III. Economic policies and developments in the rest of the world

Highlights

Economic growth remained buoyant and inflation fell further in the emerging economies last year. Average growth in Latin America rose on the strength of the recovery in Argentina and Mexico, while stabilisation and reform policies in Africa promoted the fastest growth in two decades. In several Asian countries policies shifted to restraint to deal with incipient overheating. Weak export markets contributed to the moderation of growth in Asia from its earlier rapid pace and also prevented large external imbalances from narrowing much last year. In a number of Eastern European countries more advanced in the transition process, solid growth was maintained. However, the recovery of output in Russia has yet to become firmly established, even though inflation has continued to trend downwards.

As in many industrial countries, financial globalisation and liberalisation are transforming the task of pursuing both internal and external balance in the emerging economies. Limited capital mobility in the past made it relatively easy for monetary policy to address inflation while exchange rates could be set to maintain competitiveness. In the current environment of high capital mobility, pursuing separate monetary and exchange rate policies has become much more problematic. Raising interest rates to contain inflation will induce capital inflows that push up the exchange rate, diminish competitiveness and weaken external balance. Conversely, maintaining a highly competitive exchange rate may raise import costs, increase demand for domestic output and heighten inflationary pressures. While the real exchange rate cannot be kept above or below its equilibrium level in the long run, the experience of Mexico in 1994–95 indicates that financial markets can react strongly and abruptly to a marked deterioration in competitiveness and external balance in the short and medium term.

Conflicts between internal and external objectives have been more pronounced in some countries than in others. In many Latin American countries, tight monetary policies and/or fixed exchange rates led to significant reductions in inflation in the 1990s, but at the price of real exchange rate appreciation and widening current account deficits. On the other hand, several Asian countries have been able to maintain competitive exchange rates without unduly fuelling inflation. More recently, however, overheating in much of the region has called for greater monetary restraint and real appreciation has emerged. It remains to be seen whether the Eastern European countries will succeed in reducing inflation further without sacrificing external balance.

Recent developments in Latin America

Anti-inflation strategies in Latin America in the 1990s include …

Efforts towards greater price stability have been much in evidence in the Latin American region in recent years. Various strategies have been tried, some based

Growth and inflation

	Real GDP				Consumer prices			
	1980–89	1990–94	1995	1996	1980–89	1990–94	1995	1996
	annual percentage changes							
China	9.5	10.5	10.2	9.7	7.9	11.6	16.8	8.3
India	5.9	4.6	7.1	6.8	8.1[1]	10.5[1]	9.3[1]	5.9[1]
Other Asia[2]	6.5	7.0	7.8	6.8	7.8	6.9	6.4	5.9
Hong Kong	7.5	5.2	4.7	4.7	8.6	9.5	9.2	6.3
Korea	8.0	7.6	8.9	7.1	8.1	7.0	4.5	5.0
Singapore	7.4	8.6	8.8	7.0	2.7	2.9	1.7	1.4
Taiwan	8.1	6.5	6.1	5.7	4.4	3.8	3.7	3.1
Indonesia	5.8	6.9	8.5	7.5	9.6	8.6	9.4	7.9
Malaysia	5.7	8.7	9.5	8.2	3.6	3.8	3.4	3.5
Philippines	1.8	1.9	4.8	5.5	14.4	11.6	8.1	8.4
Thailand	7.2	9.0	8.6	6.7	5.7	4.8	5.8	5.8
Latin America[2]	2.3	3.1	0.5	3.5	120.5	256.8	42.5	24.7
Argentina	–0.8	6.8	–4.6	4.4	319.2	148.3	3.4	0.2
Brazil	2.9	0.9	4.2	2.9	226.0	1,425.9	66.0	15.5
Chile	3.4	6.4	8.5	7.2	21.2	17.4	8.2	7.4
Colombia	3.4	4.3	5.2	2.1	23.4	26.3	20.9	20.9
Mexico	2.2	3.9	–6.2	5.1	65.1	16.1	35.0	34.4
Venezuela	0.1	3.9	3.4	–1.6	21.4	40.7	59.9	99.9
Eastern Europe[2]	0.9	–2.5	5.5	4.7	29.7[3]	62.1	23.2	17.8
Czech Republic[4]	2.1	–4.2	4.8	4.4	1.3[3]	20.5	9.1	8.8
Hungary	1.5	–3.3	1.5	1.0	8.9	25.4	28.3	23.6
Poland	0.2	–1.6	7.0	6.0	43.0	97.6	27.7	19.9
Russian Federation[5]	3.3	–8.7	–4.2	–6.0	1.4[6]	347.0	197.5	47.7
Israel	3.2	5.8	7.1	4.4	104.7	14.2	10.0	11.3
Saudi Arabia	0.3	4.1	1.6	2.4	0.0	1.7	4.9	1.2
Africa	2.6	1.4	2.7	5.1	17.5	37.2	38.4	25.0
South Africa	2.2	0.1	3.3	3.1	14.6	12.4	8.6	7.4

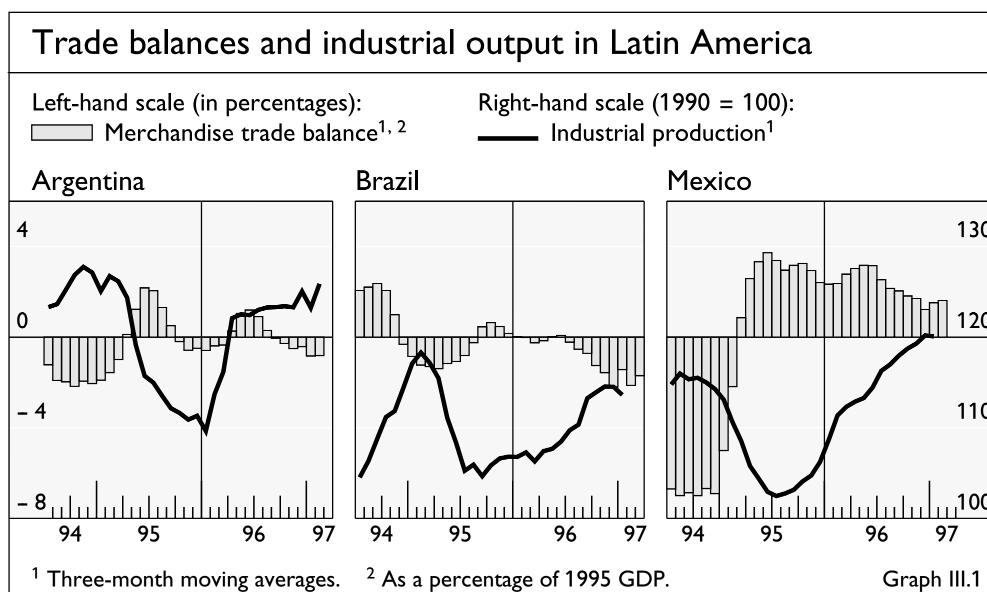
Note: Data for 1996 are partly estimated.

[1] Wholesale prices. [2] Average of countries shown, calculated using weights based on 1990 GDP and PPP exchange rates. [3] Average 1982–89. [4] Prior to 1985, Czechoslovakia. [5] Prior to 1986, the Soviet Union. [6] Average 1986–89. Table III.1

on explicit or implicit exchange rate anchors, others depending more generally on tight domestic policies. While success in reducing inflation has been almost universal, in a number of cases it has been associated with a major appreciation of the real exchange rate and a significant widening of external imbalances. The issue of reconciling internal and external objectives is discussed in a separate section below.

… Argentina's currency-board-like scheme …

The Convertibility Plan adopted by *Argentina* in 1991 was put to a severe test in 1995 when there was a run on domestic currency assets following the Mexican peso crisis. The currency-board-like arrangement left the authorities little scope other than to allow interest rates to rise sharply and to maintain, in a cyclical context, a tight fiscal policy stance. A severe economic contraction



[1] Three-month moving averages. [2] As a percentage of 1995 GDP. Graph III.1

followed that helped to improve the trade account (Graph III.1). This, together with substantial foreign borrowing by the public sector, halted the drop in international reserves. The rapid policy response to the crisis helped to boost confidence and support the subsequent recovery. GDP growth strengthened progressively last year, reaching over 4% in the second half.

