A. THE EXTERNAL ECONOMIC ENVIRONMENT

1. THE WORLD ECONOMY

Global Trends in Outputs and Prices

In 1999, the world economy was recovering from the unfavourable consequences of the financial crises that occurred in 1997-1998, faster than had been forecast by major international financial institutions. Whereas forecasts from the end of 1998 had expected a year-on-year slowdown in the dynamics of global growth in 1999 to 2.2% (compared with 2.5% in 1998), the rate of growth accelerated and global output increased by 3.3%. Similarly, the increase in the volume of world trade (4.6%) was higher than the figure projected (3.7%).

The rate of growth in global output was accelerated by increases in the dynamics of growth in all groups of countries (advanced economies, developing countries, transition economies). In respect of the main centres of the world economy and/or the main monetary areas, the impetus to growth stemmed from the abrupt year-on-year change from decline to growth in most newly industrialised countries in south-east Asia (V-shape revival) and the continued high rate of growth in the US economy. After recession in 1998, the Japanese economy also showed signs of revival. In the euro area, the pace of growth slowed on a year-on-year basis, due mainly to unconvincing economic performance in the first months of the year, which was followed by an acceleration in the pace of growth. After the economic decline was stopped in Russia, transition economies as a whole also began to grow in 1999. However, even in the most advanced countries of Central and Eastern Europe, the rate of growth was slower than in advanced industrial countries.

Global output in 1999 grew under conditions close to price stability, despite the fact that a marked change occurred in the development of commodity prices, especially oil prices. After a pronounced fall in the preceding two years, the level of oil prices rose year-on-year by 37.6% (to US$ 18.14 per barrel) and began to move towards its long-term balanced figure. The prices of other commodities continued to fall in 1999,

Global output in 1999

	1998	1999	2000 (forecast)
Global output	2.5	3.3	4.2
Advanced industrial countries	2.4	3.1	3.6
USA	4.3	4.2	4.4
Japan	-2.5	0.3	0.9
Eurozone	2.8	2.3[1/]	3.2
Newly industrialised Asian economies	-2.3	7.7	6.6
Transition economies	-0.7	2.4	2.6
Central and Eastern Europe[2/]	2.0	1.5	3.6
Russia	-4.5	3.2	1.5
Developing countries	3.2	3.8	5.4
China	7.8	7.1	7.0
Brazil	-0.1	0.5	4.0

Source: World Economic Outlook, April 2000.
1/ According to the European Central Bank: 2.2% (ECB Annual Report 1999).
2/ Excluding Russia and Byelorussia.

but at a more moderate rate (-6.9% in dollar terms) than in the previous year (-14.7%).

Consumer prices in advanced industrial countries followed a non-inflationary course of development, with the rate of price increase continued to slow (to 1.4% in 1999). However, the fear of the negative effects of deflation on the pace of economic growth was basically suppressed. The rate of consumer-price inflation also slowed in developing countries (to a level of 6.5%). In transition economies, the price increase accelerated considerably and reached 44% for the whole group on a year-on-year basis (compared with 22% in 1998). Excluding the effect of the most inflationary economies on the price index, the mean value of the rise in consumer prices fell in this group of countries as well, to 8% (10% in 1998).

An important factor in the acceleration of global growth was the gradual revival of trust on emerging markets, which were most hit by the crisis, and which created conditions for a partial relaxation of monetary policy. The favourable course of price development also acted in favour of acceleration in the pace of global growth. In the first months of the year, it enabled countries with a decelerating rate of growth (euro area and Western Europe in particular) to relax their monetary policies to a certain extent, and to support the performance of the real sector. Later, during the second half of the year, monetary policy was gradually tightened in connection with the steep rise in oil prices; and in the USA, with regard to the growing fears of the economy becoming overheated. On a global scale, fiscal policy was of a neutral character in the absence of potential inflationary pressures.

On international foreign exchange markets, the single European currency - the euro - emerged on 1 January 1999, within the third stage of the European Economic and Monetary Union. A dominant feature of developments on the foreign exchange markets in 1999, was the persistently strong exchange rate of the US dollar, profiting from the burgeoning of the American economy and the favourable situation on eurodollar markets. The high exchange-rate value of the US dollar and the slowdown in the pace of economic growth in the euro area (and to a certain extent the effect of the change in the structure of Western European integration) complicated the position of the euro, which weakened against the dollar throughout the year, with the exception of the summer months. On an annual basis, the euro depreciated in relation to the dollar by an average of 4.9%; on a monthly basis, (from December 1998 to December 1999), the average depreciation was much higher (13.7%). The Japanese yen continued to show a tendency to appreciate due to the country's improved prospects of economic revival.

