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

Highlights

A series of financial crises in Asia, of unanticipated intensity and power of contagion, dominated developments in the emerging market economies last year. In those most adversely affected – Indonesia, Korea, Malaysia and Thailand – activity and demand slowed sharply in the face of eroded confidence. Elsewhere in the region, economic uncertainty also rose and the dynamic pace of activity marking the preceding decade gave way to more modest output growth.

An intricate and often opaque combination of macroeconomic distortions and financial fragility has been at the core of the crises in Asia. Growing awareness of these vulnerabilities, and the difficult challenge of addressing them through conventional policy measures, not only amplified the downward pressure on exchange rates when confidence broke, but also cast a large shadow over the prospects for engineering a quick recovery. Even though sharp depreciation has been accompanied by only modest inflation, thereby producing sizable gains in competitiveness, activity has so far failed to respond. Demand at home and in several major markets abroad has been generally weak and financing to support output growth has become significantly scarcer.

Spillover from Asia's crisis clouded a number of welcome developments in Latin America last year which, in a more settled environment, would have received greater attention. Policy commitment to stability and reform in several Latin American countries has in recent years produced some of the fastest rates of growth and lowest rates of inflation since the late 1970s. When investor anxiety hit the region, a further tightening of monetary policy and, in the case of Brazil, fiscal restraint helped to limit contagion. Elsewhere in the developing world, sounder macroeconomic and structural policies also contributed to appreciable non-inflationary growth. Developments in Eastern Europe were more uneven, although a first year of recorded positive growth in Russia raised hopes that a larger number of countries may be experiencing a successful if slow transition.

Financial turmoil in Asia: the macroeconomic background

Financial causes of the crisis aggravated by …

A fragile financial sector, weak supervision and prudential regulation, and a corporate sector burdened with high levels of short-term debt were at the heart of a series of crises in Asia in the second half of 1997. In particular, they greatly increased the complexity of managing in a sound and productive manner the foreign funds that surged into Asia in the mid-1990s. Chapter VII deals in detail with the interaction between these aspects of financial intermediation and the recent currency turmoil. However, two of the macroeconomic factors that,

Growth, inflation and current account balances

	Real GDP			Consumer prices			Current account balance		
	1990–95	1996	1997	1990–95	1996	1997	Average 1990–95	1996	1997
	annual percentage changes						as a percentage of GDP		
China	10.6	9.7	8.8	12.4	8.3	2.8	0.9	0.9	2.3
Hong Kong	5.0	5.0	5.2	9.3	6.0	5.7	3.3[1]	–1.7[1]	–3.8[1]
India	5.1	7.5	5.0	10.3[2]	5.9[2]	5.1[2]	– 1.5	–1.1	–1.2
Other Asia[3]	7.2	7.0	4.6	6.7	5.8	4.6	– 0.5	–1.7	–1.7
Korea	7.8	7.1	5.5	6.6	4.9	4.4	– 1.2	–4.8	–1.9
Singapore	8.6	6.9	7.8	2.7	1.3	2.0	12.7	15.5	15.2
Taiwan	6.4	5.7	6.8	3.8	3.1	0.9	4.0	4.0	2.7
Indonesia	7.2	7.8	4.6	8.7	8.0	6.6	– 2.5	–3.7	–2.9
Malaysia	8.8	8.6	7.8	3.7	3.5	2.7	– 5.9	–4.9	–5.1
Philippines	2.3	5.7	5.1	11.0	8.4	5.1	– 3.8	–4.7	–5.2
Thailand	8.9	6.4	–0.4	5.0	5.8	5.6	– 6.7	–7.9	–2.0
Latin America[3]	2.7	3.4	5.0	206.2	24.6	13.8	– 2.0	–1.9	–2.8
Argentina	4.8	4.3	8.4	114.6	0.2	0.5	– 1.6	–1.4	–3.2
Brazil	1.5	2.8	3.0	954.2	15.5	6.0	– 0.6	–3.3	–4.2
Chile	6.7	7.2	7.1	15.8	7.4	6.1	– 2.6	–5.4	–5.2
Colombia	4.5	2.1	3.0	25.6	20.2	18.5	– 1.7	–5.5	–5.8
Mexico	2.1	5.1	7.0	19.0	34.4	20.6	– 5.1	–0.6	–1.8
Venezuela	3.8	–1.6	5.1	43.7	99.9	50.0	2.5	13.1	6.0
Eastern Europe[3]	–1.2	4.7	5.1	54.8	17.8	13.9	0.1	–3.0	–3.7
Czech Republic	–2.8	3.9	1.0	18.5	8.8	8.5	– 0.1	–7.6	–6.2
Hungary	–2.6	1.3	4.4	25.9	23.5	18.3	– 4.0	–3.7	–2.2
Poland	–0.2	6.1	6.9	83.7	19.9	14.9	1.9	–1.0	–3.2
Russian Federation	–7.9	–4.9	0.4	317.7	47.7	14.8	1.2	2.7	1.7
Israel	6.1	4.5	2.1	13.5	11.3	9.0	– 3.9	–7.4	–3.6
Saudi Arabia	3.7	2.3	2.6	2.2	1.3	0.1	–11.6	0.9	–2.2
Africa	1.7	5.1	2.7	37.4	25.1	11.4	–11.1[4]	–7.8[4]	–6.1[4]
South Africa	0.6	3.1	1.5	11.8	7.4	8.6	0.7	–1.6	–1.5

Note: Data for 1997 are partly estimated.

[1] Balance of goods and non-factor services. [2] Wholesale prices. [3] Weighted average of the countries shown, based on 1990 GDP and PPP exchange rates. [4] As a percentage of exports of goods and services.

Table III.1

ironically, received much of the praise for fuelling the dynamism of the Asian economies in the 1980s and the first half of the 1990s also played a crucial role in provoking the sudden loss of confidence. These were the heavy build-up of capacity in a number of sectors and the impact of the chosen exchange rate regime on both trade competitiveness and the stance of monetary policy.

The economic performance of the emerging market countries in Asia has been impressive over the last decade and a half. Average annual growth rates of 7½% since 1980 have been combined with modest inflation, with much of the growth momentum coming from the increasing openness of most economies.

This striking performance was achieved while keeping macroeconomic policies on a prudent course. Fiscal outcomes tended to be broadly balanced while reasonable price stability suggested cautious monetary policy. Even though current account imbalances widened to levels that would be considered alarming in more consumption-prone countries, the association of these imbalances with high investment spending by the private sector and rising shares of saving in GDP fed the perception of robust and sustainable growth.

… heavy investment in projects with questionable profitability prospects

These strong macroeconomic features were shared equally by the countries that were particularly hard hit during the recent period of financial turmoil (Table III.2). In retrospect, however, they can be seen to have masked the fact that systems of governance in the corporate, financial and government sectors failed to keep pace with a rapidly expanding economy, and that investment strategies increasingly focused on areas with less solid risk-to-return characteristics. To some extent, this was to be expected given that several countries needed to improve their infrastructure, with low immediate returns but high social returns in the long run. In many instances, however, the simple extrapolation of the very rapid growth of the first half of the 1990s motivated decisions to continue increasing the capacity of existing industries. Often, different countries focused on expanding capacity in similar industries. Moreover, as in the case of the Korean industrial conglomerates, deregulation in the course of the 1990s induced firms to enter unfamiliar businesses far removed from the traditional core areas of their earlier specialisation. Frequently, the failure on the part of investors as well as lenders to subject investment decisions to a true market test or due diligence reflected the implicit protection offered by active government sponsorship of projects with high political appeal but not necessarily sound profitability prospects.