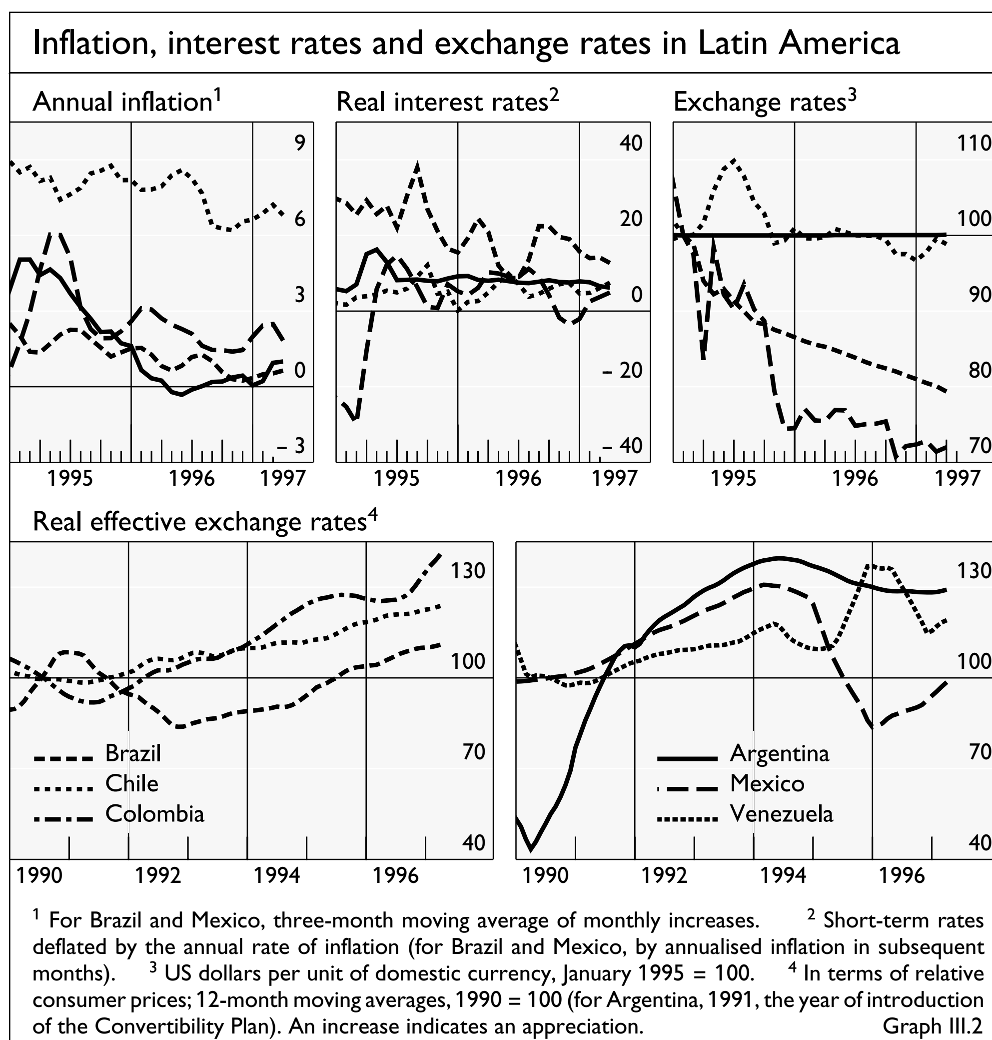
The maintenance of Argentina's exchange rate policy has been aided by the partial reversal of the erosion of competitiveness during the early phases of inflation reduction. As annual inflation fell from over 500% to about 10% in the first two years of the Convertibility Plan, real appreciation reached about 33%. Subsequently, inflation was brought down well below that of major competitors such as Brazil and Chile and part of the loss of competitiveness was regained, limiting the real appreciation for the period as a whole to 25%.

… Brazil's Real Plan aimed at greater exchange rate stability …

Brazil's Real Plan introduced in mid-1994 has also sought to reduce inflation through greater exchange rate stability supported by tight monetary policy. Given that the exchange rate tended to appreciate initially and, since early 1995, has depreciated at a slow and gradual rate somewhat below that of consumer price inflation, a real appreciation of 20% has taken place since mid-1994.

Inflation has declined steadily from a monthly rate of over 40% just prior to the implementation of the Real Plan to well below 1% in late 1996 and early 1997. However, economic activity and trade performance have fluctuated widely, largely in response to adjustments in the stance of monetary policy (Graph III.1). As the economy had reacted quickly to the monetary restraint imposed in the first half of 1995, monetary policy was eased subsequently (Graph III.2). Activity rebounded sharply, with annual GDP growth accelerating to more than 6% in the second half of 1996. In combination with the loss of competitiveness, renewed growth in Brazil soon spilled over into a widening of the trade deficit as imports rose rapidly in late 1996 and exports performed poorly.

Only modest support for stabilisation has come from fiscal policy. Last year's operational public sector deficit was 4% of GDP, somewhat below the preceding year's gap (5%) but well above the initial target (2½%). Moreover, the reduction



Inflation, interest rates and exchange rates in Latin America

[1] For Brazil and Mexico, three-month moving average of monthly increases. [2] Short-term rates deflated by the annual rate of inflation (for Brazil and Mexico, by annualised inflation in subsequent months). [3] US dollars per unit of domestic currency, January 1995 = 100. [4] In terms of relative consumer prices; 12-month moving averages, 1990 = 100 (for Argentina, 1991, the year of introduction of the Convertibility Plan). An increase indicates an appreciation. Graph III.2

reflected lower interest rates, rather than sustained reforms in the social security and tax area and in public sector administration. In late 1996, however, a package of measures was announced aimed at revenue enhancements and a cutback in public sector employment and benefit entitlements.

… and, since 1995, money growth targeting in Mexico

Since the peso crisis of late 1994, *Mexico* has cast its monetary policy in a framework radically different from that of Argentina or Brazil, as well as from the one applied prior to the crisis. Instead of relying on an exchange rate anchor, inflation reduction has been pursued through money growth targets, and the exchange rate has been allowed to move in response to basic market conditions. Fiscal policy has remained restrictive.

In the second half of 1995, the economy started recovering as the authorities' determined policy stance, along with significant official international support, boosted confidence at home and abroad. At the same time, annual inflation moderated from a peak of 52% at the end of 1995 to 25% in early 1997. Exports continued to rise strongly, reflecting both higher oil prices and buoyant exports of manufactured goods, offsetting vigorous import growth and preserving external balance.

Except for some weakening in October, the peso was relatively stable against the US dollar for most of 1996, depreciating by just 3% in nominal terms in the

course of the year. In part, the relative stability reflected attempts – through reductions in money market liquidity or, since February 1997, through sales of a fixed amount of dollars if the peso fell by more than 2% in a single day – to avoid excessive speculative pressures. Moreover, exchange rate options were used to reconstitute foreign exchange reserves during periods of peso strength, an approach designed to allow reserve growth without signalling an official exchange rate target. Given continued large inflation differentials vis-à-vis trading partners, nominal stability implied a real appreciation that has reversed about half of the real depreciation that occurred in late 1994 and early 1995.

Monetary policy dilemma in Colombia

Policy challenges intensified in *Colombia* last year. With the central government deficit widening to about 4% of GDP and a political crisis triggering capital outflows in early 1996, monetary policy was kept tight even as the economy slowed significantly. The stricter stance attracted renewed capital inflows that pushed the exchange rate to the top of its preset sliding band, effectively limiting monetary policy tightening. As inflation failed to decline, the real exchange rate appreciated by nearly 20%. Special measures were proposed in early 1997, including spending cuts and a tax on foreign credits, to slow capital inflows, bolster public finances and alleviate the monetary policy dilemma.

Chile's approach

Arguably, *Chile's* approach to curbing inflation and maintaining competitiveness has met with most success. Monetary policy has been rather tight in recent years with real interest rates – most financial instruments are still indexed so that yields are expressed in real terms – being set in accordance with a rigorously pursued target of gradual inflation reduction. As the economy threatened to overheat in early 1996, real interest rates were increased. Together with a major decline in copper prices, monetary policy restraint cooled the economy and slowed inflation to 6½% in late 1996. The exchange rate has been managed so as to avoid volatility and undue appreciation, as well as depreciation, in real terms. Monetary and exchange rate policies, however, would not have been able to address the twin policy objectives as harmoniously had they not been supported by two additional policy elements. One is the strength of public sector finances – surpluses of between 1 and 3% of GDP have been achieved in recent years; the other is the use of selective controls on shorter-term capital inflows attracted by high Chilean interest rates, and the promotion of capital outflows.

Policy adjustment in Venezuela

The April 1996 adjustment programme implemented to correct *Venezuela's* severe external and internal imbalances heralded the abandonment of earlier interventionist policies. Its success received a significant boost from the sizable rise in oil prices last year. Despite a 1½% contraction in GDP, central government finances improved sharply, returning to surplus following a deficit of 5% of GDP in 1995. Monthly inflation fell from a peak of over 12% in May 1996 to below 2% in early 1997. Controls on both exchange rates and interest rates were eliminated and a new sliding-band exchange rate regime was introduced in July 1996. Although a depreciation of the central rate had been envisaged to partially offset inflation differentials, the exchange rate, buoyed by substantial inflows of short-term capital, had, by late 1996, hardly moved. In January 1997, the central rate was reset at about the same level as that chosen in mid-1996.

Recent developments in Asia

Two common elements have featured in recent economic developments in much of Asia. First, export growth has weakened sharply in much of the region as a result of a variety of factors. Secondly, a majority of countries have relied on monetary restraint to support a process of adjustment after years of very rapid growth which had caused a number of imbalances to emerge in the form of capacity shortages, inflationary pressures or widening external deficits.

