III. Developments in the emerging market economies

Highlights

Most emerging market economies recorded a strong macroeconomic performance last year, though they shared in the industrial country slowdown as the year progressed. Average growth rose to its highest rate in four years, with particularly large increases in Latin America and central and eastern Europe (Table III.1). The rise in average growth was accompanied by a convergence of growth rates. This was especially evident in central and eastern Europe, where, for the first time since the regime change, all countries recorded positive rates of growth.

In contrast, there were marked differences across countries in the pace of their structural reforms. In Latin America, the banking sector was further strengthened through mergers and privatisations and an increasing presence of foreign banks. New legislative frameworks to enhance fiscal sustainability were also enacted, although they have not yet been tested in practice. In central and eastern Europe, only a few countries managed to reduce structural unemployment, while the recent crisis in Turkey illustrated, once again, how a weak banking sector can undermine confidence in macroeconomic policies. In Asia, some of the structural weaknesses uncovered by the 1997–98 crisis were addressed. But the success of these policies remains to be tested by the global slowdown now under way.

The aggregate current account surplus of the emerging market economies rose last year, though there were large differences across regions. Higher oil prices, together with some rise in non-oil commodity prices, explained most of the improvement in Africa. Higher oil prices also helped oil exporters in Latin America while masking an underlying widening of the region's current account deficit due to strong domestic demand growth. The buoyancy of exports to western Europe reduced external deficits in most central European countries in spite of higher oil import bills. In contrast, most Asian economies experienced a decline in their external surplus, reflecting not only their relatively high energy consumption but also the slower growth of export earnings towards the end of 2000.

Despite the pickup in growth and higher oil prices, average inflation fell to just over 6%. Inflation in the Asian region, at less than 2%, was actually below that of the industrial countries, while Latin American countries consolidated the impressive improvements achieved during the second half of the 1990s. As discussed in the last section of this chapter, containing inflation has been one of the most striking successes of emerging market countries in recent years. Tighter fiscal policies, a switch to monetary policies having price stability as the overriding target, and structural policies aimed at strengthening both domestic and foreign competition have all played a part. In addition, once inflation started to come down, forces were released which helped both to consolidate the gains and to lower inflation further. Nonetheless, most countries still face major challenges in keeping inflation low.

As the year progressed, the slowdown in the industrial countries was increasingly felt in the emerging market economies. In retrospect, the sharp decline in equity prices early in the year was a forewarning of a turnaround

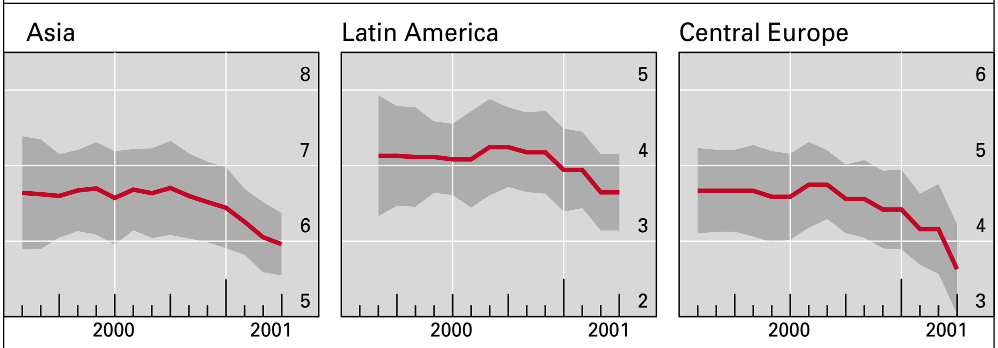
Growth, inflation and current account balances

	Real GDP			Consumer prices			Current account balance		
	1993–98	1999	2000	1993–98	1999	2000	Average 1993–98	1999	2000
	annual percentage changes						as a percentage of GDP		
Asia[1]	7.5	6.1	7.0	9.6	2.2	1.9	0.5	4.1	2.9
China	10.5	7.1	8.0	11.9	–1.4	0.3	1.6	1.6	1.5
Hong Kong	3.2	3.1	10.5	6.7	–4.0	–3.6	– 0.4[2]	5.2[2]	4.7[2]
India	6.4	6.6	6.0	7.6[3]	3.5[3]	5.3[3]	– 1.1	– 0.6	–1.0
Korea	4.7	10.9	8.8	5.4	0.8	2.3	– 0.1	6.0	2.4
Singapore	8.0	5.4	10.0	1.7	0.5	1.5	17.1	25.3	23.6
Taiwan	6.0	5.6	6.0	2.7	0.2	1.3	2.7	2.9	3.0
Indonesia	3.2	–0.1	4.8	15.4	20.5	3.7	– 1.8	4.1	7.2
Malaysia	6.3	5.8	8.5	3.7	2.7	1.5	– 3.4	15.9	9.2
Philippines	3.6	3.4	4.0	8.0	6.7	4.3	– 3.5	10.3	12.4
Thailand	3.2	4.2	4.3	5.6	0.3	1.5	– 3.6	10.2	7.6
Latin America[1]	3.6	0.2	4.4	73.4	9.1	6.7	– 3.1	– 3.1	–2.1
Argentina	4.5	–3.0	–0.5	3.2	–1.2	–0.9	– 3.6	– 4.4	–3.3
Brazil	3.5	0.8	4.5	213.4	4.9	6.0	– 2.6	– 4.7	–4.2
Chile	6.9	–1.1	5.4	8.5	3.4	3.8	– 4.5	– 0.1	–1.4
Colombia	3.7	–4.3	2.8	21.1	11.2	9.5	– 5.0	– 0.0	0.2
Mexico	2.7	3.7	6.9	19.9	16.6	7.9	– 3.5	– 2.9	–3.1
Peru	5.9	1.4	3.6	17.7	3.5	3.8	– 6.2	– 3.5	–3.0
Venezuela	1.1	–6.8	2.8	56.1	23.6	16.2	2.6	3.6	11.1
Central Europe[1]	4.2	3.1	4.0	20.6	6.5	8.7	– 2.6	– 5.9	–5.4
Czech Republic	1.6	–0.8	3.1	11.2	2.1	3.9	– 3.6	– 3.0	–4.8
Hungary	2.4	4.5	5.2	20.9	10.0	9.8	– 5.6	– 4.3	–3.3
Poland	5.6	4.1	4.1	24.1	7.3	10.1	– 1.2	– 7.5	–6.2
Russia	–5.6	5.4	8.3	151.9	85.7	20.8	2.2	13.5	19.0
Turkey	4.7	–5.0	6.1	84.8	64.9	54.9	– 0.9	– 0.7	–4.8
Saudi Arabia	1.0	0.4	4.1	1.2	–1.6	–0.8	– 5.8	0.3	10.1
Africa	3.0	2.5	3.0	19.7	5.7	4.2	–11.1[4]	–12.1[4]	0.8[4]
CFA zone	3.4	2.4	2.6	9.2	1.4	1.8	– 6.0	– 5.3	–4.5
South Africa	2.5	1.9	3.2	8.3	5.2	5.3	– 0.8	– 0.5	–0.4
Memo:									
G7 countries	*2.6*	*2.9*	*3.8*	*2.1*	*1.3*	*2.3*	*– 0.0*	*– 1.1*	*–1.6*

[1] Weighted average of the countries shown, based on 1995 GDP and PPP exchange rates. [2] Balance of goods and non-factor services. [3] Wholesale prices. [4] As a percentage of exports of goods and services.

Sources: IMF; OECD; national data; BIS estimates. Table III.1

GDP growth forecasts for 2001[1]



[1] The lines show averages of forecasts made in successive months and published in the month shown; in percentages. The shaded areas represent ±1 standard deviation around the average forecast.

Source: © Consensus Economics. Graph III.1

in the global cycle for electronics. Towards the end of 2000, output growth weakened sharply in the countries most reliant on exports of such products, and near-term growth prospects for most emerging market economies have been revised downwards (Graph III.1). The outlook is particularly uncertain in Argentina, Indonesia and Turkey, where confidence in the policies adopted has been undermined. Near-term growth prospects also depend on countries' exposure to changes in global trade as well as international financial conditions. The effects of the turnaround in the electronics cycle have been most pronounced in emerging Asia. By contrast, given their large current account deficits and external financing needs, Latin American countries are more exposed to developments in international capital markets. With less dependence on capital inflows and given the destination of a large share of their exports, the outlook for Africa and central and eastern Europe depends mainly on growth in western Europe.

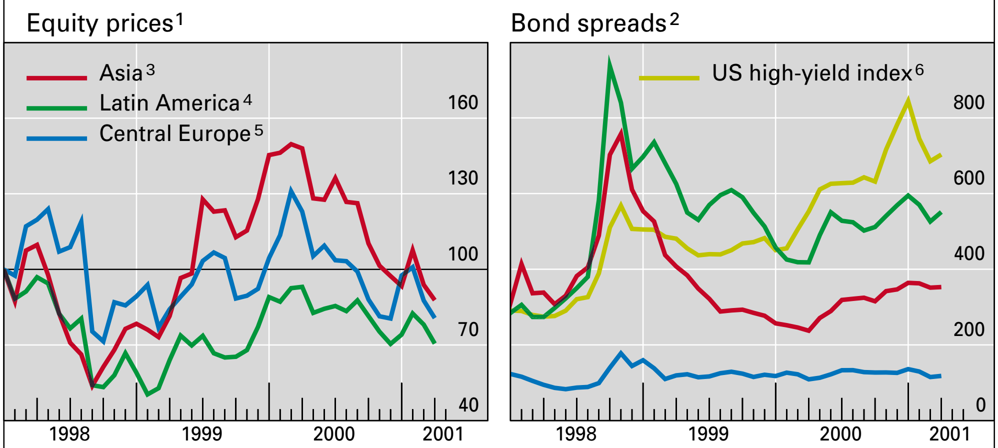
Financial market developments and capital flows

Financial conditions worsened as the year progressed ...