1996 export slump illustrates overinvestment in some sectors

As noted in last year's Annual Report, indications of excessive investment in particular sectors had already emerged by 1996. In that year, the massive investment in Asia's electronics industry contributed to conditions of oversupply and a resulting price collapse in world markets. But investment has sharply increased in other areas as well (such as automobile construction, household appliances and electricity generation) at the risk of flooding local and foreign markets. Real estate was one sector where rapid investment created speculative

Macroeconomic structure of selected Asian economies

	Investment		Domestic saving		Fiscal balance[1]		Openness to trade[2]		ICOR[3]	
	Average 1986–95	1996	Average 1986–95	1996	Average 1986–95	1996	1986	1996	Average 1986–90	Average 1991–96
	as a percentage of GDP									
Indonesia	32.6	32.1	33.8	31.2	0.9	–1.0	15.9	20.4	19.2	22.6
Korea	33.9	36.8	36.4	35.2	0.3	0.0	30.7	28.9	32.9	20.2
Malaysia	32.7	42.2	35.8	42.6	–3.2	0.7	44.3	78.9	25.1	22.1
Philippines	20.5	23.2	17.5	15.6	–1.9	0.3	16.4	31.2	20.5	12.2
Thailand	36.3	42.2	33.5	35.9	2.1	0.7	20.9	34.9	32.6	19.6

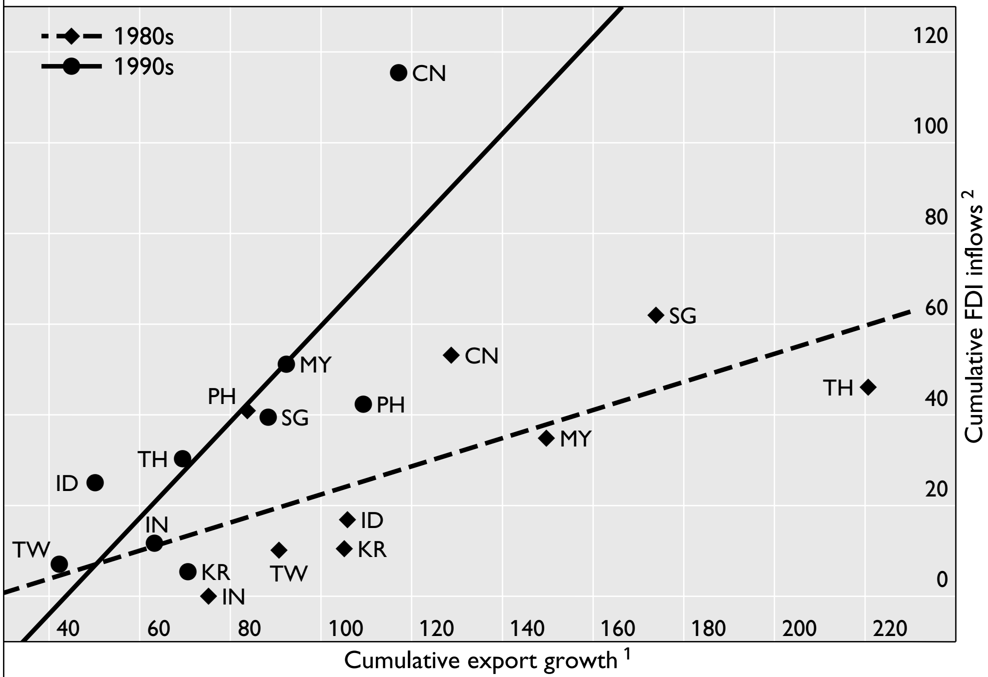
Note: Data for 1996 are partly estimated.

[1] Central government. [2] Ratio of average merchandise exports and imports to GDP. [3] Incremental capital/output ratio, shown here as its inverse, i.e. the real rate of GDP growth over investment/GDP.

Table III.2

Foreign direct investment and exports

In percentages



CN = China; ID = Indonesia; IN = India; KR = Korea; MY = Malaysia; PH = Philippines; SG = Singapore; TH = Thailand; TW = Taiwan.

[1] For the periods 1986-91 and 1992-96, in US dollar terms. [2] For the periods 1984-89 and 1990-94, as a percentage of 1986 and 1992 exports respectively. Graph III.1

price bubbles, whose subsequent deflation carried many of the seeds of last year's financial turmoil (discussed in greater detail in Chapter VII).

Falling rates of return

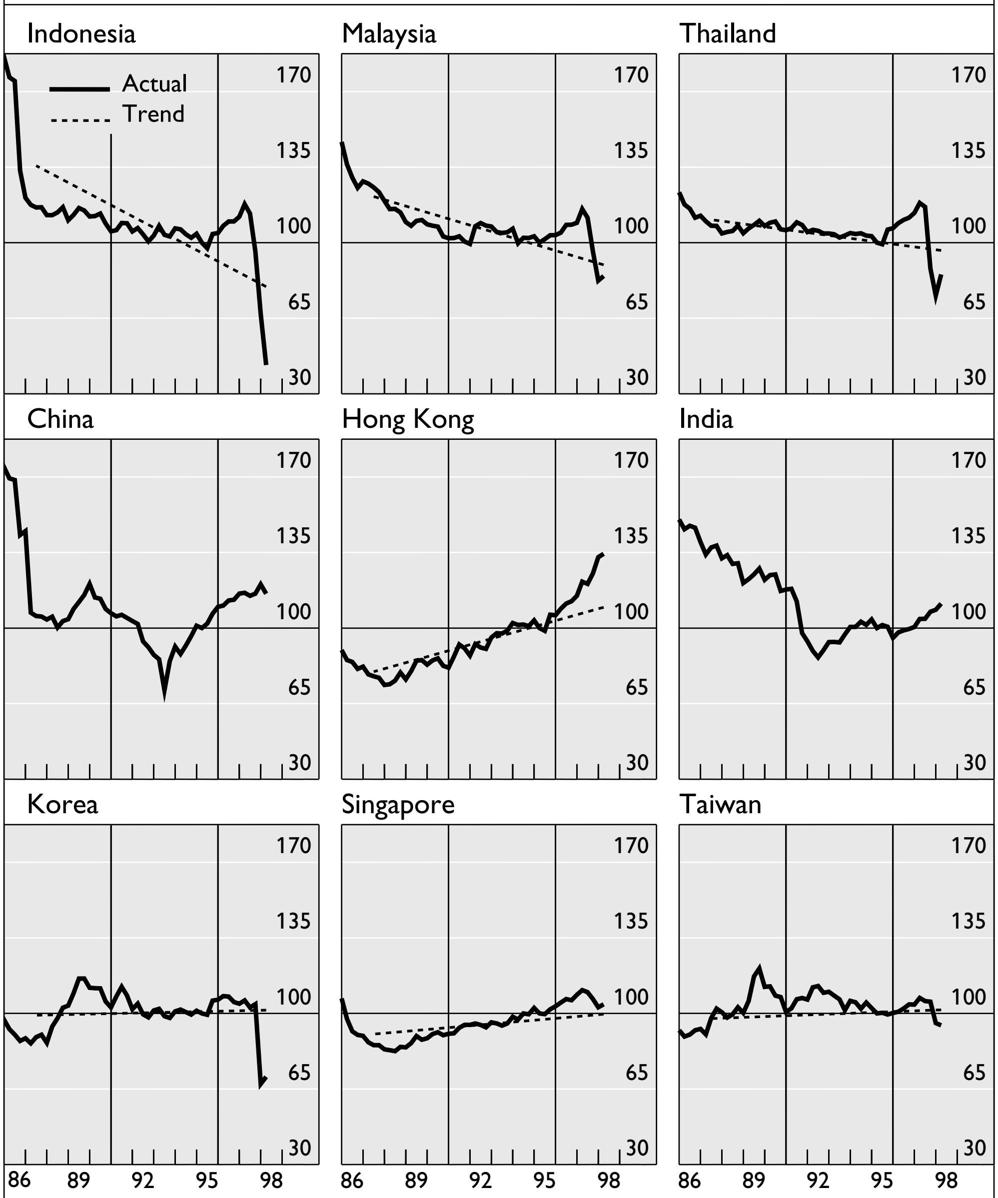
Overinvestment in particular sectors has tended to erode the rates of return on new capital in recent years. As shown in Table III.2, in many of the crisis-hit countries the growth rate associated with a given investment rate (the so-called incremental capital/output ratio) fell markedly in the first half of the 1990s. Another telling development has been the significant weakening of the relationship between foreign direct investment and the growth of exports in the 1990s (Graph III.1). Hence, prospects became dimmer that the initial deterioration of the current account, brought about by the imports of capital goods associated with foreign direct investment, would eventually be corrected by new export activity generated by the increase in capacity.

Impact of tightly managed exchange rates on competitiveness …

A second major underlying cause of the regional crisis has been the increasing difficulty of maintaining exchange rate policies based on a close peg to the US dollar. These exchange rate links have had three unwelcome implications for recent developments. First, the depreciation of the US dollar against the major international currencies up to the first quarter of 1995 implied a steady gain in competitiveness (as shown by the trend line in Graph III.2 based on the 1987–95 period) in Indonesia, Malaysia and Thailand. This promoted rapid growth of exports and capacity expansion. However, when the dollar trend reversed from early 1995, Asian competitiveness deteriorated sharply. On the eve of the outbreak of financial turmoil in mid-1997, the real effective exchange rates of Indonesia, Malaysia and Thailand had been pushed well above what an

Real effective exchange rates in Asia *

End-of-quarter data, March 1995 = 100



* In terms of relative consumer prices; an increase indicates an appreciation. The trend is calculated by applying a Hodrick-Prescott filter over the period April 1987 – March 1995.