Slowing export growth

Rapid export growth in the past …

Since the mid-1980s, many emerging Asian economies have taken advantage of the globalisation of the world economy to achieve rates of export growth well in excess of the expansion of world trade. The boom was associated with clear gains in market shares in industrial countries as well as with a significant shift towards higher value added products – an area of trade traditionally dominated by the advanced economies. Not infrequently, these gains provoked protectionist sentiment in industrial countries, despite the fact that strong export growth in Asia also generated rapid income growth, and hence import growth, that provided a significant boost to activity in the rest of the world.

… contrasts with sluggishness last year

Unlike the period of economic downturn in the major industrial countries in 1990–93, which barely dented Asian export growth, the much less pronounced slowdown of world trade last year appeared to hit Asian exports particularly hard (Table III.2). The weakening of exports has raised concerns that the large current account deficits which had emerged in the region in recent years might be more difficult to sustain than previously thought.

Causes include weakening intra-regional trade …

Three factors have contributed importantly to the drop in export growth. First, intra-regional trade, which now accounts for well over one-third of (emerging) Asia's total trade and which in the past had increased resilience to slack demand in industrial countries, had a dampening impact last year as activity slowed almost throughout the region. Moreover, little offset could be found elsewhere, as import demand in the United States and Europe also weakened.

… a slump in the electronics market …

Secondly, the market for electronic products, in particular for semi-conductors, experienced a severe slump last year as continuing strong supply increases met sluggish demand and depressed prices. US dollar prices of semi-conductors, for instance, are estimated to have plunged by up to 80% last year, putting downward pressure on the price of other electronic products as well. Many countries in Asia have become highly specialised in the manufacture of these products, which now account for between one-quarter (Hong Kong, Taiwan and Thailand) and one-half (Singapore) of exports; in Korea, Malaysia and Singapore, semi-conductors alone account for more than 10%. Although it led to excess supply last year, Asia's dynamic presence in the world electronics market (in which it now has a market share of close to 30%) has in general served to enlarge capacity, intensify competition and reduce prices, benefiting consumers worldwide.

Finally, emerging Asian economies have become direct competitors of Japan in export markets and/or host countries for cost-driven Japanese foreign investment. Because many countries stabilise their exchange rates against the

Current account balances and external trade

	Current account balance			Export volume growth[1]			Import volume growth[1]		
	Average 1990–94	1995	1996	Average 1990–94	1995	1996	Average 1990–94	1995	1996
	as a percentage of GDP			in percentages					
China	1.1	0.2	0.2	17.2	15.3	8.3	13.6	15.1	16.4
India	– 1.2	–1.4	–1.4	12.9	22.4	16.9	5.8	23.6	18.9
Other Asia	0.2	–1.6	–3.4	7.6	11.5	3.0	12.9	15.2	6.7
Hong Kong[2]	5.3	–3.5	–1.0	–1.4	1.9	–8.6	15.8	13.6	4.0
Korea	– 1.1	–1.9	–4.4	8.8	24.0	19.1	11.7	21.2	11.9
Singapore	11.2	16.9	15.0	15.2	15.7	6.3	12.4	13.0	6.4
Taiwan	4.3	1.9	3.8	5.2	5.8	–4.8	7.8	8.6	0.8
Indonesia	– 2.2	–3.5	–4.0	11.1	10.3	4.8	13.8	17.4	10.7
Malaysia	– 5.0	–8.4	–7.5	13.9	15.6	13.6	17.9	23.4	17.7
Philippines	– 4.1	–2.7	–4.3	9.1	17.0	18.8	13.4	14.6	24.2
Thailand	– 6.2	–8.1	–8.0	14.8	14.2	–0.7	13.5	15.9	–3.6
Latin America	– 2.0	–1.5	–1.4	6.6	9.5	8.4	13.9	9.5	10.4
Argentina	– 1.7	–0.9	–1.4	9.9	17.8	3.2	35.4	–17.5	25.2
Brazil	0.0	–2.5	–3.3	6.0	–5.5	2.5	14.4	36.7	4.5
Chile	– 1.9	0.2	–4.1	9.0	7.6	17.4	8.8	24.7	11.1
Colombia	– 0.6	–5.4	–5.5	8.1	11.4	11.3	23.7	12.5	2.5
Mexico	– 5.9	–0.2	–0.6	5.4	24.5	14.7	13.3	–14.9	20.8
Venezuela	2.4	2.9	10.9	6.6	5.7	3.5	0.5	36.4	–5.1
Eastern Europe	– 1.3	–3.0	–6.4	18.8	15.7	4.3	22.3	16.3	15.0
Czech Republic	0.8	–3.4	–8.6	25.9	5.4	0.6	30.2	23.7	10.1
Hungary	– 3.6	–5.6	–3.9	7.9	8.4	5.8	17.3	– 4.0	2.1
Poland	– 1.1	–1.9	–6.3	19.9	30.8	6.9	18.7	24.5	28.9
Russian Federation	1.1	3.2	2.7	21.2[3]	7.4	2.2	11.9[3]	– 4.5	3.1
Israel	– 2.4	–6.1	–5.1	7.5	7.6	6.5	12.0	8.9	9.3
Saudi Arabia	–13.2	–4.2	0.1	9.2	1.7	1.8	2.9	12.0	4.8
South Africa	1.3	–2.1	–1.6	1.9	2.4	7.8	2.4	10.6	10.5

Note: Data for 1996 are partly estimated.

[1] Merchandise trade. For the regions, average of the countries shown, calculated using weights based on the dollar value of trade in 1990. [2] Current account data refer to the balance of goods and non-factor services and export volume growth to domestic exports only. [3] Average 1991–94.

Table III.2

… and US dollar appreciation against the yen

US dollar, the marked strengthening of the dollar against the Japanese yen since mid-1995 has contributed to a significant real appreciation that has diminished export competitiveness. Table III.3 shows that the currencies of several economies, in particular Hong Kong, the Philippines, Taiwan and Thailand, have shown less long-term movement against the dollar over the 1990s, as well as less short-term volatility, than many industrial country currencies.

Some caveats

Many of the forces leading to last year's export slowdown are not likely to remain as influential. The scope for further dollar strengthening is not without limit; the downturn in the market for electronics appeared to bottom out in late 1996; and the process of adjusting to overheating is well advanced in several

Stability of US dollar exchange rates,[1] January 1990–February 1997													
	HK	ID	KR	MY	PH	SG	TH	TW	*AU*	*CA*	*DE*	*GB*	*JP*
Monthly trend change[2]	–0.01	0.32	0.16	–0.11	0.04	–0.35	–0.02	0.03	*0.02*	*0.27*	*–0.12*	*0.20*	*–0.50*
Coefficient of variation[3]	0.2	0.7	3.2	2.5	5.4	2.3	1.0	2.9	*5.4*	*3.2*	*5.7*	*6.5*	*8.7*

AU = Australia; CA = Canada; DE = Germany; GB = United Kingdom; HK = Hong Kong; ID = Indonesia; JP = Japan; KR = Korea; MY = Malaysia; PH = Philippines; SG = Singapore; TH = Thailand; TW = Taiwan.

[1] Calculated on the basis of average monthly exchange rates (domestic currency units per US dollar). [2] Based on regressing exchange rates on a constant and a time trend. A minus sign indicates an appreciation. [3] Around trend. Table III.3

Asian economies. Nevertheless, last year's development indicates that Asia's rapid industrialisation and export drive – in some cases under government guidance – may have created excess capacity in some sectors and industries, which at times stands in sharp contrast with bottlenecks elsewhere. It may also have made those financial institutions that are heavily exposed to sectors characterised by excess supply correspondingly vulnerable (see Chapter VI).

China and India

Moderate inflation and appreciable growth in China ...