The generally favourable macroeconomic performance in the emerging market economies last year must be seen against the background of periodically volatile and unfavourable financial conditions. The downward correction of equity prices in major markets in March 2000 was quickly reflected in the stock markets of emerging economies (Graph III.2). With China as the main exception, Asian markets were particularly hard hit, as the drop in the Nasdaq index was widely interpreted as signalling lower demand for electronics and thus a decline in the export earnings of countries specialising in such products (Table III.2). In some cases, the fall in equity prices was exacerbated by concerns about the slow progress of financial and corporate reforms. This was particularly evident towards the end of the year, when several countries experienced net outflows of portfolio equity investment.

Credit market developments in the industrial countries also affected the borrowing conditions faced by emerging market economies. Both in the spring and towards the end of last year, sovereign bond spreads widened

Equity prices and bond spreads



[1] In US dollar terms, end-1997 = 100; weighted average of the countries shown, based on 1995 GDP and PPP exchange rates. [2] Over benchmark US Treasury bonds, in basis points; unweighted average of the countries shown. [3] China, India, Indonesia, Korea, Malaysia, the Philippines and Thailand. [4] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [5] The Czech Republic, Hungary and Poland. [6] Sub-investment grade corporate bond yield.

Sources: Datastream; International Finance Corporation (IFC); national data. Graph III.2

sharply, especially for countries with high foreign debt, fiscal problems or a weak banking sector (see also Chapter VI). But sovereign spreads generally remained tighter than those for high-yield corporate bonds, as investors perceived the default risk to be much smaller. The shifts in market sentiment influenced net capital flows as well (Table III.3). Due to the more difficult financial conditions in the fourth quarter of last year, bond issuance faltered and net equity inflows also fell sharply. Since foreign direct investment (FDI) was lower as well, net private inflows in 2000 declined to only a fraction of the levels recorded just before the Asian crisis.

... and net capital inflows remained below pre-crisis levels ...

Some observers have interpreted the decline in debt outstanding as a deliberate reaction by lenders to the series of crises in the 1990s. But a more positive interpretation is also possible. Over the last two years, domestic interest rates have declined, more countries have floated their currencies and reforms have gradually increased the supply of domestic funds available. In these conditions, borrowers in emerging markets increasingly preferred domestic and local currency sources of finance to borrowing in international

... with net debt flows particularly weak

Correlations between changes in the Nasdaq index and equity prices[1]

	Hong Kong	Korea	Malaysia	Singapore	Taiwan	Thailand
1995–96	0.32	0.16	0.05	0.11	0.05	0.19
1999–2000	0.55	0.45	0.25	0.40	0.27	0.32
	Argentina	Brazil	Chile	Mexico	Poland	South Africa
1995–96	0.06	0.01	–0.08	0.07	0.18	0.02
1999–2000	0.23	0.44	0.23	0.38	0.34	0.36

[1] In national currencies; calculated over two years using weekly observations.

Sources: IFC; national data. Table III.2

Net private capital flows to emerging market economies				
	1997	1998	1999	2000
	in billions of US dollars			
By instrument				
Foreign direct investment	145	151	150	144
Portfolio equity investment	43	1	22	25
Other private capital flows	–68	–99	–102	–136
By region				
Asia	13	–47	1	– 2
Latin America	68	62	40	39
Africa	17	11	13	9
Central and eastern Europe	3	19	13	3
Others	19	8	4	– 16
Total flows	120	53	70	33
Memo: Change in reserves[1]	*–62*	*–35*	*– 86*	*–120*

[1] A minus sign indicates an increase.
Source: IMF, *World Economic Outlook*. Table III.3

markets. In addition, there have been structural changes in the supply of credit. Most notably, international banks have strengthened their presence in emerging market economies through acquisitions of local institutions while reducing their cross-border lending correspondingly. Finally, the accumulation of sizeable current account surpluses in Asia has allowed a restoration of foreign exchange reserves as well as a reduction in short-term foreign debt.

Regional distribution remained stable

The regional composition of net private capital flows changed relatively little last year. Inflows to the Asian region remained close to zero, mainly due to higher repayments of foreign debt. FDI inflows also weakened, as the decline in inflows to Southeast Asia more than offset larger inflows to China (given the country's impending accession to the WTO) and Korea (stimulated by capital account liberalisation). Net private inflows to Latin America were stable while those to central and eastern Europe and Africa remained below the year-earlier level. Despite a small decline last year, FDI was still the most stable source of inflows to the emerging market economies. The distribution of FDI also remained stable and highly concentrated. Five countries (Argentina, Brazil, China (including Hong Kong), Mexico and Korea) received two thirds of total FDI flows to the emerging market economies. Africa, with 50 countries, received less than 5%.

Asia

Growth and external sector developments

Recovery outpaced expectations ...

Output in Asia rose strongly in 2000, generally outpacing expectations. Even though higher oil prices may have reduced real income in the oil-importing countries by ½–1%, average growth in the region still rose to 7%, with particularly high rates being recorded in Hong Kong, Korea and Singapore.

Even Indonesia and the Philippines managed to expand significantly despite political uncertainties and social unrest. The sources of growth differed across countries (Table III.4). In the large and relatively closed economies of China and India, domestic demand remained the principal source of growth. The strengthening of growth in *China* was supported by fiscal stimulus and an accommodating monetary policy. Public investment was increased and various measures (higher public sector wages and the imposition of a tax on interest income) were introduced to encourage consumption. Nonetheless, as state-owned enterprises were widely expected to reduce both their workforces and the social benefits provided to their remaining employees, households tended to increase precautionary saving. The growth of private investment was also moderate, despite the rise in FDI inflows.

... including in China

Slower growth in India

Growth in *India* slowed somewhat last year owing to a combination of poor weather affecting the agricultural sector and deceleration in the services sector. The sharp increase in oil prices and a severe earthquake were other factors adversely affecting growth. Buoyant exports (the fastest expansion since 1997) partly offset slower domestic demand and supported the rupee, which had come under pressure due to the higher oil import bill. The authorities attempted to stem the rupee's depreciation by raising interest rates and mobilising special deposits from non-resident Indians. In addition, the government tightened fiscal policy and advanced the schedule for privatisation, including the reduction of holdings in state-owned banks.

Shift from net exports to domestic demand in other countries ...

As exports slowed in the more open Asian economies, domestic demand increasingly became the major source of growth. The shift was most evident in countries relying on exports of electronics (Malaysia and Singapore) but was also noticeable in Hong Kong, Indonesia and Thailand. *Taiwan*, which had been more or less immune to the 1997–98 crisis, experienced a particularly sharp change in both the size and sources of overall growth. Following the decline in the Nasdaq, equity prices fell sharply and the slump was exacerbated by political disputes. Since banks had lent against equities as collateral, attention next turned to the banking sector, where the proportion of bad loans had reached a historical high and profits had shrunk because of

Domestic demand (DD) and net exports (NEX)

	Percentage contribution to GDP growth									
	China		Hong Kong		India		Indonesia		Korea	
	DD	NEX	DD	NEX	DD	NEX	DD	NEX	DD	NEX
1994–98	8.6	1.3	3.5	–1.1	7.2	–0.4	3.1	–0.5	0.5	3.9
1999	7.4	–0.3	–5.0	8.1	6.1	0.3	–2.7	3.0	11.9	–1.0
2000	7.5	0.5	9.3	1.2	5.1	0.6	4.7	0.1	5.3	3.5
	Malaysia		Philippines		Singapore		Taiwan		Thailand	
	DD	NEX	DD	NEX	DD	NEX	DD	NEX	DD	NEX
1994–98	1.9	3.9	5.0	–1.4	4.5	3.0	6.3	–0.2	–2.0	3.8
1999	1.7	4.1	0.3	3.0	4.3	1.6	1.9	3.5	2.9	1.3
2000	12.6	–4.0	–1.7	5.6	8.9	0.9	4.3	1.7	3.8	0.5

Sources: JP Morgan, *World Financial Markets*; national data. Table III.4

overcapacity. Finally, as the demand for electronics fell off towards the end of the year, real growth slowed abruptly.

... but not in Korea and the Philippines

Despite the importance of exports of electronic products, the relative contribution of net exports increased in both Korea and the Philippines. In the case of *Korea*, however, this reflected a shift in the composition of domestic demand towards less import-intensive components rather than a rise in export growth. In the *Philippines*, a contraction in business investment, attributable to a lack of domestic confidence as well as a fall in foreign portfolio investment, was a major factor behind the decline in domestic demand.

Accommodating monetary policies

The strengthening of domestic demand last year was generally supported by accommodating monetary policies. Moreover, with many currencies now under regimes of managed floating, the tightening of interest rates in the industrial countries had a relatively small impact on Asian interest rates. China, Malaysia, Singapore and Thailand maintained low rates, reflecting the absence of inflationary pressures. While strong growth and rising inflation led to some interest rate increases in Korea, these were kept moderate due to concerns about the fragility of the corporate sector. Interest rate increases were somewhat larger in India, Indonesia and the Philippines owing to pressure on their currencies.

