

**A. THE EXTERNAL ECONOMIC ENVIRONMENT**



## **1. THE WORLD ECONOMY**

### **Global Trends in Outputs and Prices**

Forecasts of the development of the world economy in 1998 held that the year concerned would see a marked slowdown in the rate of growth in global output and continuation of the trend of moderate increase in prices. These forecasts were based on the assumption that the divergent development in the main regions of the world economy would continue and that price levels would continue to show a tendency to fall on global commodity markets. Both tendencies showed a stronger than expected intensity.

In 1998, global output increased by 2.5% (in 1997 by 4.2%) and global trade by 3.3% (in 1997 by 9.9%). With regard to the fall in the dollar price of petroleum (32.1% on average) and other commodities (14.8%), as well as in the prices of several items of final production, the value of global trade fell somewhat in 1998.

The continued divergence in the trends of development in the world economy resulted mainly from the regional effects of the financial crises that erupted in 1997 in countries of Southeast Asia and which spread to other economies belonging to the group of emerging markets (Russia, Brazil).

In 1998, advanced industrial countries (mainly the USA and Western Europe) experienced a relatively dynamic economic growth, the rate of which, however, slowed over the course of the year. The Japanese economy showed signs of recession. The revival of economic activity in emerging markets (Southeast Asia, Latin America) was again suppressed by the unfavourable effects of the financial crisis in Russia and the devaluation of the rouble in August 1998 with a view to regain the confidence of investors. A massive outflow of capital was recorded first and foremost in

Brazil, which was on the verge of financial crisis at the end of the year.

A slowdown in the rate of economic growth was recorded in most transition economies of Central and Eastern Europe. Apart from the Russian financial crisis, which acted in these countries as a factor causing an outflow or marked slowdown in the inflow of foreign capital, the slowdown in the rate of growth in Central and Eastern European countries was also supported by microeconomic problems connected with the uncompleted structural reforms in their corporate and banking sectors.

### **Development in the Main Centres of the World Economy: USA, Japan, European Union**

In 1998, the US economy recorded the most rapid economic growth among advanced industrial countries. Over the course of the year, however, the dynamics of growth in GDP slowed somewhat, to 3.5% at the end of December. The slowdown in the rate of economic growth was due to the growing deficit in the current account, caused mainly by the downturn in Asian markets and the strong exchange rate of the dollar. Domestic demand remained high, the economy worked close to the level of potential output, and the rate of unemployment fell to 4.5%, which exerted upward pressure on the level of wages. Prices showed a very moderate increase and the annual rate of inflation reached 1.6%.

Economic development in Japan during the 90's was marked by ineffective economic procedures applied for the solution of long-term structural problems, a crisis in the banking system, and the direct effect of the financial crisis in Asia on the position of Japan and the entire East Asian region in the global structures of the world economy. In 1998, the Japanese economy ran into recession, characterised by a fall in GDP (2.6%), increased unemployment (to 4.1%), and a moderate year-on-year increase

in consumer prices (0.6%). The economic decline was caused by a marked reduction in domestic aggregate demand and a fall in exports due to the collapse of demand in the leading East Asian markets.

Over the course of 1998, the dynamics of economic growth slowed in EU countries as well. Nonetheless, domestic demand maintained its high level and the constraining effects of the Asian crisis on Western European exports were to a significant extent offset by the favourable development of trade relations, the low level of long-term interest rates, and the continued rapid growth in several non-Asian markets. In 1998, the rate of growth in GDP for the EU as a whole, continued to show an upward trend and reached 2.8%, while the annual rate of inflation stood at 1.4%. A persistent problem was the situation on the labour market. The high rate of long-term unemployment (10.2% in 1998) was due mainly to the high share of structural unemployment.

Countries in the euro-area recorded higher dynamics of growth than the European Union as a whole. Gross domestic product increased in these countries by 3.0% (in 1997 by 2.5%), while the rate of increase in consumer prices (expressed in terms of the harmonised consumer price index - HICP) slowed to 1.1% (compared with 1.6% in 1997). The engine of economic growth was the high domestic demand, which partially replaced the reduced volume of net exports, caused by uncertain conditions in the external economic environment. The share of the trade surplus in the euro-area's GDP in 1998 reached 1.4%, representing a moderate decline compared with the 1997 figure (1.6%). Despite a decrease of 0.8 percentage points year-on-year, the rate of unemployment in the euro-area reached a two-digit figure (10.9%).