The global macroeconomic stability achieved and the widespread increase in optimism about the future prospects of global growth in 1999 led to a marked increase in share prices on major international stock markets. A particularly high rise in share prices was recorded in the euro area, where the level of the Dow Jones EURO STOXX index rose by 40% on a year-on-year basis (December 1999/1998). During the same period, America's Standard & Poor's 500 index increased by 19%, and the Japanese Nikkei 225 index by 37%.

Development in the Main Centres of the World Economy: USA, Japan, Euro Area

In 1999, the US economy continued to grow at a fast rate. With a GDP growth of 4.2% year-on-year, the US economy (followed closely by the economy of Canada with the same growth in GDP, i.e. 4.2%) was again the most dynamically growing economy among advanced industrial countries. In the long term, the rate of growth in GDP is stimulated mostly by the high level of domestic private demand, which grows at a faster rate than supply despite the increased level of entrepreneurial activity. In 1999, this gap led to a marked deterioration in America's balance of payments on current account, which resulted in a deficit amounting to 3.7% of GDP (exceeding the record deficits from the mid-80ies).

Owing to a marked increase in labour productivity coupled with an expansion in fixed investments and technological progress over the last few years, the high rate of growth did not threaten economic stability with inflationary pressure even in 1999. Consumer prices increased year-on-year by 2.2% (compared with 1.6% in 1998) due largely to a rise in oil prices. The rate of unemployment fell to 4.2% (the lowest figure in the last 30 years); however, the sufficient number of job vacancies compensated for the potential effects of wage inflation.

The high rate of growth and macroeconomic stability in the USA in recent years, can be regarded as the result of a correct combination of fiscal policy, monetary policy conduced by the Federal Reserve System (FRS), and structural policies designed to improve the flexibility of individual markets. However, fears arose that other types of economic imbalances might emerge, casting doubts on the sustainability of the existing model of investment, based on high equity prices (mainly shares) and the high level of private debt, accompanied by a decrease in the proportion of household savings.

After recession in 1998, economic development in Japan turned into a relatively dynamic revival in 1999, supported by public investments and a subsequent increase in private demand. After a downturn in public investment, economic growth slowed during the second half of the year and turned again into decline. Although GDP recorded an annual increase of 0.3%, consumer and business confidence in the possibility of a more convincing economic revival remained low. In 1999, the economy developed in a deflationary environment, with the year-on-year change in consumer prices reaching a negative value (-0.3%). The rate of unemployment increased to 4.7%. An accompanying phenomenon of the signs of revival in the Japanese economy, was an appreciation in the value of the yen, which, on the other hand, weakened the export performance of Japanese producers. For that reason, the Central Bank of Japan intervened to the detriment of the yen several times during the year.

Developments in 1999 confirmed the extent of the problems that the Japanese economy must solve if the country wishes to maintain, under liberalised conditions, its position as one of the three main centres of the world economy. To reduce the vulnerability of the economy to external effects, the share of domestic private demand in GDP creation is to be increased substantially. The dependence of domestic demand on public investment clearly indicates that the Japanese economy still lacks these internal mechanisms of growth. The liberalisation process also requires substantial structural reforms and deregulation measures in the banking as well as corporate sectors. In 1999, the revival of demand was again supported by fiscal means, which – in addition to being intrinsically futile - absorbed resources meant for the support of accelerated restructuring in the Japanese economy.

After the pace of economic growth had slowed in countries of Western Europe at the turn of 1998-1999, the second half of 1999 saw signs of accelerating growth in this region. The trend of growth was supported by improved conditions for business activity in the external economic environment, relaxation of monetary policy by the European Central Bank, and by several central banks outside the euro area, improvement in the indicators of business confidence, and a high level of consumer confidence supported by a further reduction in the level of unemployment in 1999.

An additional factor in overcoming cyclical decline and the revival of demand and economic activity in the euro area, was the exchange rate of the euro, which has been weakening against the dollar continuously since the beginning of 1999. However, the depreciation of the euro posed no threat to the stability of prices in the euro area, defined in terms of annual inflation below 2%. In the euro area, the 12-month rate of growth in GDP reached 2.3% in 1999, consumer prices measured in terms of the harmonised index of consumer prices (HICP) rose by 1.1% (as in 1998), and the average rate of unemployment reached 10.1%.