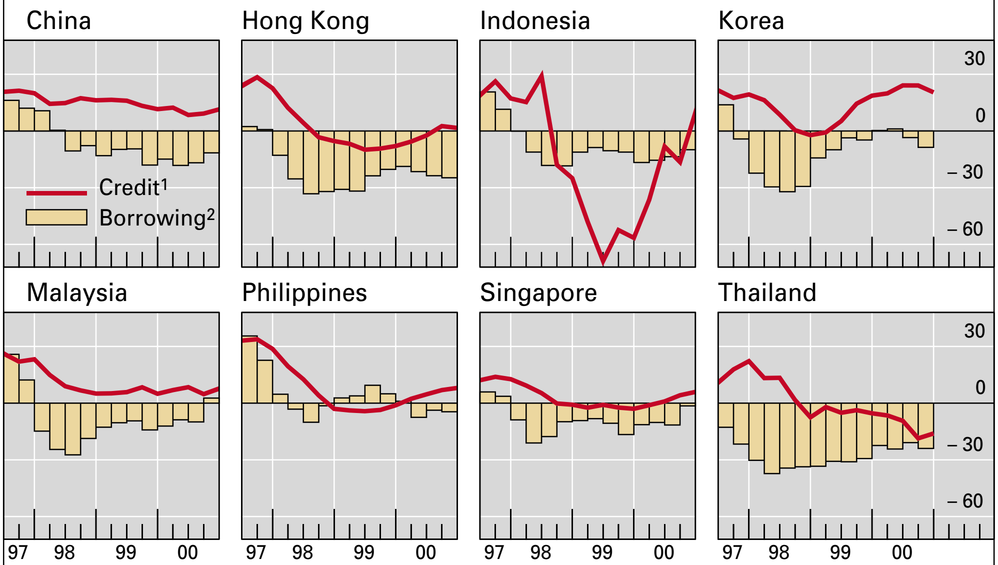
Banking sector performance and bank lending

Credit growth remained low except in Korea

Despite accommodating monetary policies, bank credit growth remained low or negative last year. In fact, throughout the post-crisis recovery, bank lending has been weak everywhere except in Korea (Graph III.3). Developments there

Domestic credit and international borrowing

Annual percentage changes



¹ To the private sector. For Indonesia, in inflation-adjusted terms. ² External liabilities (in US dollars) to BIS reporting banks.

Sources: IMF; BIS; national data. Graph III.3

partly reflected the relatively high level of investment and the shift (since mid-1999) from commercial paper and corporate bond markets to borrowing from banks. However, the growth of credit was also the result of official intervention, including expanded government guarantees for loans to small and medium-sized firms and the rapid recapitalisation of Korean banks. Recent data for several other countries suggest that bank credit to corporations has begun to grow again.

Progress with banking sector reform ...

It is always hard to determine whether low or negative credit growth results from a "credit crunch" (ie a situation in which normally promising loans are not made because banks do not have sufficient capital), reflects poor lending prospects, or is attributable to lack of demand. Bank restructuring in Asia has advanced slowly but steadily. A large number of banks have been closed, merged, temporarily nationalised, or sold to foreign buyers. Banking systems now seem sounder than before the crisis, although only in Korea and Malaysia has this been reflected in markedly improved credit ratings. While the economic recovery enabled some borrowers to renew loan servicing, a major role in reducing non-performing loans (NPLs) was played by publicly funded asset management companies. These took over a large proportion of banks' NPLs in Indonesia, Korea and Malaysia. Thailand recently introduced a similar arrangement, with a view to enabling banks to lend again. The authorities in all Asian countries have also taken steps to strengthen banking supervision and adopted new rules against connected and insider lending.

... but weaknesses remain

Yet substantive bank restructuring has been constrained by several factors. Falling equity prices have limited the capacity to raise new capital. The fact that some restructured loans have again become NPLs, and thus a potential drain on capital, is also a cautionary sign at a time when the economies are slowing. Finally, despite the progress made, many weak institutions remain and some banks have not made the operational changes required to rebuild longer-term profits. This state of affairs might explain why banks in some countries have been unable to expand lending.

Greater awareness of risks

There are also signs that banks' assessment of credit risks and prospective returns, rather than their capacity to lend, explains weak credit growth. One is that the recovery in corporate loans has been hesitant even in Hong Kong and Singapore where banks are relatively robust. The fact that Asian banks are actively marketing mortgages and that spreads have narrowed on high-quality syndicated lending provides further evidence that, for some banks at least, capital is not a constraint when the rewards cover the risks.

Lower demand for credit

Several factors also suggest that the demand for credit has been low. First, many firms deliberately acted to reduce their gearing, while others simply did not need to borrow. On the eve of the crisis, investment in several countries amounted to around 40% of GDP, with corporate investment spending far exceeding cash flow. After the crisis, rising sales were sourced from existing and unused capacity, so that investment spending stayed low even as cash flow recovered. As a result, the corporate sector ran a financial surplus and had little need for external funding. Second, the sectoral composition of growth limited credit demand, as the credit-intensive sectors remained in recession.

In particular, an overhang of office space and high vacancy rates in major centres depressed construction. In contrast, the export sectors, which are less dependent on credit, expanded strongly.

Fiscal policy challenges

Growing debt has become an issue ...

The Asian economies had generally run budget surpluses, or only small deficits, before the 1997 crisis. In its aftermath, however, measures to stimulate domestic demand, large expenditures to recapitalise the banking systems and the effect of the recession on tax receipts meant that most recorded sizeable fiscal deficits in 2000 and saw large increases in public debt (Table III.5). Since government contingent liabilities were also high, and interest payments already accounted for a significant proportion of budget outlays, the accumulated deficits of recent years made debt dynamics an increasing source of vulnerability in the region.

... in China ...

China has depended on fiscal expansion to stimulate growth over the last three years. This raised the fiscal deficit steadily, from less than 1% of GDP in 1996 to nearly 3% last year. While government debt was still moderate by international standards, the actual fiscal burden increased due to extra-budgetary transactions and the actual and prospective liabilities arising from

Fiscal balances and public debt

	Nominal balance			Interest payments			Public debt		
	1996	1999	2000	1996	1999	2000	1996	1999	2000
	as a percentage of GDP								
Asia									
China	–0.9	– 2.2	–2.9	0.7	0.8	0.8	7.3	12.7	14.6
Hong Kong	2.2	0.8	–0.9	–	–	–	–	–	–
India	–4.9	– 5.4	–5.1	4.3	4.6	4.6	49.4	52.2	53.0
Korea	0.1	– 4.6	1.0	0.5	2.3	2.4	11.9	22.3	23.1
Singapore	14.7	10.3	11.4	–	–	–	74.0	88.5	84.5
Taiwan	–1.8	1.0	–0.3	1.4	1.5	2.0	26.4	27.5	29.8
Indonesia	1.1	– 1.6	–3.2	2.0	3.8	5.7	27.3	105.7	106.9
Malaysia	0.7	– 3.2	–5.8	2.7	2.6	2.7	35.3	37.3	37.0
Philippines	0.3	– 3.5	–3.9	3.4	3.4	4.0	53.2	59.2	64.9
Thailand	0.7	– 2.6	–2.2	0.2	1.2	1.2	16.3	42.4	54.4
Latin America									
Argentina	–2.2	– 2.6	–2.4	1.7	2.9	3.4	35.7	43.0	46.0
Brazil	–5.9	–10.3	–4.5	5.8	13.6	8.1	33.3	49.4	49.5
Chile	2.3	– 1.5	0.2	0.6	0.4	0.5	28.1	29.4	31.1
Colombia	–3.7	– 5.8	–6.9	1.9	3.3	4.5	14.4	29.4	36.8
Mexico	–0.2	– 1.6	–1.3	3.7	3.2	3.3	31.1	25.7	23.5
Peru	–1.3	– 3.2	–3.2	2.4	2.1	2.2	45.2	37.5	35.6
Venezuela	0.7	– 2.3	–1.8	5.0	2.6	2.5	33.8	29.8	...

Note: Comparisons across countries should take into account that different definitions of the public sector are used; for Hong Kong and Indonesia, fiscal years; for India, federal government only.

Sources: IMF; Institute of International Finance; national data; BIS estimates. Table III.5

the resolution of banks' non-performing loans. Contingent liabilities in the pension and social security system are also likely to be high.

... and even more in India ...

India's fiscal vulnerability was clear from the federal deficit, which stayed close to 5% of GDP. With the state governments also running large deficits, the overall borrowing requirement was almost 10% last year, raising the level of general government debt to over 60% of GDP and even more if contingent liabilities of the financial sector and state-owned enterprises are also included. Even though the government has increasingly moved away from monetising its deficit, the large debt has led to relatively high real interest rates, thus raising debt servicing costs and crowding out private investment. Realising the critical importance of fiscal sustainability, the government introduced a fiscal responsibility bill aimed at bringing down the federal fiscal deficit to 2% of GDP over the next five years and the public debt ratio to less than 50% over the next 10 years.

... the Philippines and Indonesia

Fiscal sustainability also became an issue in other Asian countries. The Philippines has a legacy of poor fiscal discipline and its debt burden, at nearly 65% of GDP by the end of 2000, was among the highest in the region. Already last year, a doubling of the projected budget shortfall was a major factor behind the decline in investor confidence and downward pressures on the exchange rate. Indonesia came even closer to the debt sustainability limit, given the speed with which the public debt grew and the fact that a large part of the debt was in foreign currency. For the past two years, the government has actually relied on official inflows and asset sales to finance interest payments and amortisations. At about 55% of GDP, the public debt in Thailand was still manageable. However, given recent plans to revitalise the financial sector, the debt/GDP ratio could rise quickly unless steps are taken to improve the primary balance.

Reliance of Asian economies on exports of high-tech products

Lower demand growth and falling prices

The high-tech sector has increasingly dominated the exports of many Asian economies (Table III.6). Exports of such goods to the United States have

High-tech exports of Asian economies

	Share of economy's total exports to OECD countries									% change in US imports during year to	
	CN	HK	ID	KR	MY	PH	SG	TH	TW	Jun 00	Feb 01
Computers[1]	6	7	2	13	19	22	54	16	28	8	–6
Telecommunications[2]	7	4	5	6	15	6	5	7	4	43	1
Components[3]	8	18	2	23	24	33	17	11	17	22	–2
Total	20	30	9	41	58	60	77	34	50	19	0

CN = China; HK = Hong Kong; ID = Indonesia; KR = Korea; MY = Malaysia; PH = Philippines; SG = Singapore; TH = Thailand; TW = Taiwan.