Graph III.2

extrapolation of the 1987–95 trend would have suggested. This measure may even understate the more difficult competitive environment since the mid-1990s because it does not capture the significant gains in market share made by China in that period. In Korea, however, the competitiveness factor played a much smaller role in precipitating the crisis given that the won had been allowed to depreciate against the dollar since the mid-1990s.

… efficacy of monetary policy …

A further implication of managed exchange rate regimes in Asia has been the reduced ability of monetary policy to focus more directly on the liquidity requirements of the domestic economy. As overheating became apparent in many of the Asian economies in the mid-1990s, exchange rate commitments prevented central banks from raising interest rates to cool domestic demand, in particular investments in property and projects with inherently low rates of return. Increasing international capital mobility and shrinking risk premia for emerging economies' debt heightened this policy constraint. Finally, a third consequence of a long period of relative stability against the US dollar has been the blunting of perceptions of exchange rate risk and the resulting incentive to take large unhedged exposures in foreign currency. Chapters VI and VII consider these issues more fully.

… and borrowing behaviour

Developments in individual Asian countries

The depth of the crisis which unfolded in Asia in the second half of 1997, and the speed of contagion, came as a surprise to most observers and participants. Strong speculative pressure began to mount against the Thai baht in early 1997 and, by mid-year, could no longer be resisted. Given shared vulnerabilities, turbulence quickly engulfed several other South-East Asian economies, in particular Indonesia, Malaysia and the Philippines. As the year went on, the loss of confidence spread further afield, dragging Korea into a deep financial crisis in the final months of 1997 (see Table VII.6 for a more detailed chronology).

Short-term impact of the currency crisis

With each new month of statistical information, the downturn in industrial production and the build-up of price pressures have become more evident in the countries worst hit by the crisis (Table III.3). The swing in trade balances within less than one year has been dramatic and, given that it occurred primarily through a reduction of imports, particularly painful; by early 1998 imports of Korea and Thailand had fallen year-on-year by as much as one-third. Real exchange rates, which in early 1997 still showed significant appreciation, had by early 1998 dropped to between one-quarter and one-half of their level a year earlier. However, caution is advised when interpreting these real depreciations since the indices used here are mainly based on exchange rates against industrial country currencies. As major competitors in world markets in fact include neighbouring countries which also experienced large depreciations, the gains in competitiveness in Asia have certainly been smaller than those shown.

Short-term impact of financial turmoil in Asia[1]

	Industrial production		Consumer prices		Trade balance		Imports		Real effective exchange rate[2]	
	First half 1997	Latest three-month period	First half 1997	Latest three-month period	First half 1997	Latest three-month period	First half 1997	Latest three-month period	First half 1997	Latest three-month period
Indonesia	..	..	5.0	29.7	8.3	18.9	0.7	–21.5	7.0	–64.4
Korea	6.4	– 7.8	4.4	8.9	–18.3	34.5	2.3	–35.1	–2.9	–38.7
Malaysia	11.5	7.8	2.8	4.3	– 2.2	3.2	5.1	–16.5	7.2	–29.8
Philippines	..	..	4.6	7.0	–11.1	–6.6	11.1	0.4	7.7	–28.3
Thailand	6.0	–13.0	4.4	9.0	–13.1	11.0	–8.9	–35.9	7.2	–35.6

[1] Percentage change vis-à-vis the same period of the preceding year, except for the trade balance, which is in billions of US dollars at an annual rate. [2] In terms of relative consumer prices. An increase indicates an appreciation.

Table III.3

Common policy responses include …

A number of common elements have marked the responses of policy-makers to the crisis which, in Indonesia, Korea, the Philippines and Thailand, were formulated in the context of an IMF programme and were backed with official credits (see Chapter VII). First, in all directly affected countries, floating exchange rate regimes had to be adopted soon after their currencies came under attack. Very sharp exchange rate adjustments ensued which contributed to pushing real exchange rates well below the trends seen over the past decade. Exchange rate overshooting is likely to have occurred and may have complicated adjustment by creating price distortions and paralysing corporate and financial activity. A second common feature has been the tightening of monetary policy throughout the region, although the stage at which this tightening was implemented and the determination with which it was applied varied significantly. To a large extent, differences reflected varying degrees of reluctance on the part of the authorities to aggravate, through high interest rates, the financial position of already vulnerable financial and corporate sectors. However, such policy wavering may well have added to the downward pressure on the exchange rate, thus propagating financial distress via the exchange rate channel. Initially, commitments to fiscal restraint were also made, but, as the depth of the crisis became clearer, fiscal stances generally eased. Finally, in recognition of the structural weaknesses at the core of the sudden loss of confidence, adjustment programmes included unprecedented degrees of institutional and structural reform, both in the financial and in the enterprise sector.

… adoption of floating exchange rates …

… tighter monetary policy …

… and structural reform

The crisis in South-East Asia

Crisis hits Thailand first …

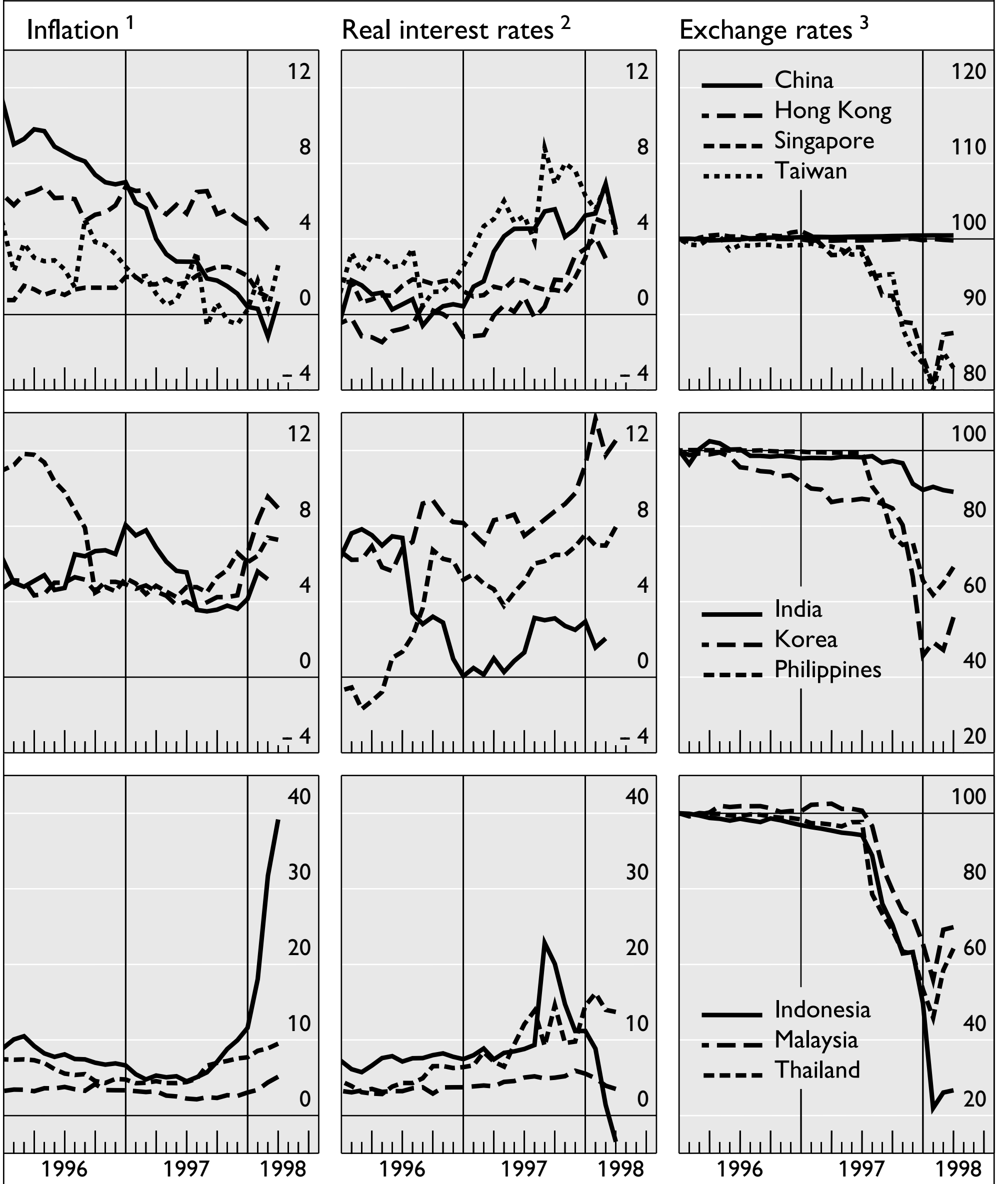
Thailand was the first Asian economy to be faced with the consequences of waning investor confidence. Concerns focused on a continuing slump in exports in early 1997, clouding the prospects of reducing the large current account deficit (8% of GDP in 1996), along with mounting evidence of deep-seated financial and economic vulnerabilities. Intervention could not stem for long the outflow of capital in the first half of 1997 and, by early July, the authorities were forced to let the baht float. Despite an adjustment programme put together in August, confidence remained shaky as the policy response to the crisis, in particular the restructuring of the financial sector, was neither prompt nor appeared to enjoy full government commitment. Even though interest rates were increased significantly (Graph III.3), the baht continued to weaken, losing some 45% of its value vis-à-vis the US dollar by the end of the year. With output stagnating and inflationary pressures building up, domestic demand and imports collapsed and the current account deficit narrowed sharply to just 2% of GDP for 1997 as a whole.