The course of the business cycle in individual EU countries showed marked differences. The ascending phase of the cycle, characterised by a moderate year-on-year increase in GDP growth, was entered by Germany (2.7%), France

(3.1%), and Italy (1.5%). In Great Britain, where the business cycle peaked in 1997, the rate of GDP growth slowed (2.7%), due mainly to the downward effect of the persistently strong exchange rate of the pound on the volume of net exports, and to the fall in domestic demand after the tightening of monetary and financial policy. The annual rate of inflation (HICP) fell to 0.2% in Germany; to 0.3% in France; to 1.7% in Italy; and to 1.5% in Great Britain. The majority of small EU countries achieved a higher rate of growth in GDP: the fastest rate in Europe was recorded in Ireland (9.1%); which was followed by Finland (5.0%); the Netherlands and Spain (4.0% both); and Portugal (3.8%). The level of inflation in these countries was also low (in Spain and Finland, this was achieved through wage control); the fast economic growth generated potential risk of inflation in Ireland, Portugal, and the Netherlands.

### **Monetary Conditions and Fiscal Policy**

Central banks responded to the slowdown in the dynamics of growth in output and inflation by lowering key interest rates, especially during the last quarter of 1998. In countries of the euro-area, the relaxation of monetary policy was connected with the final phase of the convergence process, and was therefore most evident in countries with high interest rates (Ireland, Portugal, Spain, and Italy). During September and October, basic interest rates fell in Portugal from 4.25% to 3.50%; in Spain from 4.50% to 3.75%; in Italy from 5.0% to 4.0%; and in Ireland from 6.75% to 3.7%. However, monetary policy was in fact not relaxed, because real interest rates remained unchanged after the nominal rates had been reduced, with regard to the fall in inflation. As one of the final steps of preparation for transition to the third stage of the monetary union, the central banks of eleven euro-area countries lowered their rates to 3% at the beginning of December (except for Italy, where the rate was lowered to 3.5%). By this co-ordinated step, the eleven central banks set the initial level of interest rates within the Economic and Monetary Union (EMU).

### Fiscal positions of countries in the euro-area (% of GDP)

	Surplus (+), deficit (-) of general government			Gross debt of general government		
	1996	1997	1998 <sup>1/</sup>	1996	1997	1998 <sup>1/</sup>
<b>Euro-area</b>	-4.1	-2.5	-2.1	75.0	74.6	73.8
<b>Belgium</b>	-3.1	-1.9	-1.3	128.0	123.4	117.3
<b>Finland</b>	-4.6	-1.2	+1.0	57.8	54.9	49.6
<b>France</b>	-4.1	-3.0	-2.9	55.7	58.1	58.5
<b>Netherlands</b>	-2.0	-0.9	-0.9	77.0	71.2	67.7
<b>Ireland</b>	-0.3	+1.1	+2.3	69.4	61.3	52.1
<b>Luxembourg</b>	+2.8	+2.9	+2.1	6.3	6.4	6.7
<b>Germany</b>	-3.4	-2.7	-2.1	60.8	61.5	61.0
<b>Portugal</b>	-3.3	-2.5	-2.3	64.9	61.7	57.8
<b>Austria</b>	-3.7	-1.9	-2.1	69.8	64.3	63.1
<b>Spain</b>	-4.5	-2.6	-1.8	68.6	67.5	65.6
<b>Italy</b>	-6.6	-2.7	-2.7	124.6	122.4	118.7

Source: Eurostat

<sup>1/</sup> Estimate

Outside the EMU, monetary policy was relaxed in 1998 by the Bank of England, which, after a temporary increase in June by 25 points (to 7.50%), lowered the base rate to 6.75%. The key rates were also reduced in Denmark, Sweden, and Canada. In the USA, the Federal Reserve System lowered its base rate gradually from 5.50% to 4.75% during the last quarter of 1998, with the aim of mitigating the impact of turbulence of global markets on the American economy. In the USA, this meant a fall in real rates as well, but the main effect of this step was stabilisation of the international financial markets.