[1] SITC division 75: office machines and automatic data processing machines. [2] SITC division 76: telecommunications and sound recording and reproducing apparatus and equipment. [3] SITC division 77: electrical machinery, apparatus and appliances not elsewhere specified and electrical parts thereof.

Sources: OECD; national data. Table III.6

grown fourfold in the past decade. On some measures, electronic goods accounted for two thirds of the recovery in industrial output in the region in recent years. However, during 2000, many Asian economies suffered from both reduced global demand for these products (Graph III.4) and lower prices for components (for example, the benchmark DRAM semiconductor price fell by almost two thirds over the year). This drop in demand for various types of high-tech exports continued into early 2001, and both information on orders placed and comments from industry groups implied further sharp declines.

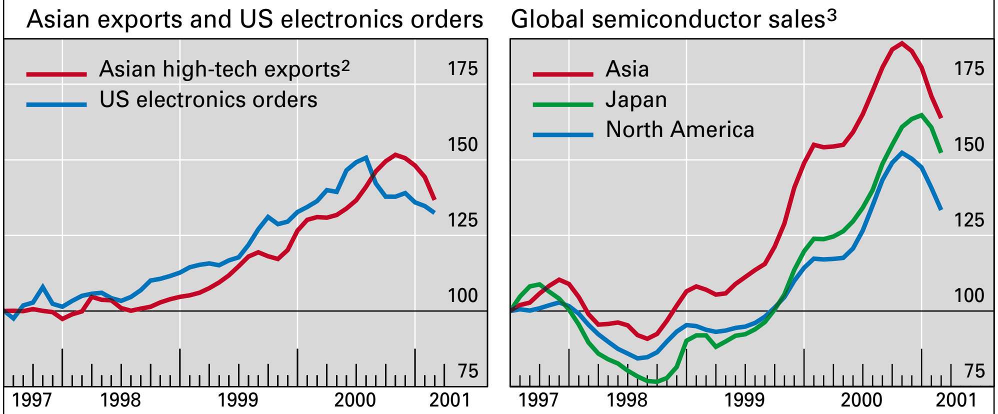
Impact on final demand depends on local value added

However, the export figures shown in the table may give a misleading picture of the total influence of high-tech exports on Asia and of the extent to which individual countries are exposed to the downturn now under way. First, in some countries, the high-tech industries are almost entirely foreign-owned. Consequently, except for downward pressure on wages, the fall in prices for electronics may have relatively little impact on the local economies. Second, because of linked production sites, shipments of components between countries account for the bulk of intraregional trade. This not only increases the risk of trade-induced contagion effects but also implies that the local value added portion of exports, and thus the impact on final demand, varies significantly across countries. For example, Korea's imports of high-tech products in 1999 equalled over 60% of its exports, and a third of these imports, principally components, came from other emerging Asian economies. For the Philippines, the local value added portion may be no more than 20%. It is also low for Malaysia and Thailand but relatively high for Singapore and Taiwan.

Implications for the business cycle in Asia

Despite these caveats, the high and rising technology content of the Asian economies has probably both increased their trend growth rates and accentuated their business cycles. The product cycle of electronics and other high-tech products is significantly more volatile than that of traditional

High-tech activity in Asian economies[1]



[1] June 1997 = 100; three-month moving averages. [2] To the United States; defined as the sum of the trade classifications SITC 75, 76 and 77 (see Table III.6 for details). Asia defined as China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand. [3] Including domestic sales.

Sources: Bloomberg; Semiconductor Industry Association; national data. Graph III.4

manufactured goods. Consequently, were there to be a substantial slowdown in the world economy, demand for computer-related products could fall further as firms delay upgrading their equipment. In the United States, a strong and rising correlation has been observed between firms' cash flows and spending on computers.

The near-term outlook

Less favourable global climate

With the exception of China and India, the Asian economies seem more exposed to the current weakening of global growth than most other emerging market countries. As discussed above, several countries are highly exposed to lower demand for electronics. Total exports will also be affected by generally slower growth in the United States as well as the poor prospects in Japan. Finally, despite reforms, the resilience of financial and corporate structures and balances to a cyclical downturn remains to be tested.

Measures to stimulate domestic demand

In response to the less favourable growth prospects, lower interest rates in the industrial countries and, in some cases, reduced inflationary pressures, several countries eased monetary policies early this year. In addition to further fiscal stimulus, the Chinese authorities started implementing a programme to liberalise interest rates and capital markets and announced their intention to gradually move towards a more flexible exchange rate. Malaysia and Taiwan planned major increases in public spending and the latest budget in India proposed a further liberalisation of the investment environment as well as new reforms to increase growth.

Latin America

Growth and external sector developments

Growth rebounded last year ...

After a severe recession in 1998–99, the Latin American economies rebounded strongly in 2000. Real GDP expanded by over 4% while inflation remained stable at less than 10% in most countries. Virtually all economies in the region registered positive growth, with the largest two – Brazil and Mexico – being among the best performers. The main exception to this favourable trend was Argentina, where output again declined. Improvements in the external current accounts were modest. Growth was generally stronger in the first half of the year, while in the second the US economic slowdown began to affect exports. In addition, greater volatility in global capital markets and renewed concerns about remaining fiscal vulnerabilities slowed capital flows to the region. By the end of the year, fears had also emerged that political factors could negatively affect economic performance in Argentina, Colombia, Peru and Venezuela.

... mainly due to domestic demand and oil exports

Although the region's total exports surged by over 20% in value terms in 2000, output growth was, in most countries, driven by domestic demand (Table III.7). Terms-of-trade changes tended to favour the oil exporters, as most agricultural prices stagnated or declined and only metals (especially copper) prices rose significantly. Oil exports also played a key role in bringing the region's current account deficit down to 2% of GDP from 3% in 1999.

Trade, oil exports and growth in Latin America in 2000						
	Current account balance[1]	Net oil exports[1]	Contribution to growth[2]		Terms of trade[3]	Degree of openness[4]
			Net oil exports	Net non-oil exports		
Argentina	– 9.4	3.6	0.5	0.7	6	22
Brazil	–24.6	–6.0	–0.5	0.6	–7	24
Chile	– 1.0	–1.9	–1.3	1.0	2	61
Colombia	0.1	4.3	1.0	–0.3	16	35
Ecuador	1.4	2.4	6.7	–5.3	14	77
Mexico	–17.7	16.4	1.3	–1.9	3	64
Peru	– 1.6	–0.7	–0.6	0.9	–1	34
Venezuela	13.4	26.4	9.8	2.6	44	47
Total	–39.7	44.5	1.0	–0.1	3	41

[1] In billions of US dollars. [2] Of nominal GDP, in percentage points. [3] For merchandise trade, annual percentage change. [4] Sum of exports and imports of goods and services as a percentage of GDP.

Sources: Economic Commission for Latin America and the Caribbean; JP Morgan; national data; BIS estimates. Table III.7

Investment remained weak

As the Latin American economies are still fairly closed (with the exception of Chile, Ecuador and Mexico), domestic demand was bound to play the main role in reactivating growth. However, the sources of demand growth in 2000 were unbalanced: investment strengthened only in Mexico and, from a low base, in Colombia. Elsewhere in the region, private consumption outpaced real GDP growth, leading to a sharp acceleration in imports. Moreover, the weakness of domestic investment was accompanied by a decline in inflows of foreign direct investment, notably in Argentina and Chile. Viewed against this background, the buoyancy of consumption and imports, coupled with the recent weakening of external demand, has raised concerns about the sustainability of growth in Latin America even if external financing conditions remain favourable.

Changing macroeconomic policy mix

Changing policy mix in 2000

The Latin American economies had responded to the slowdown in activity and financial market turbulence in 1998–99 with a combination of tighter monetary and fiscal policies and, in some cases, more flexible exchange rate regimes. As the external environment improved in early 2000, the emphasis shifted towards further reducing fiscal deficits while, at the same time, easing domestic monetary conditions. In addition, several countries attempted to improve competitiveness through structural reforms.

Favourable financial market conditions

The conditions in international financial markets were, for the most part, favourable to Latin America in 2000. Estimated net inflows of private capital to the region were roughly stable at about $40 billion, covering the bulk of the current account deficit. However, the inflows were volatile, and concentrated on Brazil and Mexico. Moreover, a large portion of bond issues were swaps of previously existing debt for new securities with longer maturities. Spreads for long-term government bonds increased on average during the year, reflecting country-specific concerns.

Monetary conditions eased ...

The easing of the external liquidity constraint enabled most countries in the region to relax monetary conditions in 2000. In *Brazil*, the central bank lowered the benchmark rate from 19% at end-1999 to 16½% in July and further to 15¾% in December 2000. This triggered a strong expansion in credit to the private sector, where the financial position of households improved with the rebound of growth and a significant rise in employment. In early 2001, the central bank cut its policy rate by a further 50 basis points, but then raised the rates by a total of 100 basis points from late March to mid-April as the real weakened and demand pressures began to emerge. Interest rates were also cut in *Colombia* and, in the second half of 2000, in *Chile*, while the authorities in *Peru* lowered reserve requirements. In contrast, *Mexico* had to tighten monetary policy in the course of the year to prevent domestic demand from overheating.

... and fiscal performance improved

Fiscal performance improved in most Latin American countries in 2000, with Argentina being a major exception. Revenues were higher due to the cyclical recovery and, in the oil-exporting countries, buoyant oil revenues. Many governments also benefited from lower debt servicing costs; Brazil, for instance, by as much as 5% of GDP. On average, fiscal deficits declined to 2.8% of GDP from close to 4% in 1999, with the largest improvements in Brazil and Chile.