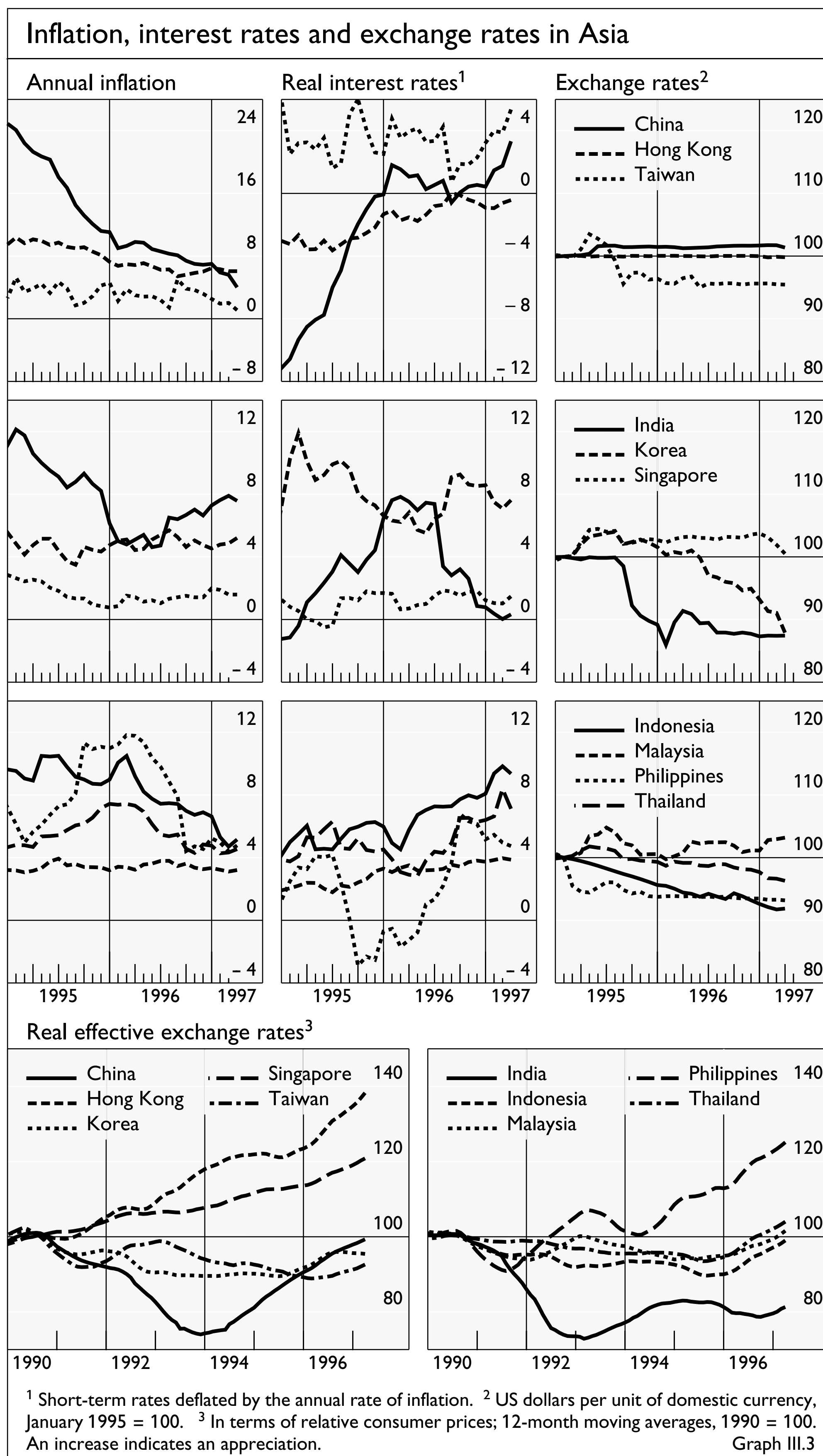
Inflation in China moderated to 7% by the end of last year, while economic growth was maintained at around 10%. Against the background of falling inflation, administered interest rates were reduced in May and again in August. Yet monetary policy remained cautious as real interest rates were kept positive. Major progress was also made last year in modernising the monetary policy framework, including the establishment of an interbank market no longer subject to interest rate ceilings, the promotion of more competitive sales of Treasury securities and a trial launching of open market operations. In early 1997, the scope for re-discount operations was widened.

... but competitiveness weakens ...

The yuan stayed virtually unchanged against the dollar as intervention channelled strong capital inflows into reserves. Given still large inflation differentials vis-à-vis trading partners, there was a real appreciation of 8%, following one of 11½% in 1995. The continuing erosion of the competitiveness gains achieved in early 1994 (when the dual exchange rate regime was abolished) has been an important factor behind the near-halving of export growth to just 8½% and the continued buoyancy of imports.

... and reform in the state-owned enterprise sector is urgent

Further successful demand management will depend on reforming China's state-owned enterprise sector. Cutting the deficit of these enterprises (equivalent to nearly 7% of GDP in 1995) is a prerequisite for public sector consolidation. Last year, the state-owned sector's losses are estimated to have soared by more than 40% as export performance was poor and output largely served to bloat inventories. Moreover, weak finances of state-owned enterprises can complicate monetary policy. Not only does credit restraint imposed on them almost inevitably cause inter-company debt levels to rise, but the effect of higher interest rates on their financial position, as well as on the quality of the loan portfolio of the state-owned creditor banks, may constrain monetary policy in implementing macroeconomic stabilisation.



[1] Short-term rates deflated by the annual rate of inflation. [2] US dollars per unit of domestic currency, January 1995 = 100. [3] In terms of relative consumer prices; 12-month moving averages, 1990 = 100. An increase indicates an appreciation.
Graph III.3

Progress achieved with respect to trade opening, financial sector liberalisation and fiscal reform since 1991 has enabled India to increase its annual

growth rate to an average of 6% over the last five years. At the same time price inflation has been reduced and a large external imbalance has been avoided. Slowing credit growth and the favourable inflation performance last year permitted an easing of monetary policy and a significant drop in real interest rates. A relaxation of restrictions on foreign borrowing and the continued encouragement of inward foreign direct investment induced capital inflows which financed a modest current account deficit, boosted reserves and supported a relatively stable rupee/dollar exchange rate.

Continued structural adjustment and balanced growth in India …

Although the economy has grown much more solidly in recent years, closing the gap with other Asian countries will depend on increasing domestic saving, in particular by reining in public sector dissaving. Although narrowing slightly in the last fiscal year, the central government deficit remained sizable at 5% of GDP. Other parts of the public sector, including state-owned enterprises, added further to the financing shortfall. While current budget proposals encourage deficit reduction, even greater support would come from the additional growth likely to result from continued efforts to reform taxes, public administration and labour laws, rationalise state subsidy policies, promote competition and expand and make better use of the country's economic infrastructure.

… depend on public sector reform

Other Asian economies

The stance of domestic policies in the Republic of Korea remained cautious in the face of a slackening of growth (to 7%) and a further widening of the current account deficit (to 4½% of GDP) last year. Central government finances remained balanced, with spending increases being offset by measures to broaden the revenue base. Inflation was stable at around 5% throughout 1996 but monetary policy was eased little. The subdued economy and the associated vulnerability of the banking sector put downward pressure on the exchange rate: the won depreciated by 7% against the dollar in the second half of 1996 and by a further 5% in the first quarter of 1997. A return to high and sustained growth rates will depend on the effective implementation of structural reform. Key objectives include making goods markets more competitive (after decades of heavy government intervention), as well as reforming labour markets. Moreover, it is important that efforts to deregulate the domestic financial system and to ease restrictions on capital flows and trade in financial services continue.

Korean growth slowdown …

… also calls for structural reform

Slow export growth and sluggish private investment spending also characterised Taiwan last year. As economic growth dropped below 6%, inflation remained subdued and the current account surplus widened. Nevertheless, as the year went on, easier monetary and fiscal policies contributed to a progressive recovery of manufacturing production and a stock market rally. From late 1996 onwards, financial conditions were re-tightened somewhat.

Taiwan

The slowdown of Hong Kong's economy bottomed out in the first half of 1996 as services exports, private consumption and property investment strengthened. With domestic demand recovering and liquidity buoyed by continuing capital inflows, consumer price inflation climbed back to just under 7% by the end of 1996 and property prices boomed (see Chapter VI).

Hong Kong

As Singapore's economy slowed significantly, price pressures remained moderate and import demand declined, preserving a large current account

Singapore

surplus. The pattern of steady exchange rate appreciation that had been a consistent feature throughout the first half of the 1990s was interrupted after mid-1995 when the rate of exchange between the Singapore and US dollars stabilised close to the 1.40 mark.

Adjustment in Indonesia and Malaysia

Both Indonesia and Malaysia have adopted a more restrictive policy stance over the last year and a half to deal with incipient economic overheating. As growth in Indonesia accelerated to over 8% in 1995, inflation climbed to almost 10% and the current account deficit widened to 3½% of GDP. Even higher growth in Malaysia resulted in a very tight labour market and one of the largest current account imbalances in the region (8½% of GDP). Restrictive monetary policies from late 1995 onwards have led to rising real interest rates in both countries. In response to the resultant surge in capital inflows, Indonesia progressively widened its exchange rate band in the course of 1996. The results were greater volatility in the rupiah/dollar rate around a more level trend and a significant real appreciation (7% over the year). Modest steps were taken in both countries to maintain small central government budget surpluses. In the event, growth moderated, although external imbalances remained large.

Slowing growth …

… and financial sector problems in Thailand

Adjustment in Thailand to overheating in the first half of the 1990s has been complicated by sluggish export growth and a fragile financial sector. Tighter monetary policy succeeded in slowing domestic demand and import growth in 1996, but the current account deficit failed to narrow in the face of stagnating export growth. A slump in the property sector, a sharply weakening stock market and the economic slowdown also caused difficulties in the financial sector (discussed in more detail in Chapter VI). This posed problems for interest rate management given that high interest rates accentuated the vulnerability of the financial sector but were at the same time necessary to retain foreign investors' willingness to finance the large current account deficit. Indeed, the baht came under pressure on a number of occasions in the second half of 1996 and early 1997. To maintain investor confidence and protect an economy with a high level of foreign indebtedness, the authorities remained committed to their policy of closely pegging to a dollar-dominated basket, supported by positive interest rate differentials as well as official intervention.