In the euro area, the balance of payments on current account resulted in a surplus of 0.7% of GDP in 1999, due mainly to the positive balance of trade, which was to a large extent reduced by the deficit of current transfers. The output of foreign trade in the euro area declined by roughly a third, due to a sudden rise in import prices (mainly oil prices and partly due to a fall in the exchange-rate value of the euro), and to the low volume of exports during the first half of the year, which was hit by the effects of decline in foreign demand in 1998.

The balance of foreign direct investment resulted in a negative figure, i.e. net outflow, due to the higher investment activity of euro area residents abroad and the reduced inflow of foreign investment into the euro area. A net outflow was also recorded in portfolio investments, but in comparison with 1998, the balance diminished substantially due to an increase in foreign demand for debt securities issued by euro area countries (mainly for money market instruments).

Development in the euro area was marked by continued cyclical differences in the dynamics of growth and potential inflationary pressures in countries tending towards overheated economies such as Ireland (with, in the long run, the highest rate of growth in GDP within the EU, reaching 8.4% in 1999), the Netherlands, Portugal, Spain (where GDP grew by 3.0 to 3.7%). On the other hand, small GDP increases were recorded in large economies, i.e. Germany (1.5%) and Italy (1.4%). With a 2.7% growth in GDP, France represented the most stable economy in the euro area.

During the past two years, the economy of the United Kingdom has been in the upward phase of the cycle. The pace of growth started to accelerate in the spring of 1999 and led to an annual increase of 2.0% in GDP. Inflation rate reached 2.3%, but remained below the level set by the central bank (2.5%). Favourable development was also recorded on the labour market, when the rate of unemployment decreased year-on-year, to 4.4%.

A high rate of growth by European standards was also recorded in the economy of Sweden (a GDP growth of 3.8% in 1999), due to a marked expansion in domestic private demand and to export opportunities. The rate of inflation reached only 0.4%, which was much lower than the average value (2%) of the target range set by the central bank. In Denmark, Norway, and Switzerland, GDP growth in 1999 (up to 1.7%) achieved the lowest figures among Western European economies. The slowdown in the dynamics of growth in Denmark and Norway was due primarily to the economic-policy measures taken for the purpose of mitigating the effects of macroeconomic imbalances from the previous period. The performance of the Swiss economy mirrored the country's poor export performance and a substantial fall in domestic demand.

Monetary Conditions and Fiscal Policy

The monetary conditions of economic development in advanced industrial countries were stable in 1999. The monetary stability achieved was without doubt an evidence of the appropriateness and technical feasibility of the monetary-policy objectives of central banks, aimed at price stability, usually with a stated or implied inflationary goal. The non-inflationary environment, supported in part by the previous trend in oil prices and the prices of other commodities, enabled central banks to support economic activity by relaxing monetary policy during the first half of 1999. On the other hand, the faster than expected rate of economic growth on a global scale and the steep increase in oil prices led the central banks to adjust the rates of interest upwards, in the second half of the year.

The Federal Reserve System (Fed) lowered its base rate relatively significantly as early as the last quarter of 1998 (from 5.5% to 4.75% step by step), with the aim of placating international financial markets. In 1999, the Fed focused its monetary policy on stabilising the domestic economic environment by signalling the necessity to moderate activities in the real sector of the US economy, and raised its base rate in two steps to 5.25% in August.

The European Central Bank (ECB) lowered its rates in April 1999. The rate for main refinancing operations was reduced by 0.5% points, to 2.5%. The rates on standing facilities were also lowered (the rate for refinancing by 1% point, to 3.5%; that for sterilisation by 0.5% of a point, to 1.5%). In April, the Bank of England also lowered its base rate, from 5.50% to 5.25%. In June, the rate was adjusted to 5.00%, but later in September, it was again raised to 5.25%. The ECB decided to raise its rates by 50 base points in November: the main rate for refinancing to 3%, the marginal to 4% and/or 2%. (At the beginning of February 2000, the three rates were raised again by 25 base points.)

The decisions of ECB on changes in interest rates were made with respect to the development of consumer prices in the euro area (based on the harmonised index of consumer prices), the expected course of main commodity prices (i.e. oil prices in particular), and to the indicator of money supply in the euro area compared with its reference value defined in terms of a three-month moving average of the 12-month rate of growth in M3, at the level of 4.5%. In the first months of the year, the dynamics of growth in M3 slowed, which supported the decision to lower rates in April. The growth in bank lending (mainly in the household sector) in the following months, caused the dynamics of growth in M3 to accelerate. In November, the rate of growth in M3 reached 6% in terms of a 3-month moving average (1.5 points above the reference value), which supported the decision of ECB to raise its key rates.