Fiscal responsibility laws enacted ...

In spite of improved fiscal performance last year, concerns about longer-term fiscal sustainability persisted in many countries. To address these concerns, *Brazil* introduced a Fiscal Responsibility Law that requires each tier of government to maintain current expenditure in balance with current revenue, limit spending on personnel, and keep the ratio of debt to current revenue within preset limits. *Argentina* and *Peru* passed laws that mandate spending increases in line with economic growth and the establishment of fiscal stabilisation funds. By imposing such constraints, these laws are intended to increase fiscal credibility in the same way that the adoption of central bank independence and inflation targeting (or a very hard peg) is expected to increase credibility in the monetary sphere.

... but need to be backed up by firm implementation

In Brazil, the fiscal law was backed up by consistent policy plans and solid macroeconomic performance last year, thus making a favourable impression on investors. In Argentina, however, the implementation of the Law on Fiscal Solvency was postponed until 2005, making fiscal discipline less credible (see below). Investors were also unimpressed by the introduction of discretionary fiscal measures in Chile in the second half of 2000.

Recession in Argentina

Need for fiscal reform in Argentina ...

The lack of recovery in Argentina has been the main exception to the favourable macroeconomic performance of the region. While Argentina was hit by a series of external shocks in the past few years, domestic political instability has undoubtedly played a role in delaying investment decisions and dampening consumer confidence. In particular, Argentina's excessively high level of public expenditure put constant upward pressure on interest rates. Not only did this increase debt servicing costs, but tax revenues also suffered. Moreover, the revision of short-term fiscal targets has delayed the implementation of the balanced budget provision of the Law on Fiscal Solvency, which is essential to lower the tax burden and restore the competitiveness of local industries working within the currency board constraint.

... but lack of political support

In the absence of the political commitment, particularly at the provincial level, to deal decisively with the fiscal problem, market confidence failed to improve following the agreement with the IMF in December 2000. In March 2001, bond spreads widened again and domestic interest rates rose sharply, reflecting markets' perception of elevated credit risk. In April this year, banks' liquidity requirements were modified, thereby easing the immediate pressure on the government to borrow foreign currency. Over the longer term, however, credit risk perceptions depend on the broader policy framework, including fiscal discipline, real growth prospects, and a sound banking system.

Privatisation and restructuring in the banking industry

Progress with privatisation

Considerable progress has been made in privatising state-owned assets, with proceeds estimated at about $15 billion for the region in 2000. Brazil accounted for the largest share of the proceeds, while Spanish corporations and banks were the most active in acquiring Latin American assets. Greater emphasis has also been placed on deregulation and the promotion of competition in energy and utilities, telecommunications and transportation services, including the use of private sector concessions to meet infrastructure needs. Although the pace of privatisations is expected to slow over the years, the pool of public sector assets available for sale remains large.

Increased role of foreign banks ...

A long-standing impediment to private investment in Latin America has been inefficient financial intermediation. To address this problem, Argentina and Peru have encouraged consolidation in the banking industry, while Brazil and Mexico have launched major bank privatisation programmes. In addition, the region has opened up to foreign banks, which increased their share of total assets in Latin America's banking systems to 40% in 2000 from about 10% in the mid-1990s. By bringing in capital, know-how and technology, foreign banks have strengthened the soundness and stability of banking systems in the region.

... but real bank lending continued to decline

Despite the increased presence of foreign banks and the easing of monetary conditions, bank credit contracted in real terms in 2000, except in Brazil, Chile and Venezuela. One explanation for this phenomenon was the apparent reluctance of foreign banks to lend to public enterprises as well as small and medium-sized firms perceived to be risky and to lack adequate collateral. Moreover, following privatisations, many branches where managers had a good knowledge of their local customer base were closed. Lending behaviour of domestic banks may also have turned more conservative because of the need to restructure operations in an environment of increased competition. In *Mexico*, for example, bank credit to the private sector, relative to GDP, has fallen by half since 1994, even though some $76 billion of public funds were spent on restructuring banks' balance sheets. In contrast, credit from suppliers and non-bank sources in Mexico expanded strongly, so that production, exports and household purchases of durables were not affected. Also vulnerable were the region's small and medium-sized banks, totalling about 300 in Argentina, Brazil and Mexico. Several such banks collapsed in Peru last year. Due to growing competitive forces, the continued existence of others may depend on whether they are able to refocus their business strategy on niche markets.

Africa

Growth improved in 2000

Helped by higher real income growth in oil-exporting countries and some recovery in non-fuel commodity prices, Africa experienced an improvement in economic activity last year. However, at 3%, average growth remained below that of other regions. Once again, Africa's low degree of integration in the world economy and its undiversified export structure prevented it from reaping the benefits of a surge in world trade. While the sharp rise in oil prices boosted economic activity in North and West Africa, most sub-Saharan countries suffered substantial terms-of-trade losses and a sharp deterioration in their current account deficits. Nevertheless, countries with a sounder policy environment and a better infrastructure such as Botswana and Tanzania still managed to improve their growth performance. In contrast, growth suffered in those countries that were affected either by civil strife (the Democratic Republic of Congo and Zimbabwe) or adverse weather conditions (Kenya).

Higher inflation and external imbalances

Inflationary pressures rose in several countries, driven by the oil price rise and unsustainable fiscal expansion. For example, in Ghana and Zimbabwe annual inflation rates last year rose to 25% and over 50% respectively, in the wake of a sharp deterioration in their fiscal balances. In contrast, inflation in the CFA zone was about 2%, with some countries even experiencing price deflation. In many countries, rising fiscal imbalances seem to have influenced fragile external balances, raising external financing requirements to high levels.

Growth recovered in South Africa but unemployment remained high

South Africa experienced a rebound of growth last year. The recovery was accompanied by an improvement in productivity as well as a strengthening of the fiscal position. The improved performance of the economy was reflected in a low current account deficit, a reversal of capital outflows and, after a steep fall in the value of the rand, the return of stability to the exchange market. Yet the continuing slide in the employment rate in the formal sector remains of serious concern. Thus, the economy continues to face the challenge of lowering real wages to create scope and incentive for firms to expand employment and to raise the level of investment. This is the only sound basis for a lasting increase in living standards.

Increasing investment is key to promoting growth

Looking forward, the most important challenge facing virtually all African economies is how to step up the low rate of saving and investment. The principal restraint on both remains poor governance. Much needs to be done to put in place sound macroeconomic policies and to restore confidence in the rule of law. It is also essential to build a financial infrastructure that will help improve confidence and channel domestic as well as foreign savings to appropriate areas. Despite attempts to liberalise the financial system, government control over the banking system has remained pervasive and regulatory and legislative infrastructures inadequately developed. Investment prospects are also affected by increased political uncertainty, which takes its predictable toll on the credibility of fiscal and monetary policy regimes. As a result of these shortcomings, net capital flows to Africa account for a very small portion of the aggregate flows to emerging market economies. Indeed, many African countries have experienced net outflows in recent years. It has also been particularly unhelpful that the prospects for export diversification have been impaired by inadequate access to markets in advanced economies. The European Union started to remove restrictions on agricultural exports from Africa in 2000 and has urged other countries to follow its lead.

Middle East

Oil revenues stimulated output of oil exporters

Stimulated by higher oil prices and increases in oil production, average GDP growth in the Middle East rose last year to almost 5%, the highest rate in about a decade. For the major oil exporters, the balance of payments surplus averaged 15% of GDP. However, since the revenue gains were mostly used to pay back debt or strengthen fiscal balances, inflation remained low, except in *Iran* and *Yemen*. To reduce their vulnerability to volatile oil prices, major oil exporters, led by *Saudi Arabia*, have proceeded with reforms to strengthen the non-oil producing sectors while, at the same time, attempting to stabilise crude oil prices by adjusting the supply of oil to expected demand.

Slightly lower growth in most other countries

In countries less reliant on oil exports, growth slowed somewhat compared with 1999. In *Egypt*, for instance, a liquidity crisis in the banking sector and resulting slower credit growth adversely affected output early last year. Moreover, following major structural changes in the mid-1990s, the reform process seems to have stalled in recent years. The growth performance of *Jordan* and *Syria* improved somewhat in 2000 and inflation remained low. Yet, as in Egypt, progress with trade and foreign investment reforms seems to have slowed. *Israel* saw average growth increase to 6% last year. However, given its reliance on exports of high-tech products, it was among the first countries to feel the effects of the turnaround in the global electronics cycle. On the other hand, with inflation well below the central bank's target and the general government budget deficit having been reduced to less than 1% of GDP, policy constraints have become less binding.

Central and eastern Europe

Growth and external sector developments

Positive growth recorded by all transition economies

For the first time since 1988, real GDP in all European transition economies and former Soviet republics rose in 2000, with average growth reaching almost 6% and growth rates converging across the region. The highest rate of expansion was achieved by the oil- and gas-exporting economies (including Russia), while some of the resource-poor and inward-oriented former Soviet republics recorded rather low rates. The growth of consumption generally remained below that of GDP, while investment strengthened noticeably in the Czech Republic, Hungary, Russia and Ukraine.

Growth driven by exports and oil

Growth in 2000 was for the most part externally driven, supported by the strong expansion in the European Union and high oil prices. Current accounts improved visibly, with Russia recording a large surplus and most other transition economies smaller deficits. Besides paying for higher imports, the transition economies used increased export revenues to build up reserves and reduce their external debt.