The Philippines

One of the few Asian economies to enjoy faster growth last year was the Philippines. Economic liberalisation, financial deregulation and fiscal reforms in recent years helped to raise growth to almost 6% in 1996. Although export growth remained strong, it was outpaced by that of imports, causing the current account deficit to widen to 4% of GDP. Very rapid credit expansion, fuelled to a large extent by heavy capital inflows, has been countered by a rise in real short-term interest rates. However, in the context of a policy aimed at minimising changes in the peso/dollar rate, there are limits to the degree of restraint which monetary policy can produce on its own.

The Middle East and Africa

Saudi Arabia

Israel

Fiscal austerity pursued in Saudi Arabia over the last two years, as well as the rise in oil prices, helped to restore growth at a moderate rate of inflation and a balanced current account. In contrast, Israel's economic performance worsened

last year as an increase in the (domestic) fiscal deficit to 5% of GDP led to excessive demand growth and accelerating price inflation in early 1996. Monetary policy had to be tightened sharply in consequence, with interest rates rising by the middle of the year to levels that created considerable turbulence in bond and equity markets. Moreover, large capital inflows attracted by high interest rates complicated the management of the exchange rate within its sliding band. A stronger-than-targeted exchange rate not only added to the erosion of competitiveness already caused by rapid wage growth, but also necessitated heavy intervention in early 1997.

A boost to growth in Africa

Growth in Africa accelerated to 5% last year as structural adjustment efforts have been increasingly bearing fruit and encompassing a larger number of countries. Growth was again strong in the CFA countries, where the 1994 devaluation was instrumental in supporting economic reforms. Moreover, in countries such as Kenya, Malawi, Uganda and Zimbabwe, which have adopted policies to open their economies, strengthen public finances and modernise financial markets, encouraging growth rates were recorded.

South Africa

Exchange market turbulence contributed to relatively weak growth and an upturn of inflation in South Africa last year. A sudden decline in capital inflows in early 1996, a deepening current account deficit and very low international reserves caused the rand to depreciate sharply and monetary policy to be tightened significantly. Progress was also made in promoting greater fiscal discipline. By late 1996, these policies had succeeded in arresting the deterioration in the current account and regaining investor confidence.

Price stability and competitiveness in emerging economies

The pursuit of both internal and external balance …

In their quest for sustained high growth, emerging economies are subject to a number of constraints. First, internal balance must be maintained so that the expansion of domestic demand does not outstrip supply, leading to increased inflation, macroeconomic instability and heightened uncertainties that inhibit future investment and growth. Secondly, external performance must be sustained, both to avoid destabilising balance-of-payments problems and to ensure that exports continue to help shape the process of growth and development.

… and the changing effectiveness of monetary policy in a liberalised financial environment …

As was seen in the preceding sections, monetary policy can play a pivotal role in controlling aggregate demand. However, the transmission mechanism of monetary policy has been strongly influenced by progress made towards domestic financial liberalisation and the opening of the capital account in many emerging economies. This progress has enhanced prospects for higher efficiency and growth, but may also have made it more difficult to use monetary policy to achieve simultaneously the objectives of internal and external balance. In particular, in an environment of high capital mobility, monetary restraint to reduce inflation will induce capital inflows that temporarily strengthen the exchange rate. This reinforces downward pressure on inflation, but may also bring about an unwanted loss of competitiveness and a worsening external balance despite the moderating influence on imports of lower domestic demand.

… may lead to policy conflicts

These considerations point to potentially important inconsistencies, at least in the short and medium term, between the objectives of inflation containment

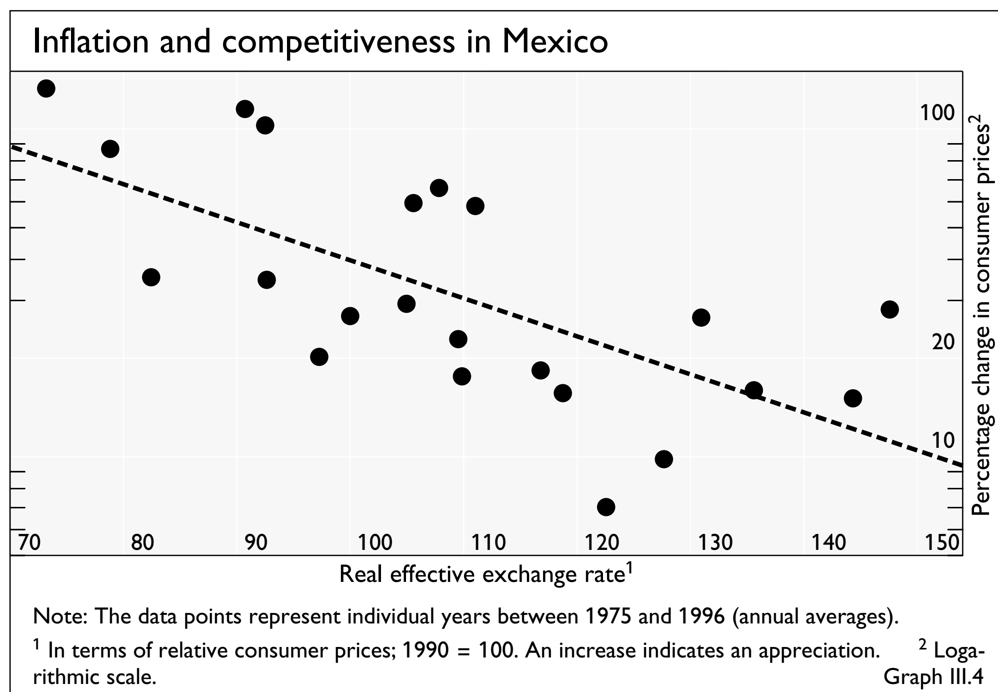
and strong external performance. Tightened monetary policy may reduce inflation, but at the price of an appreciated exchange rate and wider external imbalances. Conversely, making the exchange rate very competitive may induce higher inflation.

The link between inflation and competitiveness in the medium term …

It is well known that a one-time devaluation of the *nominal* exchange rate may result in a *temporary* increase in inflation. However, it is also true that keeping the level of the *real* exchange rate depreciated for an extended period of time may lead to a *sustained* increase in inflation. A devaluation of the nominal exchange rate raises domestic prices, both because it increases the domestic currency cost of imports and because it shifts demand from imports to domestically produced goods. In the absence of further nominal devaluations, these increases in domestic prices work to reverse the initial real depreciation, returning the real exchange rate to its original level. Hence, maintaining the real exchange rate at a depreciated level may require continuous nominal devaluations. The resultant sustained higher rate of nominal exchange rate depreciation, in turn, is likely to be associated with a sustained higher rate of domestic price inflation. As an example, Graph III.4 illustrates the strong negative correlation between the *rate* of inflation and the *level* of the real exchange rate in Mexico over the last two decades.

… and in the long term

In the long run, of course, policy trade-offs between inflation containment and competitiveness will be less well-defined. Movements in domestic inflation and external payments will work to return real exchange rates to their equilibrium value, while the pass-through of past inflation into future expectations will attenuate the link between inflation and the real exchange rate. In the short and medium term, however, changes in inflation and competitiveness can have profound effects on external balance and overall economic performance, as indicated by the recent experience of disinflation, real appreciation, current account deterioration and subsequent financial crisis in Mexico.