The development of market interest rates reacted sensitively to the decisions of central banks to alter their key rates and to the change in prospects of economic growth. In terms of annual average, short-term money market rates fell in 1999, due to their extremely low level in the first months of the year. From the second quarter, short-term rates rose steadily; this trend in the euro area was in large part associated with the military conflict in Kosovo, but also mirrored the risk factor in the transition to the year 2000 (Y2K). In the euro area, the average interest rate on three-month deposits was 2.96% in 1999, though it reached 3.44% in December; in Great Britain 5.54% on average and 6.06% in December; in the USA 5.42% on average and 6.10% in December. In Japan, where the central bank pursued a policy of 'zero interest rate' in 1999, interest rates on the money market fluctuated around zero (the annual average being 0.22% and the figure for December 0.33%).

The development of long-term interest rates confirmed faith in the stability of the US economy and the favourable outlook for Japan. In comparison with 1998, yields on 10-year government bonds increased in both countries (in USA from 5.33% to 5.64%; in Japan from 1.30% to 1.75%) in 1999. Lower yields were recorded in the euro area (4.66% compared with 4.71% in 1998), where the long-term interests of investors were vitiated by the economic as well as non-economic aspects of development in the region, including the falling exchange-rate value of the euro. The average annual yield on 10-year government bonds issued in Great Britain also fell, from 5.60 to 5.01%.

Fiscal policies in the USA and in the euro area followed a neutral strategy in the context of a monetary and financial mix oriented towards macroeconomic stability. In 1999, there were favourable conditions for the maintenance of fiscal stability in the USA. With regard to the high level of economic activity, fiscal policy focused on restricting the growth in internal demand, which led to a surplus in general government budget (around 0.5% of GDP). In the fiscal sector of euro-area countries, a certain 'exhaustion' was reflected, due to the effort over recent years to achieve fiscal consolidation in line with the Maastricht criteria of convergence, as well as the slowdown in economic growth in the real sector. No appreciable progress in the implementation of the strategy of a sustainable long-term fiscal position was recorded in euro-area countries in 1999. From a standard Euro-American point of view, a menacing development was recorded in the fiscal sector in Japan, where the general government deficit (excluding social insurance) reached 9.0% of GDP in 1999. As in its monetary policy, the fiscal policy of Japan also focused on short-term tasks designed to support the revival of domestic demand in 1999.

The world economy in 1999 reached, after several years of turbulence, a state of global macroeconomic stability. The state achieved can be attributed to the acceptance of the strategy of sustainable growth and the use of an adequate set of policy instruments. Under global strategy, however, the marked trends of polarisation continued, mainly in relation between the USA and the rest of the world. The dominant position that the US economy has acquired over the past years as stabiliser and motor of global economic growth, gives rise to certain fears of the international consequences of a contingent sudden reduction in the dynamics of the US economy.

2. ECONOMIC DEVELOPMENT IN TRANSITION ECONOMIES

In 1999, the rate of growth in transition economies was at the level of 2.4%, which was more than was generally expected. The growth in the group was supported by the surprisingly good economic results of Russia, which recorded a growth of 3% after recession in 1998. The results of associated countries in Central and Eastern Europe were somewhat weaker than in 1998. Economic activity during the first half of 1999 was negatively affected by the last traces of turbulence on the financial markets from previous years, the Russian crisis in 1998 (affecting Baltic countries in particular), and the conflict in Kosovo (its impacts on

Macroeconomic results of CEFTA countries (year-on-year changes in %)

		Slovakia	CR	Hungary	Poland	Slovenia	Rumania
GDP growth (%)	1997	6.5	-1.0	4.6	6.9	4.6	-6.1
	1998	4.4	-2.2	5.1	4.8	3.9	-5.4
	1999	1.9	-0.2	4.5	4.1	3.7	-3.2
Consumer prices (%)	1997	6.1	8.5	18.3	14.9	8.4	154.8
(average for the period)	1998	6.7	10.7	14.3	11.8	7.9	59.1
	1999	10.6	2.1	10.0	7.3	6.2	45.8
Unemployment rate (%)	1997	12.5	5.2	10.1	10.5	14.8	8.8
(at the end of the period)	1998	15.6	7.5	9.1	10.3	14.6	10.4
	1999	19.2	9.4	9.5	12.5[1/]	13.0	11.1[1/]
Current	1997	-6.9	-6.2	-2.1	-3.2	0.2	-6.1
account BOP	1998	-10.3	-1.9	-4.8	-4.2	-0.0	-7.2
	1999	-5.8	-2.0	-4.5	-7.6	-2.9	-3.8

Source: National statistics
1/ November 1999

countries in south-east Europe). Prospects started to improve in the second half of the year in connection with the acceleration in growth in EU countries. The accelerated growth in Western Europe creates conditions for increased exports from associated countries and consequently for their economic growth in 2000.