Russia's recovery strong but due to transient factors

In *Russia*, the real effective exchange rate rose sharply but remained some 30% below its pre-crisis level, stimulating growth in both export-oriented and import-competing industries. Higher profitability in these industries, in turn, stimulated investment, as retained earnings remained the principal funding source given Russia's underdeveloped financial markets. The downside of the economic expansion was further delay in the implementation of structural reforms, in particular to improve the tax system and public administration. Moreover, weaker industrial growth and a higher inflation rate in the first quarter of 2001 indicated that the positive effects of high energy prices and the rouble's devaluation have begun to wear off. Prospects for the Russian economy thus remain highly dependent on the future development of energy prices and external competitiveness.

Inflation, macroeconomic policies and unemployment

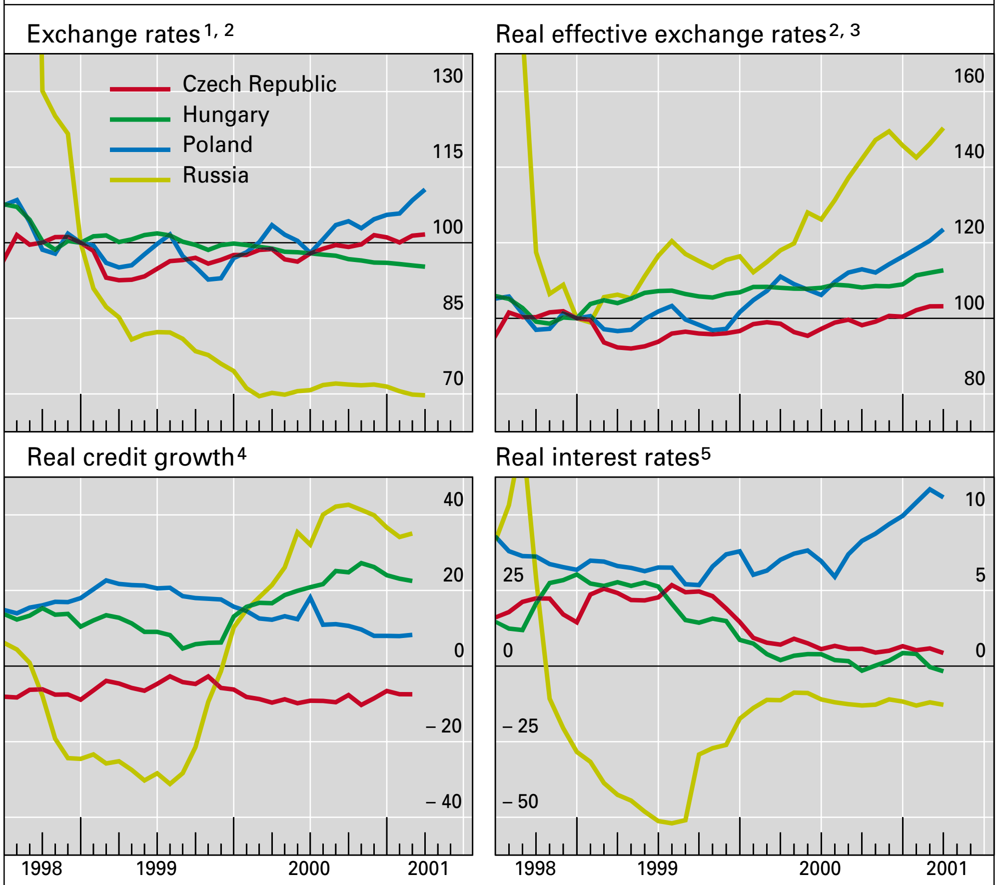
Inflation accelerated

Inflation accelerated throughout the region, except in Russia, with the price of oil and gas being the main contributing factor. Other cost-push factors included adjustments in VAT and excise tax rates and administered prices. As utilities remained largely state-owned, increases in administered prices were deemed necessary to reduce public sector deficits and enhance allocative efficiency, in spite of their short-term effects on inflation. In Russia, by contrast, higher world energy prices enabled the authorities to postpone adjustment of administered prices until early 2001, which provided an implicit subsidy to energy users, particularly in the industrial sector.

Interaction of interest rates and exchange rates

Because of buoyant economic activity, macroeconomic policies in the region became focused on possible signs of overheating. Early in the year, capital inflows into Poland and the Czech Republic were strong. This led to pressures for an appreciation of nominal exchange rates and was one factor behind the floating of the zloty in April 2000 (Graph III.5). As the oil import bill surged and domestic demand strengthened, trade deficits widened or remained high. In response, the *Polish* central bank raised interest rates by 250 basis points between January and August 2000. Moreover, it was reluctant to lower them subsequently, partly out of concern for its own credibility as inflation targets had been missed two years in a row. In addition, the central bank felt that fiscal policy was too expansionary and thus cut interest rates only following the announcement of a relatively tight budget for 2001. The *Czech* authorities, by contrast, left nominal interest rates unchanged as the appreciation of the koruna reduced the inflation threat and the economy was still recovering from a prolonged recession in 1997–99. The *Hungarian* central bank raised overnight rates in October in response to signs of rising inflation. It noted that it would have preferred to let the forint appreciate by widening the exchange rate band, given the strong competitive

Financial market developments in central Europe and Russia



[1] Euros (for Russia, US dollars) per unit of domestic currency. [2] December 1998 = 100; an increase indicates an appreciation. [3] In terms of relative consumer prices. [4] Annual percentage changes; domestic credit to the private sector deflated by consumer prices. [5] Short-term rates deflated by the annual rate of inflation, in percentage points (for Russia, left-hand scale).

Sources: IFC; IMF; national data; BIS calculations. Graph III.5

position of manufacturing, but the government maintained that such a move would be premature and could dampen export growth.

Money demand expanded in Russia

In Russia, high oil receipts and upward pressure on the rouble allowed the central bank to acquire $16 billion of reserves in 2000, which resulted in an expansion of 60% in base money. Possible inflationary implications of this expansion were muted by a revival in money demand. However, its implications for banking stability were potentially serious, as real interest rates remained negative and the banking sector lacked the expertise to extend a large volume of loans in a prudential manner.

Increases in fiscal revenues as well as spending

Fiscal policies were, for the most part, accommodative: the Baltic states reduced budget deficits perceptibly, while Hungary kept its deficit at about the same level as in 1999. The deficit in the Czech Republic widened to 5% of GDP owing to the cost of rescuing the country’s third largest commercial bank. Russia recorded a large budget surplus in 2000 in spite of spending much of the increased oil revenue on clearing wage arrears and raising minimum wages and pensions.

Employment growth still weak

Strong economic expansion brought little relief to the transition economies' labour markets. The Czech Republic and Hungary managed to keep the rate of unemployment under 10% in 2000, while in other transition economies the rate averaged 15–25%. Labour productivity growth in industry averaged close to 15% in 2000 but, with the exception of Hungary, it was achieved largely through cuts in employment. In Russia, however, the labour market did improve significantly and the unemployment rate dropped by 2 percentage points to 10%. While real incomes grew by 10%, real wages remained below pre-crisis levels.

Labour market reform requires deregulation and tax reform

Hungary's relatively good record of job creation indicates that, in addition to maintaining macroeconomic stability and attracting foreign investment, the essential ingredients of a successful employment strategy are labour market deregulation and tax reform. In particular, since jobs in the formal sector are highly protected and workers in the informal sector often pay no tax, employers' social security contributions in the formal sector often amount to 15–20% of GDP compared with 9% in western European countries. This disproportionate tax burden, together with rigid tax laws, significantly increases both the cost and the risk of hiring new employees in the formal sector. Moreover, because of the pressure of unemployment on government budgets, there is the need to run a relatively restrictive monetary policy, which further constrains the scope for growth-oriented policies.

Crisis in Turkey

Disinflation dependent on structural reforms

Following the adoption of a disinflation programme in late 1999, real growth in Turkey accelerated and confidence returned to financial markets. Output expanded by an estimated 6% in 2000 after a 5% decline the previous year. By the end of October, inflation had fallen to 44% from a 65% annual average in 1999, and overnight interest rates had dropped to 26%. The main objective of the programme was to bring inflation down to single digits by 2003 through structural reforms that would curtail government spending and a crawling peg exchange rate regime. With interest payments on the public debt equivalent to around 14% of GDP at end-1999, the programme was highly sensitive to shifts in confidence and any departure from the assumed pace of structural reforms.

The November crisis was resolved quickly ...

Unfortunately, the sharp rise in oil prices, the vulnerability of local banks in an environment of declining inflation and interest rates, and delays in privatising key state assets gradually worsened the programme setting. Moreover, inflation did not decline sufficiently fast to prevent a loss of external competitiveness, so that the current account deficit widened to nearly 5% of GDP in 2000. As a result, market interest rates rose sharply in late November 2000 and liquidity dried up in the interbank market, causing a medium-sized bank to fail. The ensuing crisis was resolved through a $10 billion IMF support package that envisaged putting structural reforms back on track.

... but underlying vulnerabilities were not addressed

In early 2001, political disputes led domestic and foreign investors to question anew whether the government commanded sufficient public trust to implement the measures necessary to restructure the weak banking sector and to cut inflation. The loss of investor confidence led to large capital outflows and a steep rise in interest rates, which forced the authorities to abandon the crawling peg exchange rate regime in late February. With the lira allowed to float freely, the central bank was in a position to provide more liquidity and the exchange rate, along with equity and bond prices, stabilised in late March, some 30–40% below the pre-crisis levels.

High costs of the crisis in February

The costs of the crisis and its impact on the public sector were considerable. Although exports of goods and tourism services are expected to benefit from the lira devaluation, Turkey could experience a fall in output in 2001. In the short term, inflation seems set to increase sharply as well since, historically, the pass-through of exchange rate movements has been high in Turkey. Moreover, with the stock of short-term external debt estimated at 14% of GDP at the end of 2000, the domestic currency burden of servicing this debt has increased by a third since the depreciation in February 2001. Finally, commercial banks taken over by the government in the last two years are estimated to have some $12 billion of non-performing loans. Agreement on a rollover of debt and a credible package of banking reforms thus remain critical in achieving macroeconomic stabilisation in 2001.