By early 1998, despite considerable lingering uncertainty with respect to the outlook for the property market in particular, a greater degree of stability appeared to be emerging. The financial sector restructuring process seemed to gain momentum; the baht's depreciation came to a halt; the equity market picked up; the exchange rate controls put in place in May last year were abolished; and the tight fiscal stance could be loosened somewhat.

… spreading quickly to Indonesia …

Indonesia quickly became engulfed in the regional financial crisis, notwithstanding strong growth in 1996, a moderation of inflation to around 5% in

Inflation, real interest rates and exchange rates in Asia



[1] Annual percentage increase in consumer prices. [2] Short-term rates deflated by the annual rate of inflation. [3] US dollars per unit of domestic currency, December 1995 = 100. Graph III.3

early 1997 and a rather modest current account deficit of about 3% of GDP. Contagion focused on the country's financial weaknesses, in particular a fragile and weakly supervised financial sector, a highly indebted corporate sector and high external debt. The existence of domestic market distortions and associated inefficiencies further heightened uncertainty. Because the progressive widening of the intervention band around the exchange rate failed to accommodate growing pressure, the authorities allowed the rupiah to float freely in mid-August. At that stage, too, they tightened monetary policy. However, recurrent turbulence in the foreign exchange market could not be avoided in the face of doubts about the extent to which the economy could sustain a protracted period of high interest rates; indeed, interest rates were lowered again from late August.

… where its resolution proves very difficult

Despite a comprehensive adjustment programme calling for wide-ranging cuts in public spending, financial sector reforms and economic and trade liberalisation (including the abolition of marketing monopolies and restrictive market arrangements), political uncertainty, policy slippages and major difficulties in establishing a framework for restructuring the large private corporate debt triggered a veritable collapse of the exchange rate in late 1997 and early 1998. The rupiah sank to an absolute low of over Rp 15,000 to the US dollar in late January, less than one-sixth of its value just prior to the outbreak of the crisis in mid-1997. In the subsequent weeks, it settled in a broad range of Rp 8,500–10,500 to the dollar.

At these exchange rate levels, the ballooning cost of servicing the external debt rendered much of the affected corporate sector technically insolvent, while the purchase of even the most basic essentials severely strained the budget of large parts of the population. With a drought also causing agricultural output to stagnate, activity crumbled and annual inflation jumped to 40% in March 1998. Against this background, support was sought by the Government in February for the establishment of a currency board based on a peg well above the prevailing rate. However, several of the necessary preconditions for such an exchange rate regime (see last year's Annual Report) appeared to be lacking at that early stage of economic stabilisation and the plan was withdrawn.

Significant contagion in Malaysia …

Malaysia was also quickly swept into the regional financial turmoil in mid-1997 as markets became increasingly concerned about the large current account deficit, the likelihood of significant price corrections in both property and equity markets and a corporate sector heavily exposed to and dependent on domestic bank financing. In the face of sizable capital outflows, in particular of equity capital, the authorities opted for currency depreciation as the main line of defence, accompanied by some administrative measures to control capital flows and cushion equity prices. Monetary tightening was applied only moderately. Compared with most other countries in the region, the rise in interest rates in Malaysia was much less pronounced (Graph III.3). Fiscal policy, too, responded rather gradually. Only by year-end did the prospects of a steep decline in fiscal revenues trigger expenditure cuts and reductions in or postponements of major development projects.

… but less so in the Philippines

The drying-up of capital inflows in the *Philippines* in the middle of last year also led to a sharp currency depreciation. Nevertheless, a prompt policy response ensured that the adjustment to the currency crisis proceeded fairly smoothly. After the de facto exchange rate peg to the dollar was abandoned in July, monetary policy was tightened and fiscal policy was kept on a cautious course. As exports continued to grow at around 25% in dollar terms, boosted by gains in competitiveness, growth in the Philippines slackened only little and indeed became the strongest in the region.

Republic of Korea

Economic slowdown exposes indebted corporate sector and fragile financial sector

The extensive build-up of industrial capacity, fuelled in the mid-1990s by a long period of very rapid growth and by industrial deregulation, made Korea highly exposed to the slowing of its economy in 1996 and early 1997. Given that the growth of productive capacity had been financed mostly with bank credit (with little reliance on foreign direct investment), pushing debt/equity ratios among the largest industrial conglomerates to nearly 500%, vulnerability to an economic slowdown also extended to the financial sector. Externally, a slump in export receipts widened the current account deficit to almost 5% of GDP in 1996, further heightening the exposure of the economy to swings in external financing flows. The banking sector in particular was heavily reliant on foreign funding in the form of very short-term interbank credit lines.

Growing pressure in the foreign exchange market

Pressure on the won intensified when a number of high-profile bankruptcies of large industrial conglomerates occurred in the first half of 1997 and the associated loan performance problems in the financial sector became more evident. Despite repeated exchange market intervention in the summer and autumn, and a firming of interest rates, the won's slide could not be arrested. By late November, the country seemed on the brink of defaulting on its short-term external liabilities.

Policy responses to and economic costs of the crisis

Macroeconomic policies were tightened significantly and far-reaching structural adjustment measures were proposed in late 1997 and early 1998. Key features of the structural programme included capital account and foreign investment liberalisation, restructuring of the financial system together with strengthened prudential regulation and supervision, and measures to rationalise the activities of the large industrial conglomerates. When, in addition to these measures, an agreement was reached with international banks in late January to reschedule a large part of (non-trade-related) short-term commercial bank debt on favourable terms, a gradual return of confidence seemed to pull the economy out of its immediate crisis. External liquidity constraints were further eased since the current account moved into surplus towards the end of 1997. After January, the exchange rate stabilised and interest rates started falling from the 30% levels to which they had been pushed in late 1997. However, the costs of adjustment also mounted in early 1998. Corporate restructuring and bankruptcies, allied with depressed household spending, caused manufacturing production to shrink by 10% and unemployment to rise to 6½%. Moreover, inflation accelerated to close to 10% in response to rising import prices.

Other Asian countries

Although contagion from the crises in South-East Asia and Korea could not be avoided, the consequences of the turmoil were much less traumatic elsewhere in Asia. In Singapore and Taiwan, this reflected the greater resilience to exchange rate changes provided by a diversified and competitive manufacturing sector and the financial soundness of most economic sectors. In the Hong Kong Special Administrative Region of China, strict policy commitment and a robust financial system enabled the currency board regime to face successfully its severest test yet. And in other cases, a still limited degree of capital account convertibility (China and India) or a large stock of foreign exchange reserves (China) tended to protect the economies from immediate contagion.

Resilience to turmoil in Singapore …

The *Singapore* economy staged a strong recovery from the slump in the electronics industry in 1996, only to slow in the face of the financial turbulence elsewhere. To deal with its impact, fiscal policy was eased (although the fiscal accounts remained in surplus) and interest rates were raised to counter speculative outflows. Moreover, the scope for flexibility in the country's exchange rate regime was more fully used. The exchange rate, traditionally subject to a slow and steady appreciation in effective terms, was allowed to fluctuate in a wider range after mid-1997. It subsequently fell by about 20% against the US dollar before recovering some of its losses in early 1998.

… and Taiwan

Taiwan's economy also showed great buoyancy prior to the outbreak of regional financial turmoil and succeeded in maintaining significant momentum thereafter. Growth picked up to close to 7% last year while consumer price inflation, at less than 1%, fell to its lowest level in ten years. Nevertheless, currency pressure was felt from the middle of last year. Initially, the authorities sought to keep the exchange rate stable vis-à-vis the US dollar, intervening heavily at times and allowing domestic interest rates to rise. The negative implications of this policy mix for equity prices and trade competitiveness, however, induced the authorities to let the exchange rate respond to further market pressure after mid-October. An immediate depreciation of 7% was followed by another bout of weakness in late 1997 when the currency crisis erupted in Korea, one of Taiwan's main trade competitors. As in Singapore, a return of confidence in the economy's strong fundamentals strengthened the currency again in early 1998.