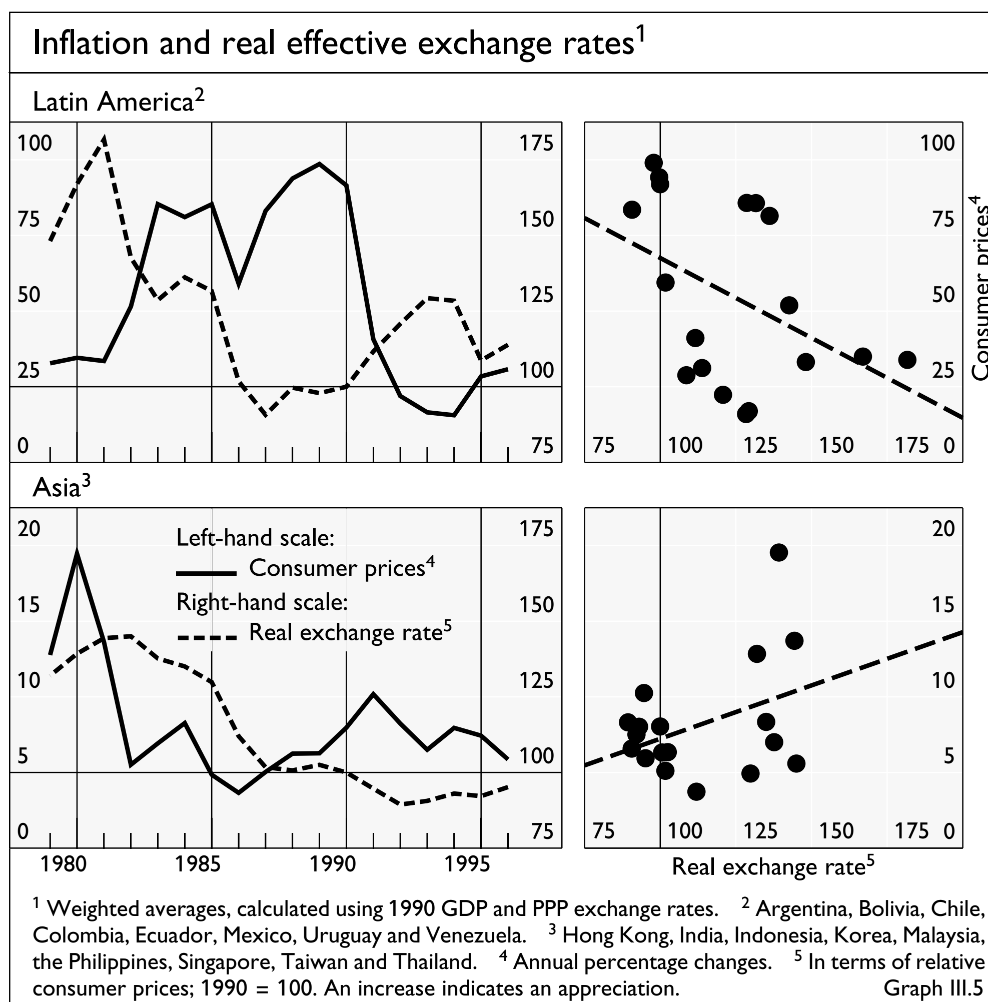


Inflation and competitiveness in Mexico

Note: The data points represent individual years between 1975 and 1996 (annual averages).

[1] In terms of relative consumer prices; 1990 = 100. An increase indicates an appreciation. [2] Logarithmic scale.

Graph III.4



Inflation and real effective exchange rates[1]

[1] Weighted averages, calculated using 1990 GDP and PPP exchange rates. [2] Argentina, Bolivia, Chile, Colombia, Ecuador, Mexico, Uruguay and Venezuela. [3] Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand. [4] Annual percentage changes. [5] In terms of relative consumer prices; 1990 = 100. An increase indicates an appreciation. Graph III.5

Inflation/competitiveness trade-offs are marked in Latin America …

The relationship between changes in inflation and competitiveness also appears to have been more marked in some economies than in others (Graph III.5). In Latin America, the short-term inconsistencies between the pursuit of price stability and maintaining external competitiveness have been particularly apparent. With the onset of the debt crisis in the early 1980s, many Latin American countries substantially devalued their currencies in order to reduce large current account deficits, contributing to a surge in inflation. In response, a number of them subsequently chose to fix their nominal exchange rates. This led to sharp reductions in inflation rates, but as these rates continued, at least initially, to exceed international levels of inflation, real exchange rates appreciated substantially. In Mexico, this appreciation proved unsustainable, and a large devaluation in 1994 boosted inflation rates in 1995 and 1996.

In sum, the focus of macroeconomic policy in Latin America has tended to alternate between disinflation, at the cost of external competitiveness, and reducing external imbalances, at the cost of domestic price stability, depending on which of these objectives seemed more urgent at the time. In contrast, macroeconomic policies in Asia have been more consistent and adverse repercussions from particular policies have been less evident. As in Latin America, Asian real exchange rates also depreciated substantially in the 1980s. In certain countries, including Korea, Malaysia, the Philippines and Thailand, devaluation was

required to reduce very large current account deficits. Further real depreciation after 1985 in part reflected the fall of the US dollar against other major currencies, since many Asian countries pegged their currencies to the dollar.

… but less so in Asia

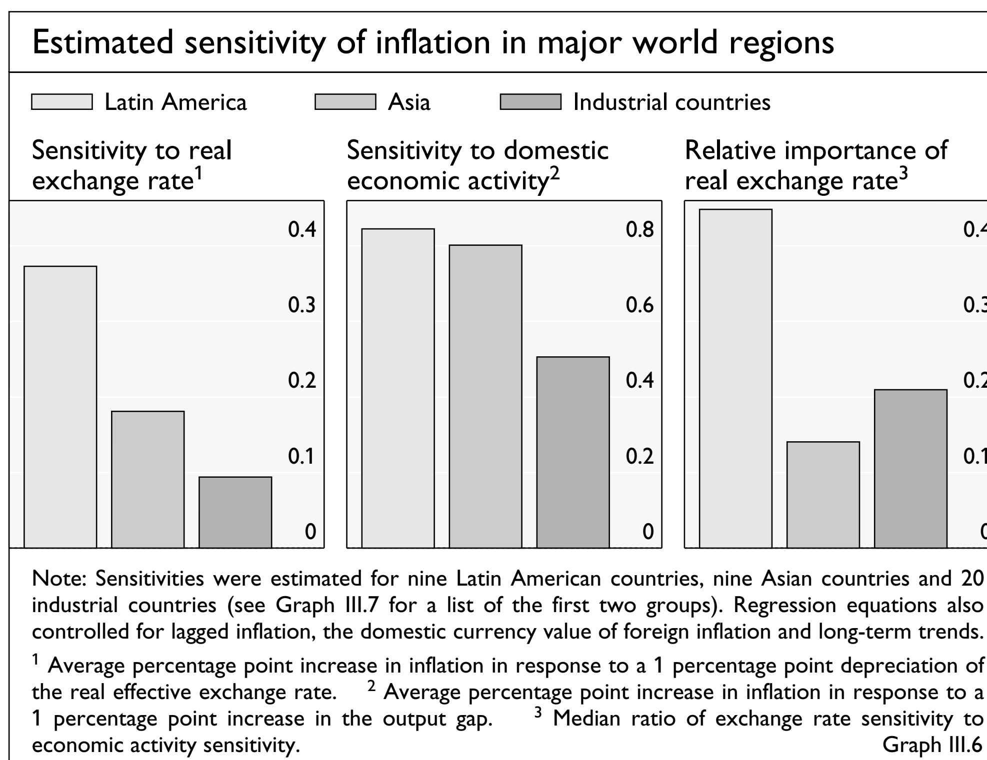
In contrast to the Latin American experience, however, the inflationary response to devaluation in Asia was relatively subdued. While Asian inflation rates picked up moderately between 1986 and 1991, as can be seen in Graph III.5, they remained well below average levels at the start of the 1980s. Moreover, again unlike in Latin America, the real exchange rate depreciation during the 1980s was not sharply reversed in the 1990s, although some slight real appreciation took place after 1992. To protect the vitality of their export sectors, many Asian countries have resisted large appreciations of their currencies, notwithstanding the strong upward pressures exerted by heavy capital inflows. In fact, it is precisely the *lack* of apparent inflationary responsiveness to the exchange rate that may have made this policy focus possible.

Estimated sensitivity of inflation to the real exchange rate …

The data shown in Graph III.5 represent merely impressionistic evidence that the underlying relationship between competitiveness and inflation has differed in the two regions. A more precise identification of the sensitivity of inflation to changes in the real exchange rate, based on the estimated relationship between the rate of inflation and the level of the real exchange rate in 38 countries, is shown in the left-hand panel of Graph III.6. The results confirm that inflation on average has indeed been more responsive in the short term to the level of the real exchange rate in Latin America than in Asia, although Asian inflation, in turn, has exhibited greater sensitivity to exchange rates than has inflation in the industrial countries.

The sensitivity of inflation to variations in domestic economic activity, shown in the middle panel of Graph III.6, is also estimated to have been higher

Estimated sensitivity of inflation in major world regions



Note: Sensitivities were estimated for nine Latin American countries, nine Asian countries and 20 industrial countries (see Graph III.7 for a list of the first two groups). Regression equations also controlled for lagged inflation, the domestic currency value of foreign inflation and long-term trends.

[1] Average percentage point increase in inflation in response to a 1 percentage point depreciation of the real effective exchange rate. [2] Average percentage point increase in inflation in response to a 1 percentage point increase in the output gap. [3] Median ratio of exchange rate sensitivity to economic activity sensitivity.

Graph III.6

in Latin America than in Asia or in the industrial countries. This, together with the results described above, suggests that inflation in Latin America has generally been more sensitive to shocks than inflation in other regions, regardless of whether these shocks are associated with internal or external factors. (It is also likely that the shocks themselves – fiscal, monetary and terms-of-trade – have been more marked in Latin America than in other regions.) However, compared with Asia and the industrial countries, inflation in Latin America has been disproportionately affected by movements in exchange rate competitiveness. In the right-hand panel of the graph, the estimated sensitivity of inflation to the real exchange rate is divided by its estimated sensitivity to domestic activity. This ratio, which measures the relative strength of the real exchange rate compared with domestic activity in affecting inflation, has also been higher in Latin America than in the other regions. This is surprising, since one would expect that prices in Asian countries, with their greater degree of openness to international trade, would have been most sensitive to exchange rates.