Changes in the inflation process in the emerging market economies

Sharp drop in inflation in the second half of the 1990s

A welcome aspect of the recent macroeconomic performance of the emerging market economies has been their success in reducing inflation. High inflation (in the range of 30–100%) has almost disappeared among the major economies and fewer countries are now even in the moderate inflation range (15–30%). Indeed, many have reached or are steadily approaching inflation rates that are comparable with those in the industrialised economies.

During the 1990s, many countries implemented wide-ranging structural and policy reforms, often following financial crises. The most notable of these changes have been the significant regime shifts in monetary and exchange rate policies. Moreover, a sharp decline in fiscal deficits, price liberalisation, market reforms and the growing pace of globalisation have all had a considerable impact on inflation (see Chapter II for similarities with the industrial countries). Nevertheless, conducting monetary policy in a low-inflation environment has also posed challenges: inflation not only has to decline, it also has to be stabilised at a low level. To the extent that achieving low inflation has strengthened the credibility of central banks, this will make their task easier.

Main features of recent disinflation

A widespread phenomenon with longer-term benefits

Several features of the disinflation process are noteworthy. First, compared with previous sporadic episodes, the recent decline in inflation is more widespread (Graph III.6, left-hand panel) and has been part of the global phenomenon referred to in Chapter II. Second, it has typically been associated with an increasing focus on price stability in the conduct of monetary policy as well as the adoption by many countries of an inflation targeting regime. Third, output costs of disinflation have differed considerably across countries and seem to be negatively related to the initial level of inflation. Nevertheless, the cross-country relationship between growth and inflation during the second half of the 1990s (Graph III.6, right-hand panel) still suggests that lower inflation will eventually produce permanent output gains that more than compensate for the temporary costs of bringing inflation down. This is particularly evident for the Asian economies, which were able to combine low inflation with high growth for most of the last decade.

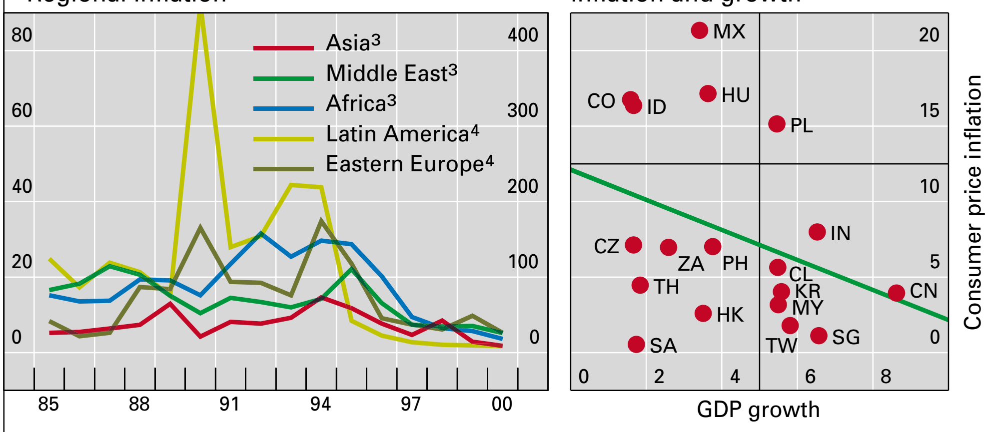
Varying speed of disinflation

The speed of disinflation has varied significantly across regions and countries. In the Asian economies, where inflation has historically been low, it fell further to between 2 and 5% in the second half of the 1990s and in some economies even to negative levels. The contraction of output played a major role in this and more than offset the effects of rising fiscal deficits and depreciating exchange rates. Latin American countries have experienced a particularly rapid rate of disinflation in recent years: the typical inflation rate fell from moderate or high levels to less than 5% in a number of countries. In Argentina, prices have actually declined over the past two years. The transition to lower inflation in Latin America was preceded by important macroeconomic policy changes such as the adoption of fixed exchange rates, the de-indexing of wages and prices to past inflation and a sharp reduction in fiscal deficits. More recently, several countries have abandoned the traditional fixed or crawling exchange rate regime and adopted a proactive anti-inflation strategy such as inflation targeting.

Relative price shifts in the transition economies

The central and eastern European economies faced a different situation during much of the 1990s as inflation was affected by the large-scale liberalisation of prices following the transition to a market economy. While relative prices are still adjusting, many countries have nevertheless moved

Inflation and GDP growth



BR = Brazil; CL = Chile; CN = China; CO = Colombia; CZ = Czech Republic; HK = Hong Kong; HU = Hungary; ID = Indonesia; IN = India; KR = Korea; MX = Mexico; MY = Malaysia; PH = Philippines; PL = Poland; SA = Saudi Arabia; SG = Singapore; TH = Thailand; TW = Taiwan; ZA = South Africa.

[1] Annual percentage change in consumer prices. [2] Average over the period 1995–2000. [3] Left-hand scale. [4] Right-hand scale.

Sources: IMF; national data; BIS estimates. Graph III.6

below the moderate inflation range by stabilising wages and tightening fiscal and monetary policies. In the larger central European economies, the move towards lower inflation has been driven by the requirements for their eventual accession to the European Union. At the other policy extreme, several of the newly independent transition economies have adopted currency boards to achieve low inflation. In Africa too, inflation has fallen across the board, with South Africa, for instance, having reduced inflation to only half the level of the early 1990s.

Sources of disinflation

Negative output gaps have kept inflation low

What factors explain disinflation in the emerging market economies? Weak demand has tended to curb inflation, as actual was below potential output in many countries during the second half of the 1990s, particularly after the 1997–98 crisis in Asia. Since firms are often forced to reduce mark-ups during a cyclical downswing, this explanation suggests that inflation could move up as demand conditions improve.

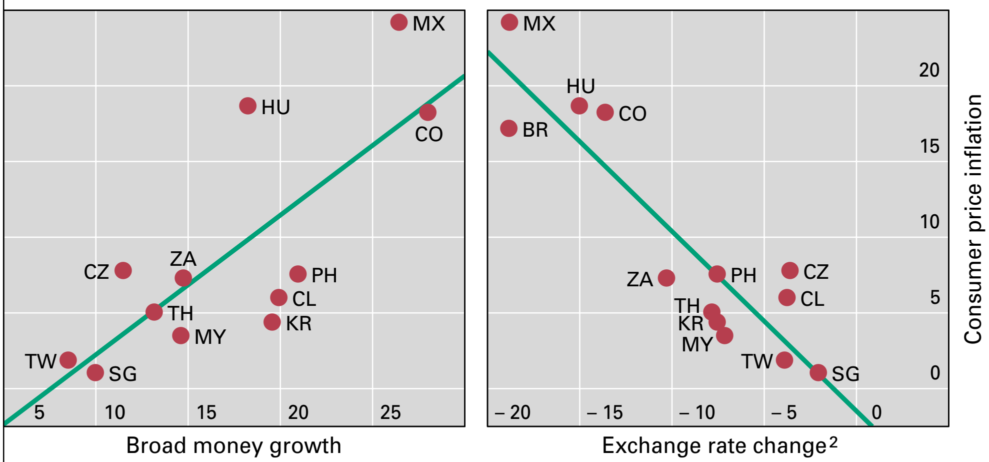
Monetary growth has also declined

Among other proximate causes, one is the link between inflation performance and the rate of monetary growth. Countries with low inflation have generally experienced low rates of monetary growth (Graph III.7). Nevertheless, annual rates of monetary growth have exhibited high volatility and thus appear to be only marginally aligned with the recent decline in inflation. For instance, in many Asian economies, broad money growth has not decelerated noticeably in recent years but inflation has declined nonetheless. One reason may be that money demand has increased in the wake of financial deepening in Asia and perhaps raised the threshold level of non-inflationary monetary growth.

Fiscal policy a major driving force

What seems better established is that disinflation has typically been preceded by up-front fiscal adjustments followed by fundamental tax and expenditure reforms, sometimes including a medium-term fiscal sustainability

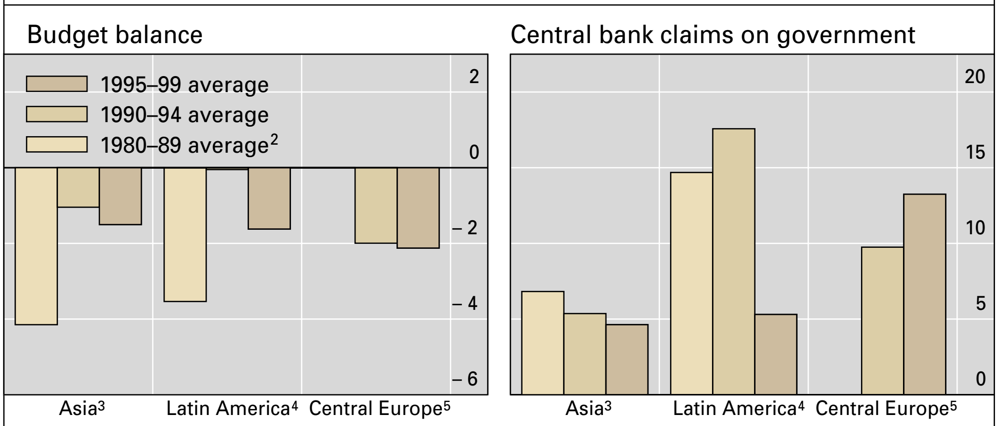
Consumer price inflation and selected determinants[1]



Note: For an explanation of the country codes, see Graph III.6.

[1] Average annual percentage change over the period 1995–99. [2] US dollars per unit of local currency.