Defence of Hong Kong's currency board

The firm commitment to a fixed exchange rate in a region rapidly converting to exchange rate flexibility, allied with the heavy build-up in early 1997 of pressure in domestic property and equity markets, made *Hong Kong* particularly susceptible to investor anxiety. Confronted with two speculative attacks – the first in August and a more violent one in October – the authorities demonstrated that the defence of a currency board was possible as long as the soundness of the domestic financial system was not in doubt. Interbank rates were allowed to rise sharply (reaching an overnight peak of 280% in late October), leaving equity and property prices to take the brunt of the adjustment. Pressure on the Hong Kong dollar diminished and interest rates came down in early 1998. Nevertheless, the continuing interest rate differential over comparable US rates suggested some remaining degree of uncertainty about Hong Kong's economy.

China's economy slows somewhat

A strong current account position, modest foreign indebtedness, a large stock of international reserves and the existence of capital controls shielded *China's* economy from much of the direct consequences of financial turmoil in the region. However, the indirect impact of the crisis may well accentuate the gentle slowdown of the economy, the first signs of which emerged in 1997. For the year as a whole, growth remained rather robust at close to 9%, but, with domestic demand collapsing in several neighbouring countries, exports lost some of their earlier buoyancy as the year went on. This added to slowing consumer demand at home and contributed to a build-up of inventories. Reflecting weaker demand pressures, inflation fell further, with retail prices actually declining in late 1997.

Medium-term policy objectives

To ensure sustainably high growth in the medium term, the restructuring of state-owned enterprises was put high on the authorities' agenda in key policy-setting meetings in late 1997 and early 1998. The fact that corporate restructuring could also contribute to checking the further build-up of non-performing loans which has severely compromised the solvency of the largest state-owned banks gave this objective even greater weight. In the short term, however, it will have adverse implications for employment growth, while possibly making high claims on public finances as existing bad loans are written off.

India

Notwithstanding some downward pressure on the exchange rate in late 1997, which triggered a tightening of monetary policy, *India* remained largely unaffected by the regional disturbances. Rather, political uncertainties, a slowing pace of structural and financial reform and infrastructure bottlenecks shaped economic developments last year. Compared with the average 7% growth rate achieved in the preceding three years, the Indian economy lost momentum, with growth slowing to around 5% last year. However, the deceleration contributed to a further reduction in inflation while helping to keep the current account deficit at around 1½% of GDP. Despite some windfall revenue gains as a result of a tax amnesty programme, the central government deficit, at 6% of GDP, remained an important constraint on achieving high, sustainable growth. A key positive development, however, was further progress in reducing the automatic monetisation of the fiscal deficit through central bank credit.

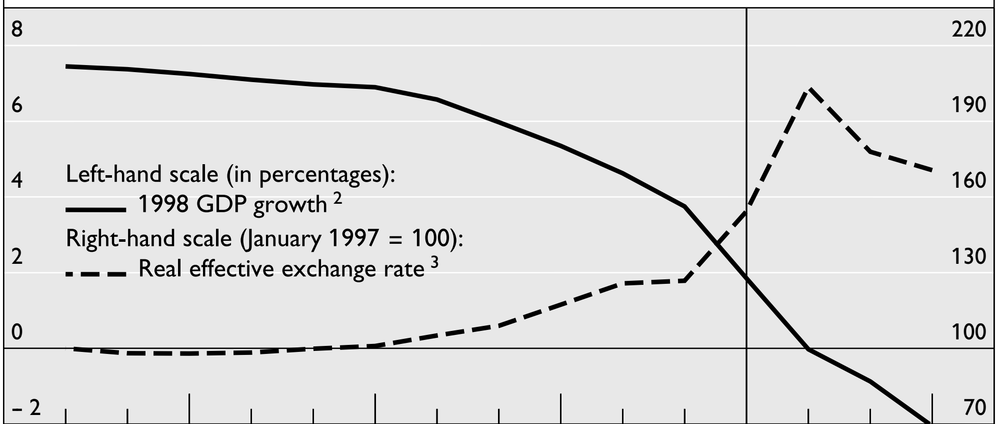
Special issues raised by the crises in Asia

Real exchange rates and output

Real depreciation associated with a slump in activity in Asia …

A pronounced slowdown of domestic demand and activity has followed large currency depreciation in several Asian economies. As shown in Graph III.4, mounting real depreciation triggered by plunging nominal exchange rates in the four most adversely affected economies went hand in hand with continuous downward revisions of their 1998 GDP forecasts. In Mexico, too, real depreciation triggered by the 1994/95 peso crisis was initially associated with a precipitous drop in output. More generally, empirical studies of the effect of real exchange rate depreciation on the level of activity in emerging economies have often revealed a contractionary effect, at least in the short run.

1998 GDP growth forecasts and the real effective exchange rate [1]



[1] Simple average of Indonesia, Korea, Malaysia and Thailand. [2] 1998 GDP growth forecast in the months shown. [3] In terms of relative consumer prices; an increase indicates a depreciation.

Sources: © Consensus Economics, London, and national data. Graph III.4

… notwithstanding high openness to trade

Structural linkages between exchange rate changes and economic activity, however, are complex and difficult to capture empirically. Conventional theory predicts that devaluation leads to an expansion of output as production in export and import-competing industries is stimulated. Given heavy reliance on trade as the engine of growth, a rapid and strong response of activity could thus be expected from real depreciation in Asia. However, if depreciation is slow in triggering an expansion of exports, and if capital flows suddenly reverse, all the external adjustment has to come from lower imports. This would imply an initial harsh retrenchment of domestic demand. Graph III.4 suggests that forecasters have gradually assigned a higher probability to such a contractionary process in Asia in the short run.

Explanatory factors include weak demand in key markets …

Several factors, some trade-related and others the consequence of financial fragility, may have played an important role in the lack of responsiveness of exports to sizable competitiveness gains. First, the weak response of output, in particular of tradable goods, has reflected in part the importance of intra-regional trade. With exports to Japan and to each other accounting for about one-quarter to one-third of total exports in Indonesia, Korea, Malaysia and Thailand, exporters have faced particularly depressed markets in which to compete. On a year-on-year basis, Japanese imports from other Asian economies shrank by 6% in the three months to end-1997, while the decline in Korea, another major trading nation in the region, was even larger. Moreover, given the prevalence of processing activity in several Asian countries, export industries are highly dependent on intermediate inputs imported from elsewhere in the region. Thus, weakening imports and exports have been feeding upon each other. Mexico's experience in the wake of the peso depreciation in late 1994/early 1995 was quite different in this respect as the US market, which accounts for 85% of Mexican exports, was booming at the time. Interestingly, exports of the Philippines are also directed more towards the US market and continued to expand rapidly in the second half of 1997.

… exchange rate uncertainty …

A further element inhibiting increased production of tradable goods is that, in an environment characterised by exchange rate overshooting and volatile inflation prospects, identifying the level at which the real exchange rate is likely to settle may be particularly difficult. Until greater certainty is gained, especially about the relative price of imports needed as inputs, enterprises may well be reluctant to make longer-term output commitments. The dominant market position which several Asian economies have acquired through heavy capacity expansion in particular industries may also have complicated the recovery process. In these industries and markets, an increase in supply often requires price concessions, which accentuate the terms-of-trade deterioration associated with depreciation.

… the need for price concessions …

… and economy-wide financial fragility

Other factors contributing to the sharp declines in activity despite real depreciation in Asia relate to the financial weakness of both the corporate and financial sectors. High corporate debt/equity ratios (as in Korea and Malaysia), or heavy exposure to foreign-currency-denominated debt or asset price changes (as in Indonesia and Thailand), forced sudden and sharp downward adjustments in borrowing and spending once monetary policy tightening, depreciation and asset price deflation confronted enterprises and households with mounting debt servicing obligations. This demand contraction is likely to have been aggravated by banks' desire to curtail credit as the increase in bad loans reduced capital ratios.

