	-0.1	-3.8	-2.8	0.3	-5.8
1997	-5.7	-1.2	-4.2	-4.0	-1.1	-4.5

Source: National Statistics

Gross Domestic Product

In 1997, economic growth continued in CEFTA countries, except for Rumania, being a new member state. The most rapid growth was again recorded in Poland and Slovakia, where real GDP has increased by more than 6% during the last three years. In comparison with 1996, the rate of growth also increased in Hungary, after the country had finally overcome the period of stagnation resulting from the implementation of the stabilisation programme of 1995. In Slovenia, economic growth was maintained at the previous year's level. The problems of the Czech Republic stemming from the growing imbalance of the economy, led to a slowdown in the rate of growth. Rumania, the youngest member of the Association, focused on the recovery of the economy from a state of external and internal imbalance, which was accompanied by a decline in real GDP.

Economic growth in Poland, the Czech Republic, and Slovakia, was driven by domestic demand, though to a lesser extent than in 1996. A positive factor was the continued growth in foreign demand. In Hungary, the main pillars of economic growth were exports and the slightly increased domestic consumption. In Slovenia, the moderate economic growth was also driven by exports, while the rate of growth in domestic consumption slowed to some extent. In Rumania, domestic demand suffered a marked decline, but foreign demand remained unchanged in 1997.

Inflation

In countries where year-on-year inflation reached single-digit levels, inflation rates remained virtually unchanged. With regard to the expected continuation of price deregulation, the room for a further reduction in inflation is considerably limited. In Slovakia, which achieved the lowest level of inflation among the compared countries in 1995, the rate of price inflation rose in 1997. In the Czech Republic, price development was affected by monetary instability, which led to a change in the country's exchange rate regime, and by adjustments in some regulated prices. In Hungary and Poland, the downward trend in the rate of price advance continued. With regard to the exchange rate regimes of these countries (i.e. the crawling peg), however, the rate of inflation can only be reduced at a slow pace. In Rumania, price liberalisation and renewed inflationary pressures resulted in a marked increase in the rate of consumer-price inflation.

State Budget

In 1997, CEFTA countries were less successful in reducing their government budget deficits. Even in the Czech Republic and Slovenia, which officially pursued a policy of a balanced government finances, the budget deficits increased.

Labour Market

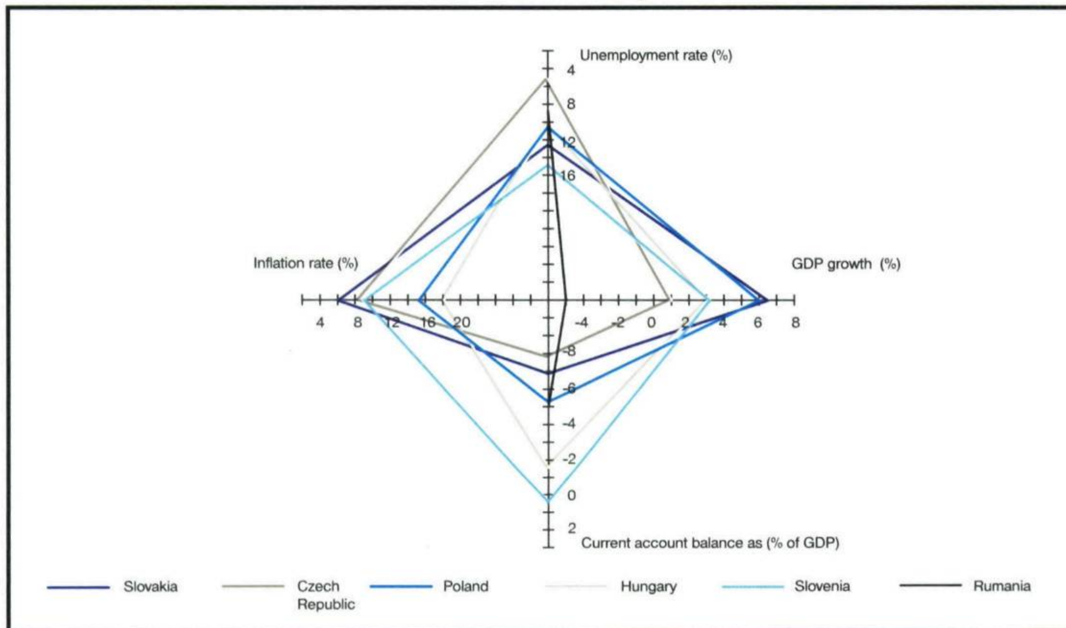
Despite the economic growth, rates of unemployment in CEFTA countries remained virtually unchanged. This clearly indicates that unemployment is of a predominantly structural nature in these countries. In 1997, a marked reduction in unemployment was reported only in Poland.

Foreign Trade

The ominous increase in the size of trade deficits in the CR and Slovakia at the beginning of the year necessitated the imposition of administrative measures, which helped to reduce the imbalance between the rates of growth in exports and imports. In Slovenia, the trade deficit decreased in comparison with the previous year and the current account even produced a moderate surplus. The large volume of cross-

border trade in Poland, which is not recorded in official data, makes the size of the trade deficit rather relative. Hungary is successfully penetrating foreign markets owing to the increased competitiveness of the economy via industrial restructuring, and this is reflected in the country's improved balance of trade.

Overall comparison in terms of macroeconomic stability



On appraisal of the indicators of economic development in the areas of output, labour market, price stability, and foreign relations, illustrated in the above chart, it is obvious that there are differences between the individual countries. With regard to the high rate of inflation, Rumania 'loses' one of the tops of the quadrangle. In the cases of the Czech Republic and Slovakia, the current account of the balance of payments shows signs of disproportion, resulting from external imbalances.