Sources: IMF; national data. Graph III.7



[1] As a percentage of GDP; unweighted average of the countries listed below. [2] Data for central Europe not available. [3] India, Korea, Malaysia, the Philippines and Thailand. [4] Brazil, Chile, Mexico and Peru. [5] The Czech Republic, Hungary and Poland.

Sources: IMF; national data. Graph III.8

framework. Fiscal balances have been particularly strengthened in Latin America (Graph III.8), where earlier chronic high inflation was often linked to the monetisation of large fiscal deficits. Financial deepening in all regions has also tended to decouple monetary movements from temporary fiscal problems by allowing the financing requirements of governments to be shifted to the market. Apart from reducing the inflationary bias of fiscal policy, a low fiscal deficit, to the extent that it resulted from tax and expenditure reforms, may also have played a role in generating positive supply side effects.

The role of exchange rate regimes

Historically, exchange rates have played an important role in the inflation process in the emerging market economies, particularly in those (mainly Latin American countries) with a long record of high inflation and volatile capital flows. The degree to which exchange rate changes are reflected in domestic prices depends not only on the competitive conditions facing firms and the state of the business cycle, but also on whether such changes are seen as permanent or temporary. Many countries in the past adopted fixed exchange rates as nominal anchors to achieve low inflation. Thus the fixing of exchange rates traditionally played a role in reducing inflation from high levels (if only temporarily) in many Latin American and central European economies. Fixed exchange rates also helped to deliver low and stable inflation in the East Asian economies before the 1997–98 crisis.

The move to flexible exchange rates …

Relying on an exchange rate anchor for disinflation had a downside risk. In many cases – most recently in Turkey – this approach led to a deterioration in external competitiveness and increases in the current account deficit that ultimately proved unsustainable. As a result of the vulnerability of fixed exchange rate regimes to currency attacks, particularly in the presence of a weak banking system and growing capital flows, there has been a movement towards either a more flexible regime or a hard peg. The majority of countries have opted for flexibility. Those that have opted for a hard peg (a currency board or dollarisation) have recognised that it would leave them with little room for an independent monetary policy. Conversely, those opting for a flexible exchange rate regime have retained a role for domestic monetary policy. But, while in principle allowing the exchange rate to be flexible, in practice, they have often attempted to strike a balance between the objectives of ensuring external competitiveness and limiting the exchange rate pressure on domestic prices. Typically this has been done by intervening in the foreign exchange market and/or by moving short-term policy rates.

... was followed by contained depreciation ...

The recent move towards flexible exchange rates has not, however, been accompanied by a rise in inflation. In Latin America this was particularly unexpected since, historically, depreciation has had immediate effects on inflation expectations. One reason is that the recent transition to a flexible exchange rate regime in the midst of crisis has typically coincided with excess capacity and global disinflation, offsetting part of the direct impact of exchange rate changes on consumer inflation. Moreover, as alluded to above, many countries succeeded in preventing their exchange rates from depreciating significantly, despite their declared intention to float (see Chapter V).

... and a lower pass-through

In addition, a credible stability-oriented monetary and fiscal policy may have contributed to moderating wage and price expectations. The greater fiscal prudence in Latin America referred to above was of crucial importance in this regard. Finally, over the past decade many countries have implemented far-reaching structural reforms aimed at improving domestic competitive conditions. A particularly important change has been the increasing integration of emerging market economies into the global economy. As a result, the capacity of firms to pass on import costs into final prices when the exchange rate depreciated has been significantly constrained (see Chapter II). As the share of the new economy increases in the emerging markets, these global pressures seem set to intensify further.

Keeping inflation low

One important issue arising from the above is whether the current low inflation rates will be sustained. In other words, have macroeconomic policy changes significantly reduced the risk of a recurrence of high inflation?

Keeping inflation low when fiscal risks are still present

A fundamental prerequisite for sustaining low inflation is eliminating the potential inflationary bias of fiscal policy. The active use of fiscal policy to support growth during a recession needs to be followed by measures to reduce deficits once recovery starts. Increasing debt servicing burdens due to the high cost of recapitalising the banking sector and the associated rise in public sector debt levels could pose a threat to fiscal credibility, particularly in some of the previously fiscally sound East Asian economies. Moreover, progress with long-term fiscal reform has been hampered by the slow pace of privatisation of state-owned enterprises and political resistance to more fundamental adjustments to taxes and expenditures. To the extent that these factors raise doubts about the long-term sustainability of fiscal policy, they affect the credibility of fiscal regimes and hence the expectation that inflation can be maintained at a low level.

Policy credibility is crucial

Another critical question is how far the decline in inflation has become self-fulfilling. The indexation of wages and prices generally decreases as inflation falls since the need for protection against high inflation disappears. Insofar as inflation expectations also decline, increases in nominal wages would reflect productivity improvements better, thus lessening the role of "catch-up" wage pressures in the inflation process. Moreover, producers would be more reluctant to pass on temporary cost increases into prices. A related effect is that a low and stable inflation environment enhances the transparency of relative price movements, sharpening the response of consumers to price changes and increasing price competition among firms. The strength of this effect depends on how far economic agents perceive the decline in inflation to be permanent.

Inflation targeting can bring long-term benefits ...

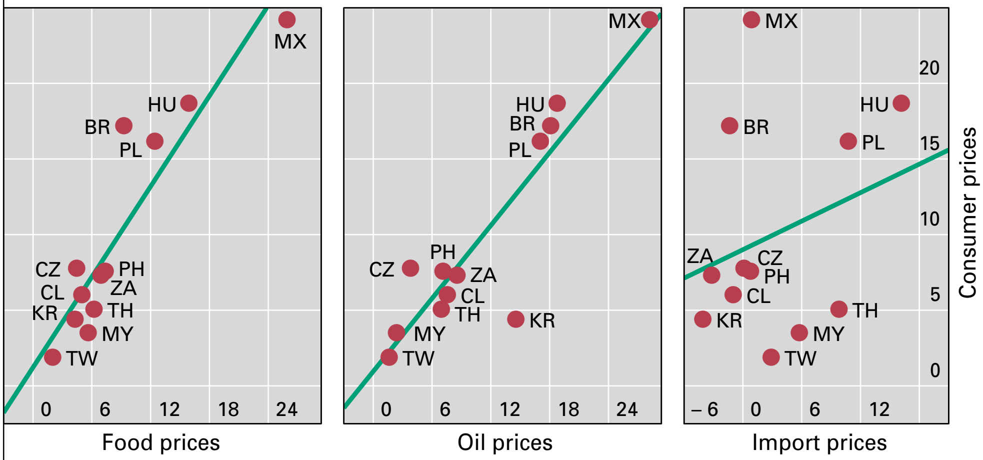
To help reduce future inflation risks, a number of countries have recently adopted inflation targeting. This strategy offers several potential advantages. First, the commitment of monetary policy to price stability is particularly important for countries with a history of fiscal excesses and monetary mismanagement. An inflation targeting strategy should help central banks resist political pressures and encourage them to focus on a consistent objective over time. Second, the transparency and accountability of inflation targeting can be exploited by central banks to promote public communication so as to gain support for and enhance the credibility of the anti-inflation regime. Third, once inflation has been reduced to a low level, the forward-looking approach of inflation targeting provides a mechanism by which central banks can lower long-term inflation expectations in the economy. This would be an important advantage since, especially for Latin America, actual reductions in inflation do not in themselves seem sufficient to lower the inflation expectations incorporated in nominal bond rates by similar amounts.

... but potential problems remain

Yet to realise these advantages several conditions must be met. One is that the financial system be strong enough to adjust to interest rate variations by the central bank. In addition, the exchange rate must be sufficiently flexible to absorb exogenous shocks but not so volatile as to pose a threat to price stability. The potential for conflict between internal and external objectives is particularly high in countries which are relatively more exposed to external shocks and have large unhedged foreign liabilities. Further, targeting the inflation rate implies adequate knowledge of the variables driving inflation. Modelling this process constitutes a separate challenge, given poor data, high volatility of certain inflation components and imperfect knowledge of the transmission mechanism of monetary policy changes.

The extent to which the current low inflation rate is sustained also depends on short-run supply factors. The sensitivity of inflation to import prices (notably oil prices) tends to be higher than in industrialised economies because of the greater dependence on imports. In addition, food prices are affected in large measure by agricultural shocks and are, therefore, volatile. Relative prices and the average rate of inflation may also be influenced by changes in administered prices. This factor has played a particularly important role in the transition economies, where large-scale price deregulation in the early 1990s led to a ratcheting-up of overall inflation in the short run while, in some cases, the pressure spilled over to the longer term through monetary

Consumer price inflation and selected components[1]



Note: For an explanation of the country codes, see Graph III.6.

[1] Average annual percentage change over the period 1995–99.

Sources: IMF; national data.

Graph III.9

accommodation. However, countries that have kept administered prices artificially low face a similar "catch-up" problem.

Graph III.9 demonstrates the cross-country relation between changes in food, oil and import prices and the economy-wide rate of inflation during the second half of the 1990s. As is evident from the graph, in several cases favourable supply shocks have played a large part in the recent decline in inflation. However, to the extent that these supply factors are reversible, they pose a challenge to central banks in maintaining future price stability. While this might suggest that the volatile supply components should be excluded from the inflation target, doing so risks increasing public confusion over what price stability really means.

Unrealistic inflation targets should be avoided

Given all these complications, a broad consensus has developed that neither industrial countries nor emerging market economies should attempt to achieve a given inflation target over too short a period. One important consequence of having an inflation target that is unrealistic, or defined within too narrow a range, is that it might require large interest rate movements, in particular when the economy is affected by adverse supply shocks. Especially for emerging market economies, this trade-off between price and interest rate stability needs to be considered seriously. Failure to meet an explicit inflation target may undermine the credibility of the monetary authority, but the interest rate changes required to meet the target may have severe economic repercussions, especially if the banking system is weak.