The credit availability factor may eventually play a more important role in slowing Asia's economy than it did in Mexico in 1995. First, corporate vulnerability, while evident, was less of a concern in Mexico than it seems to be now in Asia. This made it possible, for the larger Mexican enterprises at least, to find other sources of credit outside the country. This was especially the case for those firms with close links to US parent companies. Secondly, the consequences of banking sector fragility for enterprise funding have been amplified by high corporate dependence on bank credit in Asia and the frequent lack of deep and well-developed money and capital markets. By way of contrast, in Africa, depreciation has resulted in rapid increases in activity, consistent with low dependence on bank credit (and bank intermediation in general) and thus an absence of concerns about bank fragility.

Exchange rates and prices

A relatively low exchange rate pass-through into prices in Asia reflects …

Although accelerating in early 1998, consumer price inflation has so far shown a rather subdued reaction to exchange rate depreciation in most of the crisis-affected Asian economies. Despite their openness to external influences, the highest rates of exchange rate pass-through into consumer prices have been no more than 20–25% in Indonesia and Thailand and even less in Korea and Malaysia (Table III.4). This modest pass-through in Asia is similar to that experienced in Italy, Spain, Sweden and the United Kingdom in the wake of the 1992 ERM crisis. However, it contrasts sharply with the nearly complete translation of the May 1997 depreciation into inflation in the Czech Republic, as well as with the pass-through of over 40% recorded in Mexico in 1995. Last year's Annual Report addressed this apparent difference in the relationship between inflation and exchange rate changes in particular regions, noting that the inflationary response to effective depreciation in Asia has traditionally been relatively restrained, while in Latin America exchange rate devaluations commonly contribute to surges in inflation.

… depressed domestic demand and excess capacity …

The severe retrenchment of domestic demand in Asia doubtless explains a large part of the still muted response of prices to sharp exchange rate depreciation. Moreover, with substantial spare capacity in many sectors, a future recovery of demand may engender only a subdued price response even in the medium term. The current and prospective correction of property prices is also likely to contribute. Another important factor may be the traditionally strong aversion to inflation in Asia, an understandable sentiment given still significant pockets of poverty and the absence of social safety nets. Indeed, arrangements such as price indexation, cost-of-living adjustments in wage contracts, or even the practice itself of concluding formal wage agreements have yet to become common in most Asian economies.

… a compression of labour costs …

Initial adjustments to the crisis in the labour market have been swift, absorbing part of the potential pass-through of depreciation into prices. Even in countries with strong trade union movements, such as Korea, measures to enhance labour market flexibility have been promptly proposed and accepted. A

Exchange rate changes and inflation in selected countries

	Exchange rate[1]	Wholesale prices[2]	Consumer prices[2]	*Imports as a % of total expenditure[3]*
	percentage changes			
Indonesia				
July 1996 – July 1997	7.3	–	5.7	
July 1997 – Feb. 1998	255.4	–	69.9	*27.3*
Korea				
July 1996 – July 1997	9.6	2.7	4.0	
July 1997 – Feb. 1998	82.6	31.0	12.6	*34.0*
Malaysia				
July 1996 – July 1997	3.4	–	2.4	
July 1997 – Feb. 1998	48.2	–	7.9	*95.6*
Thailand				
July 1996 – July 1997	19.6	5.7	6.6	
July 1997 – Feb. 1998	51.6	23.8	9.0	*45.8*
Czech Republic				
April 1996 – April 1997	8.6	4.1	6.3	
April 1997 – Feb. 1998	15.6	7.3	15.3	*61.1*
Memorandum items:				
Mexico				
Nov. 1993 – Nov. 1994	9.1	7.8	7.1	
Nov. 1994 – Nov. 1995	122.5	58.1	52.0	*28.7*
Italy, Spain, Sweden and the United Kingdom[4]				
Aug. 1991 – Aug. 1992	3.9	0.8	4.1	
Aug. 1992 – Aug. 1993	23.4	5.1	3.8	*20.0*

[1] Local currency against the US dollar; for the Western European countries, against the Deutsche mark. [2] Led by one month; at an annual rate. [3] Imports defined as imports of goods and services in 1995; for the Western European countries, 1993. [4] Unweighted average. Table III.4

widespread elimination of end-of-year bonuses and a reduction in nominal wages in hard-hit sectors have also taken place. In Thailand programmed increases in minimum wages have been postponed, while in Indonesia they were recently frozen. One indication of the compression of labour cost growth (and the profit squeeze coinciding with it) might well be the wide gap shown in Table III.4 between the rise in wholesale prices, often indicative of the cost of (imported) intermediate inputs, and that in consumer prices, more indicative of final goods prices. Wholesale prices have reflected the drop in exchange rates more fully. From a somewhat different perspective, if wholesale prices more closely reflect tradable goods prices while consumer price indices include greater shares of non-tradable goods, the data may suggest that the sharpest retrenchment is taking place in those (usually labour-intensive) sectors serving mainly the local market.

… and possibly some suppressed inflation

A final note of caution concerning the favourable outcome to date would be that consumer price inflation may not be a very reliable gauge of inflation pressure in some Asian countries. In particular, the product baskets on which calculations are based may not be representative of current or average spending patterns (for example, they may use historical weights for basic food products or energy although such items have become relatively less important). Moreover, inflation may be partly suppressed, since the setting of prices of particular products in several countries remains under government control and therefore does not always reflect changing market conditions. In Indonesia, for instance, administrative measures were taken to stabilise food prices in early 1998; in Malaysia, selective price controls have been applied to essential food products and energy; and in the Philippines, government regulations kept energy prices steady until early 1998 despite the sharp drop in the external value of the peso.

Developments in Latin America

Strong growth and falling inflation …

Last year the Latin American economies grew by 5% and inflation dropped to 14%. These welcome developments are testimony to sustained structural reform efforts involving privatisation, trade liberalisation, social security reform and the strengthening of financial systems. Growing financial integration with world markets, as well as disciplined monetary policies in recent years, have also made a contribution. A cause of some concern was the widening of the region's current account deficit to about 3% of GDP, reflecting in part buoyant domestic demand growth and in part real currency appreciation in a number of countries. However, during much of the year capital inflows, a large share of which was in the form of foreign direct investment, financed the deficits with ease. In addition, fiscal imbalances remained a problem in several countries. In Colombia, the public sector deficit widened significantly, complicating efforts to reduce the country's persistently high rate of inflation and the rapid pace of real appreciation in recent years. The fiscal deficit has remained large in Brazil, while weakening oil prices are eroding Venezuela's earlier strong fiscal position and are requiring fiscal restraint in Mexico. Moreover, in late 1997, international financial turmoil cast a sudden shadow over the region's economic momentum. However, contagion from Asia tended to be well and quickly contained thanks to the authorities' willingness to strengthen monetary and, in some cases, fiscal discipline.

… but also wider external deficits …

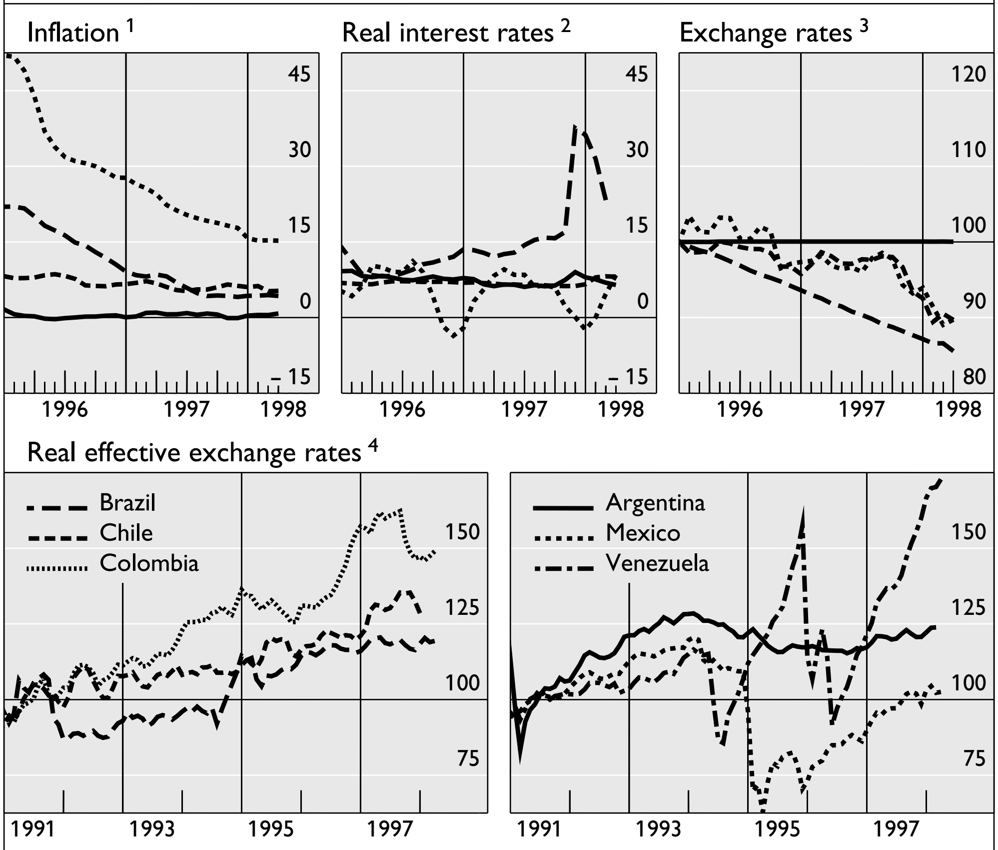
… and sizable fiscal imbalances in some countries