The year 1999 saw another important step forward in the process of integration, when the Helsinki summit of the EU decided in December 1999 to invite Bulgaria, Latvia, Lithuania, Romania, and Slovakia (and Malta) for negotiations on accession. The division of countries into a 'first' and a 'second' group in the association process was cancelled, since henceforth the speed of negotiations will be determined by the preparedness of each country for admission.

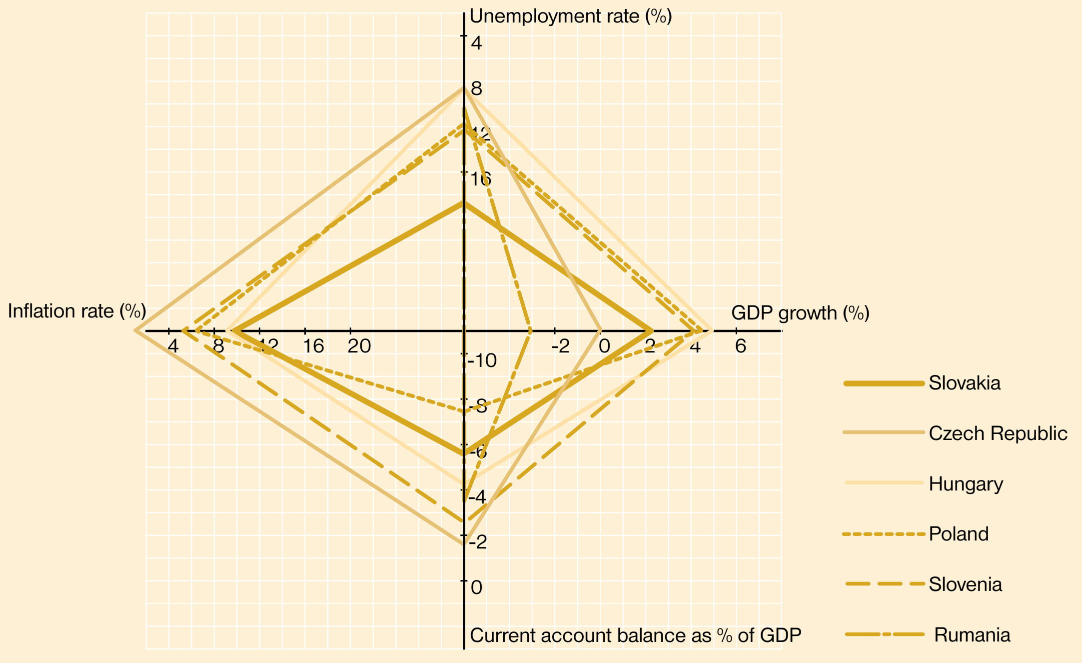
In the group of CEFTA countries, the dynamics of economic growth slowed in 1999. A growth rate exceeding 4% was maintained by only Hungary and Poland, followed by Slovenia (3.7%). In Slovakia, the rate of growth recorded a marked slowdown, due to corrective measures adopted by the Government with a view to consolidating the deficits in public finances and in the current account. The Czech Republic and Rumania entered the third year of recession, with some signs of recovery.

The slowdown in the growth of domestic demand contributed to the moderation of inflationary pressure during the first half of the year, so that non-inflationary price development continued in these countries with the exception of Slovakia. In Rumania, the rate of inflation in 1999 was well above the level in other CEFTA countries.

A less desirable concomitant effect of slowdown in economic growth and structural changes in the economy, was the increase in the rate of unemployment (except Slovenia), while Slovakia, Rumania, and the Czech Republic recorded the highest level of unemployment since the beginning of transformation.

External imbalances were mitigated successfully in Rumania and Slovakia, where the high current account deficits of previous years diminished by almost 50%. Stable results were

Development of basic macroeconomic indicators in 1999



also achieved in Hungary and the Czech Republic. On the other hand, the deficit in the current account increased significantly in Poland and the equilibred balance in Slovenia maintained for several years also deteriorated.

The indicators of economic development in the areas of output, labour market, price stability, and the balance on the current account in 1999, illustrated in the chart above, show that the most balanced development was achieved in Slovenia and Hungary. On the other hand, the most uneven development took place in Rumania, which 'loses' one of the peaks of the quadrangle with regard to the high rate of inflation, and falls behind the other countries of the group in terms of GDP growth as well. In the case of Slovakia, the largest disproportion is shown by the rate of unemployment.