The level of interest rates on the money market was also reduced. In the countries of the euro-area, average short-term interest rates (on 3-month deposits) reached 3.17% in 1998 (in 1997: 4.01%); in Great Britain 6.12% (in 1997: 7.48%); and in the USA 5.00% (in 1997: 5.62%). Interest yields on 10-year government bonds reached 4.71% in the euro-area (in 1997: 5.99%); 5.60% in Great Britain (in 1997: 7.13%); and 5.33% in the USA (in 1997: 6.45%).

In 1998, the relaxation of monetary policy in Japan encountered a situation referred to as 'liquidity trap', which is characterised by extremely low interest rates. The discount rate

was at the level of 0.50%, while the overnight call rate fell by 25 base points, to 0.25% in September. The short-term money market rate fell to 0.18% (in 1997, to 0.36%); yields on 10-year government bonds dropped to 1.30% (in 1997, to 2.15%). To revive domestic demand, the Japanese government relaxed its fiscal policy in the spring of 1998 (increase in expenditures, reduction in taxes). The unre-solved long-term problems of the Japanese banking sector, burdened by high volumes of bad loans, which remained after the collapse of the 'bubble' economy at the beginning of the 90ies, culminated in 1998 and substantially worsened the lending opportunities of Japanese banks on international financial markets. In October, the Japanese government approved a large-scale plan (12% of GDP) for the recovery and restructuring of the banking sector.

In 1998, fiscal policy in most euro-area countries was basically neutral in relation to changes in economic activity, with regard to the fact that, during the previous two years, these countries had applied fiscal consolidation measures aimed at meeting the Maastricht criteria for convergence. In other countries of Western Europe, fiscal policy had a moderately restrictive character. The fiscal

policy applied by the US Government can also be described as moderately restrictive.

### **European Union on the Threshold of the Third Stage**

In May 1998, the EU summit in Brussels approved the further details of the EMU, being the third stage of the European Economic and Monetary Union, and the introduction of the common currency - the euro. The first phase was joined by eleven EU countries (Belgium, Ireland, Finland, the Netherlands, France, Luxembourg, Germany, Portugal, Austria, Spain, and Italy), which showed interest in joining the EMU and met the Maastricht convergence criteria for national financial and monetary stability. In these countries, the euro will be used in non-cash payments as legal tender, along with local currencies, with effect from 1 January 1999. The period from 1 January 1999 to 31 December 2001 will be a transitional phase during which the euro will be used along with the national currencies of EMU countries. From 1 January 2002, all financial transactions will be conducted exclusively in the euro, and euro banknotes and coins will be put into circulation. Banknotes and coins in national currencies will be used as legal tender until 30 June 2002, with the possibility of conversion into euro at commercial banks.

The introduction of the single currency is part of the plan to adopt a common monetary policy within the euro-area, which will be operated by the European System of Central Banks (ESCB), consisting of the European Central Bank (ECB) and the national central banks (NCB) of 15 EU member states. The European Central Bank and ESCB were established on 1 June 1998. During the following months, an operating framework was created for the monetary policy of the Eurosystem (i.e. ECB and 11 NCBs of EMU member states) and relations were established between the NCBs of 4 non-member states of

ESCB (Denmark, Greece, Sweden, and Great Britain) and the Eurosystem. The agreement on the creation of an exchange rate mechanism for the third stage (ERM II) was signed on 1 September 1998. On 1 January 1999, Denmark and Greece joined ERM II by establishing a fixed connection between the central parities of their national currencies and the euro, with a fluctuation band of 2.25% Danish crown, and 15% Greek drachma.

In October, the Governing Council of ECB formulated the monetary policy of the Eurosystem. The primary objective of monetary policy is to maintain the price stability, defined as a less than 2% year-on-year increase in the harmonised consumer prices index (HICP) within the euro-area, which is to be maintained in the medium-term. A key role in the implementation of this monetary policy will be played by the money supply as a natural 'nominal anchor'. For the euro-area, the growth in the money supply (M3 monetary aggregate) was set in terms of a reference value at 4.5% per year, allowing for a less than 2% increase in HICP; 2.0-2.5% year-on-year growth in real GDP; and a 0.5-1.0% slowdown in the circulation of M3 on a year-on-year basis. Monetary development in relation to this reference value will be monitored monthly on the basis of the three months moving average of the year-on-year rate of growth in M3.