Prompt policy responses to turmoil in Brazil

Vigorous domestic demand propelled the rate of growth of *Brazil's* economy to 5% in the year ending in mid-1997. However, it also caused the current account deficit to widen to over 4% of GDP and led the central bank to tighten its stance from May. A large current account deficit, the perception of insufficient fiscal adjustment and a managed exchange rate regime made Brazil the main victim outside Asia of investor anxiety in late October. The authorities responded to the sudden crisis not only with a swift and determined tightening of monetary policy, but also by pursuing fiscal restraint and advancing the agenda for administrative and social security reform. Central bank interest rates were doubled to real annualised levels of over 40% at the end of the month and a restrictive fiscal package equivalent to over 2% of GDP was announced in November.

This policy resolve, allied with the evidence that the authorities were effectively in control, did much to restore market confidence. By early 1998 interest rates could be gradually reduced (Graph III.5) and equity prices and capital inflows regained strength. A more balanced policy mix may also have enhanced the credibility of Brazil's managed exchange rate regime and its role in

Inflation, real interest rates and exchange rates in Latin America



[1] Annual percentage increase in consumer prices. [2] Short-term rates deflated by the annual rate of inflation (for Mexico, by annualised inflation in subsequent months). [3] US dollars per unit of domestic currency, December 1995 = 100. [4] In terms of relative consumer prices, 1991 = 100. An increase indicates an appreciation.

Graph III.5

promoting non-inflationary growth. Moreover, with the rate of inflation having dropped below the gradual rate of currency depreciation, earlier concerns about potentially unsustainable competitiveness losses have diminished. Instead, the major areas of lingering uncertainty have become the control of public finances at the level of the states and continued high real interest rates. The latter entail significant costs for debt service and have undesirable implications for growth and employment. Indeed, the rate of unemployment rose to 8¼% in early 1998, the highest rate since the mid-1980s.

Currency turbulence spreads to Chile

Chile's record in recent years has been one of prudent policies that produced solid GDP growth, a gradual reduction of inflation, sizable fiscal surpluses, a sound financial system and, until recently, moderate current account deficits. Nevertheless, the turmoil in financial markets in late 1997 also spread to the Chilean economy. Investor concern focused on the current account implications of Chile's heavy trade exposure to the Asian region in general and the very steep fall in the price of several of its main commodity exports, in particular copper. The exchange rate against the dollar, which had remained stable for most of the year, was allowed to fall by nearly 10% between the end of October and early 1998. In addition, monetary policy shifted towards greater restraint, pushing central bank rates in real terms from 6½% on average in the first three quarters of 1997 to over 8% in late March.

Financial resilience in Argentina

GDP growth in *Argentina* accelerated to 8% last year; unemployment – swollen in the wake of the Mexican peso crisis – started to ease; and the 1991 Convertibility Plan, anchored on a fixed peg of the domestic currency to the dollar, continued to deliver price stability. Fiscal discipline improved, while domestic interest rates continued on a gentle downward path only briefly interrupted by the financial turmoil in late 1997. Particularly indicative of the growing financial resilience of the economy was that, in contrast to the 1995 financial crisis, no signs emerged of residents shifting from peso to dollar-denominated deposits during the recent episode of turbulence. As a safeguard against a potential swing in investor sentiment if the current account deficit (3% of GDP in 1997) were to widen, the authorities committed themselves in early 1998 to the rigours of an IMF programme for the next three years, even though drawings on IMF funds were only to be made if market conditions became unsettled. A key element of this programme is further progress in labour market reform and a shift away from payroll taxes, both being considered necessary complements to the fixed exchange rate regime.

Mexico's policy challenges

Fiscal discipline and a monetary policy focused on gradually reducing inflation provided the necessary environment of stability in which *Mexico's* economy, paced by the tradable goods industry, could expand by 7% last year and inflation could fall to 16% by year-end. Imports recovered strongly, causing the trade balance to swing into deficit and the current account deficit to approach 2% of GDP. Weakening oil prices in early 1998 and greater Asian competition in the United States threaten to accelerate this trend, and may have implications for how the balance between maintaining trade competitiveness and reducing inflation is struck. Only in late 1997, when turbulence in international financial markets put downward pressure on the exchange rate, was there a halt to the steady real exchange rate appreciation over the preceding two-year period. At the same time, however, depreciation triggered central bank concern about its inflationary impact. Liquidity conditions were tightened in mid-March this year, with further restraint likely to come from public spending cuts in response to the oil-price-induced weakening of revenue growth.

Another challenge will be to further promote the revival of a domestic financial system still burdened by a large non-performing loan problem. Much of Mexican investment spending over the last two years has been financed from retained earnings or from external sources given that domestic banks have sharply curtailed credit. Yet sustainable growth may depend on a further recapitalisation and build-up of reserves of the domestic banking sector so as to lay the foundations for a recovery of domestic credit expansion.

Africa and the Middle East

Growth in Africa moderated last year, reflecting bad weather conditions, weakening commodity prices and social and political instability in parts of the continent. The adverse consequences of financial turmoil in Asia for both commodity prices and the cost of external borrowing also tended to dampen growth prospects. Notwithstanding the current slowdown, economic performance in many African countries in recent years has improved under the influence of greater macroeconomic discipline and a growing commitment to structural reform. Prime examples have been the CFA franc zone countries and several southern African countries, where growth has averaged between 5 and 10% over the last two years while inflation has come down steadily.

South Africa

In South Africa growth slowed significantly to below 2% last year, with inflation falling to 6% by year-end. The levelling-off of the growth of bank credit (albeit at a high rate), the drop in inflation and the improvement in the balance of payments allowed some easing of monetary policy in late 1997 and again in early 1998. Recently, monetary policy operating procedures have also been revised with a view to making policy implementation more market-oriented.

Saudi Arabia

GDP growth in Saudi Arabia settled at around 2½% last year as oil prices were reasonably firm until late in the year and consumer prices virtually stabilised. While the fiscal deficit narrowed to about 3½% of GDP from 10% in the early 1990s, the intended further consolidation may become more difficult in view of the recent sharp drop in the price of oil.

Israel

In Israel, a cyclical slowdown to 2% GDP growth, as well as fiscal and monetary restraint, dampened inflation to 7% last year and contributed to a narrowing of the trade deficit. In mid-1997 the exchange rate regime was modified to allow a progressive widening of the fluctuation band. Moreover, nearly all restrictions on the use of foreign currency by citizens have been lifted as from May 1998.

Recent economic and financial developments in transition economies

The year 1997 demonstrated again that transition is not a smooth, let alone linear, process. Growth in the Czech Republic slowed considerably and Bulgaria and Romania faced serious recessions. However, growth in Poland, the Baltic states and Hungary remained strong and Russia finally recorded an expansion of its formal economy. Looking at the process of transition since its beginning, progress is evident in an increasing number of economies, with growth and particularly inflation differentials narrowing markedly (Graph III.6).