… is higher in Latin America

It remains unclear exactly why the inflationary process should have been more sensitive to the real exchange rate in one region than in another. Much of the explanation may lie in the fact that sustained high levels of inflation, as they become embedded in the psychology and institutions of wage and price-setting, may themselves increase the sensitivity of inflation to subsequent inflationary shocks. When inflation is high and variable, the length of wage contracts tends to shorten, prices are revised with greater frequency, and expectations of future inflation become a more important determinant of current wage and price-setting. In these circumstances, factors tending to signal rising prices are likely to induce a more rapid inflationary response than would be the case in a low-inflation environment. The exchange rate has played a particularly important role in this respect since it is the most visible, frequently adjusted gauge of future movements in aggregate prices. Indeed, Graph III.7 suggests that, the higher the average rate of inflation in a country, the greater is the estimated sensitivity of inflation to the real exchange rate. By the end of the 1970s, for reasons that remain unclear, inflation had already become higher and more deeply entrenched in Latin America than in Asia. The much higher rate of inflation experienced in Latin America by that time may thus explain much of the subsequent difference in the relationship between inflation and competitiveness faced by the two regions in the 1980s and 1990s.

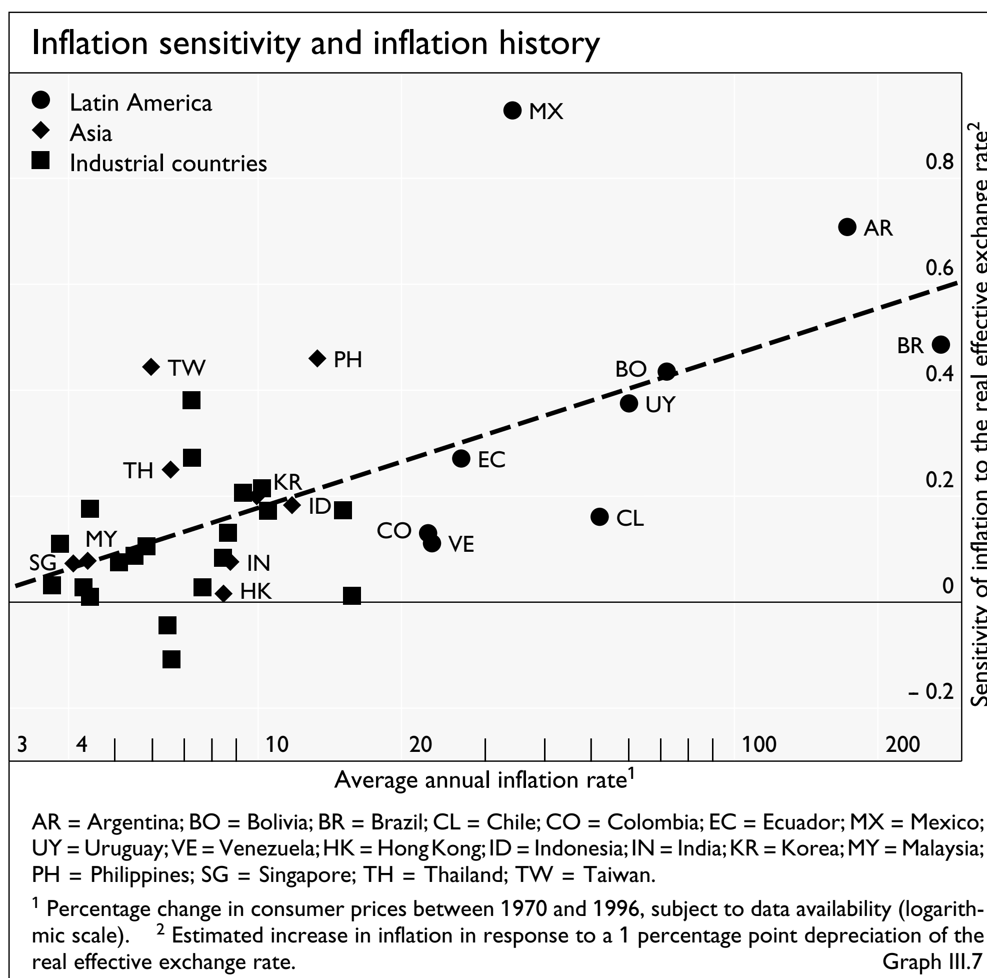
Importance of past inflation …

… for the degree of sensitivity to shocks …

The role of past inflation in affecting future inflation also highlights an element of instability in the inflationary process: because upward shocks to inflation heighten the sensitivity of inflation to future shocks, there is the risk that a succession of adverse shocks may lead to a rapid inflationary spiral. It is this risk that places such a high premium on reducing levels of inflation and keeping them low for extended periods.

Unfortunately, the more pronounced the linkage between inflation and competitiveness, the more difficult it is to reduce inflation substantially without risking a serious deterioration of external balance. In Mexico during the 1988–94 period, disinflation was associated with strong real appreciation, widening current account deficits and, eventually, a financial crisis. In Argentina during the early 1990s, disinflation was also associated with real appreciation and widening

… and the process of inflation reduction



Inflation sensitivity and inflation history

AR = Argentina; BO = Bolivia; BR = Brazil; CL = Chile; CO = Colombia; EC = Ecuador; MX = Mexico; UY = Uruguay; VE = Venezuela; HK = Hong Kong; ID = Indonesia; IN = India; KR = Korea; MY = Malaysia; PH = Philippines; SG = Singapore; TH = Thailand; TW = Taiwan.

[1] Percentage change in consumer prices between 1970 and 1996, subject to data availability (logarithmic scale). [2] Estimated increase in inflation in response to a 1 percentage point depreciation of the real effective exchange rate.

Graph III.7

external imbalances, and, in the wake of the Mexican crisis, only sharply contractionary fiscal policies could reduce these imbalances, restore confidence and maintain the exchange-rate-based stabilisation programme.

Structural reforms to mitigate short-term policy conflicts

These considerations point to the crucial need for structural reforms to mitigate the short-term conflict between the achievement of price stability and competitiveness. Measures to increase competition, liberalise trade, make labour markets more flexible and strengthen fiscal discipline, for example, may help to lower inflation for a given real exchange rate level. Similarly, reforms that boost efficiency and raise private saving – including privatisation and financial liberalisation – may lead both to improved export performance and to a reduced demand for imports, thereby allowing real exchange rate appreciation without a resultant deterioration of the external balance and rise in external debt. Finally, some countries have chosen to dismantle capital controls rather gradually as a means of maintaining some policy flexibility, although it is unclear how effective these controls might be in the absence of fundamental structural reforms.

Recent developments in transition economies

Weak activity in Russia despite falling inflation owing to …

Growth in *Russia* did not pick up as many had expected at the beginning of 1996 and, in fact, officially recorded output declined by a further 6% last year. Nevertheless, the country consolidated a number of gains, most notably a further

reduction of annual inflation to below 20% by early 1997. One important reason for greater price stability was the rouble exchange rate corridor adopted in 1995, which served to anchor inflation expectations at a lower level.

… poor enterprise governance …

Lack of economic buoyancy may reflect the still limited progress made in pursuing structural reform. Although privatisation was pursued further – 75% of large state enterprises and 50% of smaller enterprises are in private hands – the evolving corporate structure often failed to provide adequate incentives (in particular credible hard budget constraints) for good management and greater dynamism in the enterprise sector. Enterprises continued to build up wage and tax arrears, and involuntary debt accumulation between enterprises was again prominent. Clandestine stripping of enterprise assets is still widespread.

… financial sector fragility …

Against the background of an inadequate regulatory framework and insufficient incentives for efficient governance, banks' portfolios of bad loans remained substantial. In order to contain the wave of bank failures, the central bank continued its policy of providing cheap lombard credits to banks still deemed to be solvent, and of strengthening bank balance sheets through the sale of high-yielding Treasury bills. Licences of insolvent banks have been gradually withdrawn.

… and unsound public finances

The federal deficit widened to 7½% of GDP last year, in spite of continued sequestration of expenditures as only about 75% of budgeted expenditure for 1996 actually occurred. Many essential government services were either not provided or not paid for. Difficulties in collecting sufficient taxes to finance

Real and financial developments in the Russian Federation

[1] Monthly percentage changes. [2] Official refinancing rate, on a monthly basis, deflated by monthly inflation. [3] June 1995 = 100. [4] In terms of relative consumer prices. An increase indicates an appreciation. [5] Three-month moving average. [6] Left-hand scale. [7] Right-hand scale. [8] As a percentage of GDP. Federal government data.

Graph III.8

spending were at the root of the problem. Weak enforcement has fuelled incentives to evade taxes: only 17% of economic agents complied with their tax liabilities in full and on time. In part, the poor collection record has also reflected a shift of activity and resources from the taxed official sphere into the untaxed shadow economy. Concerns about tax administration were partly responsible for a number of delays in 1996 and early 1997 in the disbursement of individual tranches of the $10 billion IMF credit granted in March 1996.

Developments in Eastern Europe

Growth in most major economies in *Eastern Europe* stayed close to the levels seen in 1995. Domestic demand growth, supported by rising real wages and vigorous investment, registered 8% and 10% in the Czech Republic and Poland respectively, and was even greater in the Slovak Republic. In Hungary, however, domestic demand was subdued, in part reflecting declines in real wages. Growth declined in Romania as well, while in Bulgaria output plunged by 11%.