The ratio of minimum required reserves, which is to be maintained by every credit institution operating in the euro-area, was set at 2%.

The key parameters of monetary policy within the Eurosystem were determined by the Governing Council of ECB on 22 December 1998. The interest rate for the main refinancing operations of ECB was set at 3%. The first refinancing tender was announced for 4 January 1999. At the same time, the limit-values of interest rates for stand-by operations were set with effect from 1 January 1999 as follows: the sanction rate for overnight credits was set at 4.5% and the minimum rate for overnight deposits at 2%.

On 31 December 1998, the conversion rates of the euro were fixed irrevocably for the national currencies of the eleven member states of EMU. This will be the only rate to be applied for the conversion of the euro into a national currency as well as between the national currencies of EMU member states. The latest official rate of ECU and the first rate of the euro against the US dollar was set at USD 1.168 = EUR 1 as at 1 January 1999 at 00:00 a.m.

The macroeconomic position of the euro-area, which summarises the aggregate performance of

#### Irrevocably fixed conversion rates of the euro

1 EUR =		
<b>Belgium</b>	BEF	40.3399
<b>Finland</b>	FIM	5.94573
<b>France</b>	FRF	6.55957
<b>Netherlands</b>	NLG	2.20371
<b>Ireland</b>	IEP	0.787564
<b>Luxembourg</b>	LUF	40.3399
<b>Germany</b>	DEM	1.95583
<b>Portugal</b>	PTE	200.482
<b>Austria</b>	ATS	13.7603
<b>Spain</b>	ESP	166.386
<b>Italy</b>	ITL	1,936.27

the economic unit of 11 EU countries and the basic indicators of its monetary and financial stability in 1998, i.e. the last year before entry into the third stage of the European Economic and Monetary Union, is given in the table below:

#### Basic macroeconomic indicators of the euro-area in 1998

<b>GDP (at constant prices, annual growth)</b>	3%
<b>Inflation (HICP)</b>	1.1%
<b>Unemployment rate</b>	10.9%
<b>Trade balance / GDP</b>	1.4%
<b>Balance of general government budget / GDP</b>	-2.1%
<b>Gross debt of general government / GDP</b>	73.8%
<b>Short-term interest rate (3-month deposits)</b>	3.17%
<b>Yield on 10-year government bonds</b>	4.71%
<b>Exchange rate USD/EUR (as at 1.1.1999 at 00:00 a.m.)</b>	1.168

## 2. ECONOMIC DEVELOPMENT IN CENTRAL EUROPEAN TRANSITION ECONOMIES

The turbulence on the world financial markets and the slowdown in the rate of growth in global economy were reflected in the results of transition economies as well. The economic growth achieved in this group of countries in 1997 (2.2% in real GDP) turned into a decline of 0.2% in 1998. This result was due mainly to the monetary crisis in Russia, which stopped the trend of moderate revival that started in this country a year earlier (the 0.8% growth in GDP in 1997 turned into a 4.8% decline). The situation in Russia negatively affected the economies of neighbouring countries as well. The only transforming country, where the economic decline has not been interrupted since the beginning of the reform, i.e. the beginning of the 90ies, is Ukraine.

In the group of countries seeking admission to the EU, the rate of growth slowed from 3.5% in 1997 to 2.8% in 1998, when economic growth in dynamically advancing countries (Poland, Slovakia, Latvia, Lithuania, and Estonia) slowed below 5%, while Rumania and the Czech Republic showed an economic decline. An acceleration in the rate of growth was recorded in Hungary and to a lesser extent in Slovenia. After two years of decline, the economy of Bulgaria showed some signs of revival.

The integration of Central European countries into the EU recorded further progress at the London summit of the EU, where the applications of six candidates were confirmed - Poland, Hungary, the Czech Republic, Slovenia, Estonia, and Cyprus, which are regarded by the European Commission as best prepared to meet the criteria of admission to the EU. Apart from making efforts to join the European structures, the countries of Central Europe continue to strengthen their trade relations within CEFTA, which is gradually being extended to new countries. In 1997, CEFTA was joined by Rumania, and on 1 January 1999, Bulgaria gained admission.