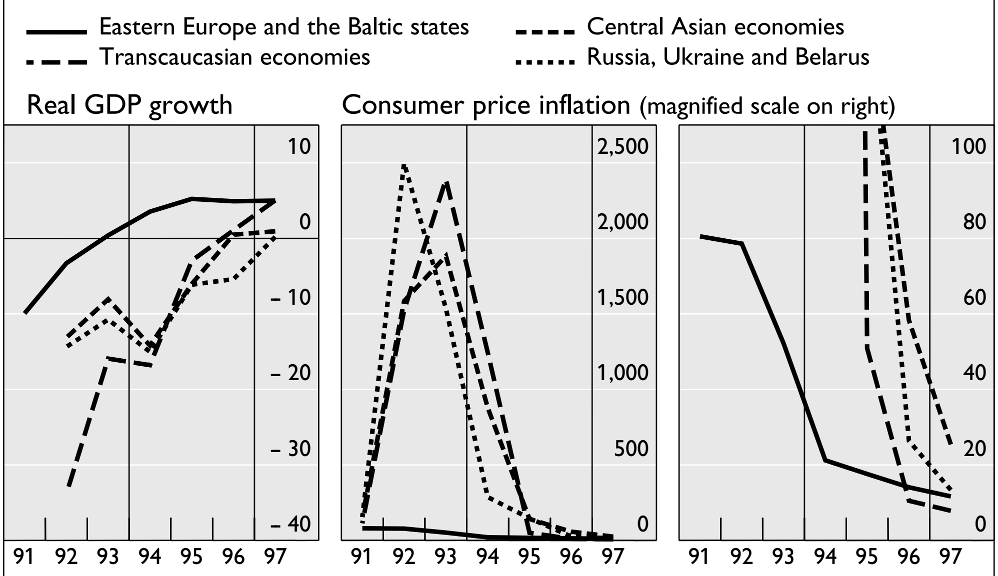
In the wake of the Asian crisis, several economies in the region, in particular Estonia, Russia and Ukraine, became exposed to rapidly shifting investor sentiment. In general, however, spillover effects remained moderate, mainly because of a widespread willingness to raise domestic interest rates in order to stabilise exchange rates.

Eastern Europe

Overall, growth in Eastern Europe has remained fairly modest in the last two years, while inflation appears to be stuck at a rather high level compared with inflation elsewhere. The latter result is due in part to the decontrol of previously administered prices and in part to price pressures in the services sector. Unemployment levels have hardly declined, which has constituted a continuous drain on public finances.

GDP growth and inflation in transition economies *

In percentages



* Calculated using weights based on 1990 GDP and PPP exchange rates. Graph III.6

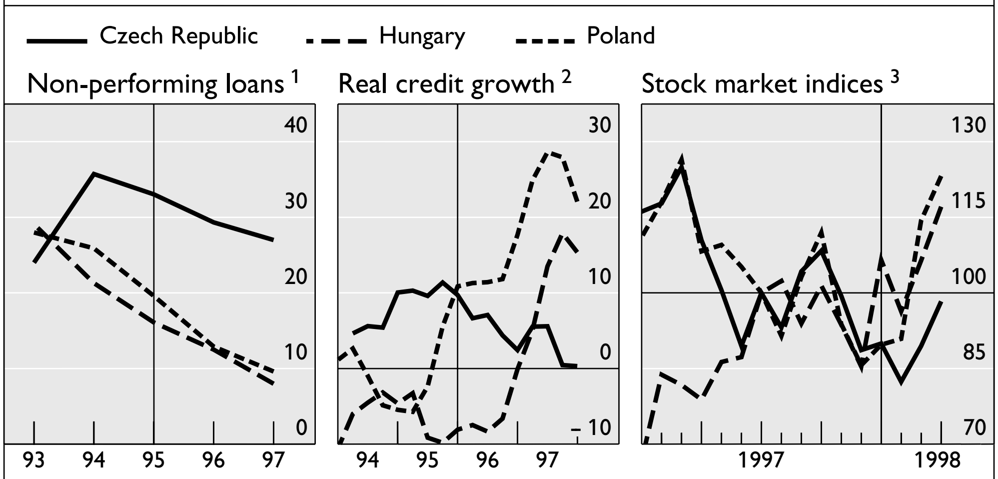
Sustained adjustment in Hungary

Economic and financial developments have differed significantly, however, between individual countries. The resolute adjustment policies adopted by *Hungary* since 1995 to deal with destabilising fiscal and current account deficits have started to bear fruit. The current account deficit fell from 9% of GDP in 1994 to 2% last year and progress was also made in reducing the budget deficit. The non-performing loan problem, which had restrained bank activity in previous years, eased further (Graph III.7). In 1998, a lower monthly rate of currency depreciation and government suasion encouraging more moderate wage settlements are aimed at tackling more effectively the country's still high rate of inflation.

Currency crisis in the Czech Republic

Perceptions of a lack of sustained structural reform and fiscal slippages caused a loss of confidence in the *Czech* economy in early 1997. In particular, concerns focused on the continued existence of soft budget constraints at the enterprise level, heavy external borrowing by enterprises and banks, financial fragility reflected in a large stock of non-performing loans, and the rather piecemeal development of a legal framework for financial transactions. Against the background of rapid real exchange rate appreciation and an associated ballooning of the current account deficit, the koruna thus became subject to increasing speculative pressure. To a more limited extent, the perceptions of institutional investors that Czech and Thai financial assets belonged to the same risk category (see Chapter VI) also made the Czech currency vulnerable to the pressure on the Thai baht in early 1997. Despite heavy intervention and a tightening of monetary policy, the central bank was forced to abandon its exchange rate band regime in late May. Prompt fiscal tightening, continued monetary restraint and a broadened framework of financial oversight did much to restore calm, albeit at the price of slowing growth.

Financial indicators in Eastern Europe



[1] As a percentage of total loans. [2] Four-quarter changes in credit to the private sector deflated by the annual rate of inflation, in percentages. [3] June 1997 = 100. Graph III.7

Strong growth in Poland

Poland has been spared a major setback since the start of transition. GDP grew by 7% in 1997, the sixth successive year of significant growth. More recently, however, concerns have been voiced about the widening current account deficit, which has been fuelled primarily by strong imports, and the very rapid real growth of credit to the private sector (Graph III.7). To counter associated risks of overheating, monetary policy was tightened several times during 1997, by raising reserve requirements as well as official interest rates. In addition, the scope for real exchange rate appreciation was increased in February 1998 as the zloty's rate of monthly devaluation was cut and its fluctuation band widened.

Impact of Bulgaria's currency board

The implementation of a currency board in July last year quickly pushed down *Bulgaria's* monthly rate of inflation from a peak of 240% in February 1997 to about 2% a year later. Foreign exchange reserves recovered during 1997 as the current account surplus widened and privatisation attracted sizable capital inflows. However, the cost of adjustment was another year of severe economic contraction; GDP fell by 7½%, following a decline of 11% in 1996.

Russia

Growth turns positive

Driven by rising household consumption, growth turned slightly positive last year, for the first time since the beginning of transition. Official GDP figures may even understate the expansion as the large informal economy is thought to have grown vigorously. Inflation fell to 11% by the end of 1997, a rate that compares favourably with many Eastern European economies. The general practice followed since mid-1995 of gradually and frequently adjusting the rouble's exchange rate vis-à-vis the US dollar was replaced at the start of 1998 by a new regime. The central rate has been set at Rb 6.2 to the dollar for the next three years, but the exchange rate is allowed to move within a 15% fluctuation band on either side of the central rate. By mid-April 1998, the exchange rate stood at Rb 6.1 to the dollar. As the real effective exchange rate of the rouble has already appreciated by a factor of two over the last three years, containing inflation further would do much to bolster the viability of the new regime.

Exchange rate regime change

In the wake of the Asian crisis, share prices dropped by nearly 50% and for the first time there were large-scale withdrawals of funds from the Treasury bill market by non-residents. International markets were virtually closed to Russian issues during October and November. In addition to intervention, the central bank reacted to the pressure by raising its indicative refinancing rate to a peak of 42% in early February 1998. To cushion against future shocks, reserve requirements were increased on foreign exchange deposits and limits were placed on foreign borrowing by domestic banks. With interest payments absorbing about half of tax revenues, higher interest rates tended to have an immediate and sharp impact on the budget. Attempts were therefore made to cut spending and so underpin the restrictive monetary policy. By March 1998, a major part of the contagion effect seemed to have been overcome: international reserves increased, interest rates were eased and international bank lending resumed.

Fallout from the Asian crisis

Several weaknesses continue to cloud the transition process in Russia. First, public finances need to be put on a sounder footing. Although tax collection rates improved somewhat last year, the tax base has remained narrow, partly because of the pervasive informal economy. Last year the federal deficit reached 7% of GDP and the budget for 1998 envisages a shortfall of close to 5%. Secondly, a spreading culture of non-payment together with an inefficient payment mechanism (more than 40% of industrial sales occur via barter) continue to hamper business activity, while the associated demonetisation complicates the implementation of monetary policy. Thirdly, large financial-industrial groups (accounting for up to half of Russia's hard currency earnings) may attempt to slow the transition to a market-driven economy with a "level playing-field", given that they enjoy special privileges, including tax breaks. A particular concern is that such groups could use their influence to compromise the progress being made towards better standards of corporate governance and a sounder banking supervisory framework. Finally, the recent weakness of oil prices is a reminder that the continuing high share of oil exports in total exports makes the fiscal deficit and the economy hostage to large terms-of-trade shocks.

Several serious policy challenges remain