In contrast to demand buoyancy at home, most countries faced weak export markets, most importantly in the European Union. Relative demand pressures were amplified by losses of competitiveness in the Czech and Slovak Republics and in Poland. A marked slowdown in export growth resulted while the momentum of imports remained strong, leading to a significant widening of current account deficits. Hungary's current account deficit, in contrast, shrank to about 4% of GDP as weak domestic demand limited import growth.

Policy challenges in the region

Two main challenges face Eastern Europe. First, despite improved profitability and a stronger capital base, the financial sector in many countries remains vulnerable, owing to widespread state control of banks, a high incidence of doubtful loans and weak corporate governance, especially in smaller banks. Secondly, as the transition to a free market system progresses, conflicts between macroeconomic objectives (as described in the preceding section) may assert themselves. In Hungary and Poland, inflation eased to below 20% and further declines may require either a slowing of the rate of exchange rate depreciation – at the price of diminished export competitiveness in the medium term – or a slowing of the growth of aggregate demand and output. In the Czech and Slovak Republics, inflation is relatively low, but external imbalances have become a cause for concern. This may require either further fiscal tightening to restrain demand (as in the Czech Republic in April 1997), significant wage moderation or an exchange rate depreciation that risks somewhat higher inflation in the near future.

Currency board arrangements

Faced with a rapid withdrawal of bank deposits, a collapse of the exchange rate, soaring inflation and plummeting growth, Bulgaria decided to introduce a currency board system in mid-1997, thus joining Estonia and Lithuania, which have both established currency boards in recent years. Bosnia-Hercegovina is also contemplating the introduction of such an arrangement, while Latvia's monetary framework resembles one. Argentina's 1991 Convertibility Plan is the most noteworthy currency-board-like scheme to have been established recently outside the transition economies.

Currency board principles

A strict application of the principles of a currency board requires a rigid exchange rate link to a reserve currency, the issuance of base money only in

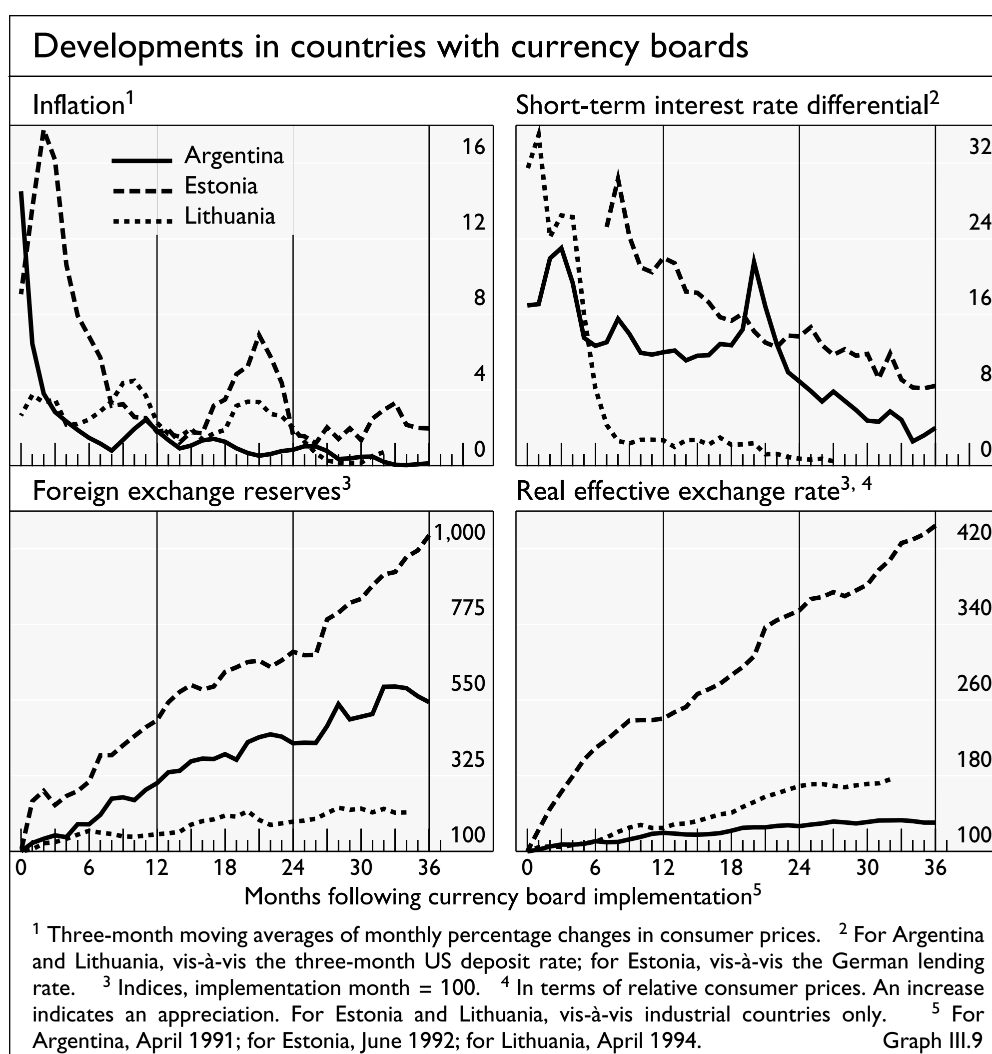
exchange for equivalent amounts of foreign exchange, and the prohibition of all central bank lending. In most arrangements, however, some limited flexibility in the application of these principles is permitted. For instance, a system of reserve requirements that leaves some scope for discretionary liquidity management is often retained.

Advantages include transparency and simplicity …

Currency boards can offer a number of advantages. Establishing a fixed and rigid link between domestic currency issuance and changes in international reserves is transparent and simple. These are useful attributes for immature financial markets or institutions with limited policy-making experience. Also, by tying the hands of the monetary authorities, it greatly reduces the scope for discretion or outside political pressure. This could enhance the credibility of anti-inflation policies, make price expectations more responsive and speed up inflation reduction. In turn, this helps to ease the conflict between inflation and competitiveness objectives observed in monetary regimes that allow more scope for discretion. Finally, as a currency board commitment may inspire more confidence in the fixity of the exchange rate than a standard fixed exchange rate arrangement, access to and funding costs on international financial markets may also become more favourable.

… policy credibility …

… and exchange rate confidence



[1] Three-month moving averages of monthly percentage changes in consumer prices. [2] For Argentina and Lithuania, vis-à-vis the three-month US deposit rate; for Estonia, vis-à-vis the German lending rate. [3] Indices, implementation month = 100. [4] In terms of relative consumer prices. An increase indicates an appreciation. For Estonia and Lithuania, vis-à-vis industrial countries only. [5] For Argentina, April 1991; for Estonia, June 1992; for Lithuania, April 1994.

Graph III.9

Existing currency-board-like arrangements in the transition economies, as well as in Argentina, have been instrumental in bringing down inflation and building credibility (Graph III.9). Both Argentina and Estonia saw inflation drop sharply within one year following the introduction of the currency board, gains which were preserved subsequently. Interest differentials vis-à-vis the reserve currency country have continued to narrow, while the significant rise in international reserves (often initiated by public sector borrowing abroad and, as the arrangement gains credibility, supported by a reversal of capital flight) has been indicative of the public's willingness to increase the stock of financial assets denominated in domestic currency.

But there are risks …

However, a currency board arrangement is subject to three sources of vulnerability, which, as in the case of Lithuania in early 1997, may force a loosening of the rules. First, because it is an exchange-rate-anchored policy in its most extreme form, a currency board raises the probability of the real exchange rate becoming misaligned. Inflation reduction cannot be instantaneous, so that some erosion of competitiveness in the initial stages of a currency board regime is unavoidable. Significant real exchange rate appreciation took place in Argentina, Estonia and Lithuania. Moreover, it may be harder to deal with shocks which cause the equilibrium real exchange rate to change.

… of exchange rate misalignment …

… insufficient fiscal support …

Secondly, the credibility of a currency board arrangement depends to a large extent on the fiscal policy stance. Only when financing requirements remain modest will pressures for central bank credit be absent and confidence in the exchange rate link strong. Argentina has supported monetary reform since 1991 with restrictive fiscal management, even at the height of the Mexican financial crisis. Estonia's fiscal approach has also been conservative.

… and difficulties in managing banking sector problems

Finally, in the absence of lender of last resort facilities, managing a fragile financial system can be problematic. Argentina, Estonia and Lithuania have all had to deal with banking sector problems in recent years. Without apparent loss of credibility, Argentina was able to use the limited room for flexibility within its arrangement (including a lowering of reserve requirements and the issuance of a small amount of dollar-denominated public sector bonds) to deal with the sharp reduction in domestic liquidity which the Mexican crisis had triggered in early 1995. Less flexibility seemed to exist or to have been relied on in Estonia when it allowed a large bank to fail in late 1992 at great cost to depositors and shareholders. This puts a premium on ensuring that the major building-blocks of a robust financial system are in place.