In CEFTA countries, economic growth was stimulated by domestic demand in Hungary, Poland, and Slovakia. In Rumania and the Czech Republic, total domestic demand declined, so economic growth was only supported by foreign demand. In Slovenia, economic growth was driven by foreign demand, while domestic demand remained weak.

The average 12-month rate of inflation in Hungary, Poland, and Slovenia continued to increase at a slower rate. In Rumania, due to restrictive monetary policy, a marked

slowdown was achieved in the rate of increase in price level. In Slovakia and the Czech Republic, the rate of price inflation accelerated in comparison with the figure for the previous period. However, Slovakia remained the country with the lowest rate of inflation within CEFTA. Slovakia's inflation rate was not affected significantly even by replacement of the fixed exchange rate regime with a floating rate system in October 1998.

In 1998, the favourable course in economic development led to a decrease in the rate of unemployment in Hungary and to a certain extent in Poland and Slovenia. At the same time, unemployment figures increased in Slovakia, the Czech Republic, and Rumania, which indicates the need for structural changes in the economies of these countries.

In transition economies, the growing coverage of domestic demand from foreign resources led to an increase in the deficit of trade, which resulted into a deficit in the current account. The current account deficit itself was not regarded as a threat to economic growth and stability where it was compensated for by an inflow of capital in the form of foreign investment. However, the recent financial crises gave rise

#### Macroeconomic results of CEFTA countries (in %)

		Slovakia	CR	Hungary	Poland	Slovenia	Rumania
<b>Index of GDP growth</b>	<b>1996</b>	6.6	3.9	1.3	6.1	3.3	3.9
	<b>1997</b>	6.5	1.0	4.6	6.9	3.8	-6.6
	<b>1998</b>	4.4	-2.7	5.1	4.8	4.0	-5.5
<b>Inflation (CPI) (average for the period)</b>	<b>1996</b>	5.8	8.8	23.6	19.9	9.9	38.7
	<b>1997</b>	6.1	8.5	18.3	14.9	8.4	154.9
	<b>1998</b>	6.7	10.7	14.3	11.8	7.9	59.1
<b>Unemployment rate (at the end of the period)</b>	<b>1996</b>	12.8	3.5	10.7	13.6	14.4	6.3
	<b>1997</b>	12.5	5.2	10.1	10.5	14.8	8.8
	<b>1998</b>	15.6	7.5	9.1	10.4	14.5	10.3
<b>Balance of payments current account/GDP</b>	<b>1996</b>	-11.0	-7.6	-3.7	-0.4	-1.3	-7.3
	<b>1997</b>	-6.9	-6.2	-2.1	-3.0	0.4	-6.2
	<b>1998</b>	-10.3	-1.9	-4.8	-4.2	0.2	-7.0
<b>State budget surplus (deficit)/GDP</b>	<b>1996</b>	-4.4	-0.1	-6.7	-2.8	0.3	-5.8
	<b>1997</b>	-5.7	-1.2	-3.1	-4.0	-1.1	-4.5
	<b>1998</b>	-5.4	-1.7	-4.7	-2.5	1.0	-2.5

Source: National statistics



to concern about the stability of such a system in an environment of highly volatile financial flows.

Except Slovenia, which maintained a balanced current account, and the Czech Republic, where the fall in domestic demand reduced the external imbalance of the economy, the countries of Central Europe showed an increase in the external imbalance during 1998. While in Poland and Hungary, the deficit in the current account increased to a level which is acceptable with regard to the capital account balances of these countries, current account deficits in Slovakia and Rumania reached a level that gave rise to concern.

The creation of a stable economic environment requires sound government financing. Reduction in the level of public consumption, the budget deficit, and the need for structural changes in the State budget remain the priorities of individual countries in connection with their intention to join the EU.

The indicators of economic development in the areas of output, labour market, price stability, and foreign relations illustrated in the chart below show that the most balanced development was achieved in Slovenia. 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 and the current account balance as well. In the case of Slovakia, the largest disproportion is shown by the current account balance, while the Czech Republic falls behind in terms of GDP growth.

The recent financial crises have focused attention on the financial stability of new markets. It is obvious that if these countries are to be able to cope with the consequences of globalisation, their sound fiscal and monetary policies, must be based on an economy with competitive structure and a healthy financial sector.

