III. Developments in the emerging market economies

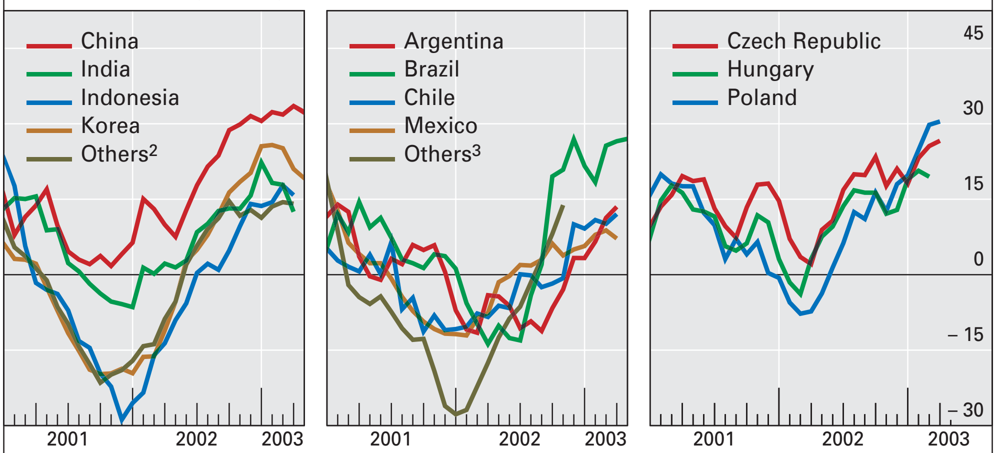
Highlights

The moderate but uneven recovery in developed economies in 2002 was associated with sharp divergence in the growth rates of emerging economies. This reflected differences in demand as well as external financing constraints. Relatively robust growth in Asia and central and eastern Europe (CEE) was underpinned by a broad recovery in exports in 2002 (Graph III.1, Table III.1), notwithstanding the modest pace of activity in developed economies. Export growth in Asia, while boosted throughout by demand from China, slowed in early 2003. In CEE, export growth was supported by sales to a wider range of countries. In contrast, financing constraints contributed to slower or negative growth, import compression and reductions in current account deficits in Latin America (Table III.1). However, exports began to raise growth in the region in the second half of 2002, in the wake of large real currency depreciations. External financing conditions also improved in the last quarter of 2002 and continued to do so in the first quarter of 2003.

The consensus forecast is that growth should recover modestly in Latin America, based on expectations that exports will continue to grow and that the recent easing in external financing conditions will be sustained. However, persistent geopolitical uncertainty and the spread of the SARS virus have led to a significant weakening in Asia. In contrast, growth is expected to rise in CEE and Africa (Tables III.1 and III.8).

Exports

Annual percentage changes[1]



[1] Three-month moving averages, in US dollar terms. [2] Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [3] Colombia, Peru and Venezuela.

Sources: IMF, *International Financial Statistics*; national data.

Graph III.1

Output growth, inflation and current account balance									
	Real GDP[1]			Consumer prices[1]			Current account balance[2]		
	Average 1998–2001	2002	2003	Average 1998–2001	2002	2003	Average 1998–2001	2002	2003
Asia[3]	5.4	6.2	5.8	2.8	1.1	2.1	3.7	2.9	1.9
China	7.5	8.0	7.2	–0.3	–0.7	0.4	2.1	2.1	1.1
Hong Kong SAR	2.0	2.2	1.7	–1.7	–3.0	–2.2	4.1	9.7	10.5
India	5.5	4.4	5.8	5.2[4]	2.3[4]	4.9[4]	–0.8	0.7	0.3
Indonesia	–1.7	3.7	3.5	21.9	11.9	8.2	4.6	4.1	3.0
Korea	3.9	6.3	4.2	3.6	2.8	3.5	5.3	1.3	0.2
Malaysia	1.7	4.1	3.8	2.7	1.8	1.6	11.5	7.7	6.8
Philippines	2.6	4.6	3.6	6.7	3.1	3.9	7.8	5.7	3.3
Singapore	3.2	2.2	2.1	0.7	–0.4	0.8	21.0	21.5	20.9
Taiwan, China	3.4	3.5	2.9	0.8	–0.1	0.1	3.4	9.1	6.6
Thailand	–0.1	5.2	4.2	2.9	0.5	1.9	9.0	6.1	4.7
Latin America[3]	1.7	–0.6	1.5	7.7	9.4	10.3	–3.1	0.2	0.1
Argentina	–1.0	–10.9	4.6	–0.6	25.9	12.7	–3.6	8.8	7.1
Brazil	1.7	1.5	1.9	5.5	8.4	12.2	–4.4	–1.7	–0.8
Chile	2.8	2.1	3.4	4.0	2.4	3.2	–2.2	–0.8	–1.0
Colombia	0.2	1.5	2.2	12.3	7.2	6.4	–1.4	–1.8	–2.5
Mexico	3.7	0.7	2.2	11.6	5.1	4.2	–3.1	–2.2	–2.5
Peru	1.1	5.2	4.0	4.1	0.2	2.4	–3.5	–2.0	–2.0
Venezuela	–0.0	–8.9	–13.7	21.7	22.4	44.7	3.9	9.6	8.6
CEE[5]	2.8	3.5	3.7	12.3	6.1	5.4	–4.8	–4.1	–4.2
Czech Republic	1.4	2.0	2.5	5.3	1.8	0.9	–3.7	–5.3	–5.6
Hungary	4.5	3.3	3.5	10.8	5.3	4.8	–3.5	–4.0	–4.7
Poland	3.5	1.3	2.8	8.6	1.9	1.2	–5.5	–3.6	–3.6
Russia	3.9	4.3	4.8	36.6	16.3	13.3	10.2	9.5	7.4
Turkey	–0.6	7.8	3.8	64.3	45.0	28.1	–0.8	–1.0	–1.8
Memo: G7 countries	*2.5*	*1.6*	*1.7*	*1.8*	*1.3*	*1.8*	*–1.0*	*–1.5*	*–1.6*

Note: Figures for 2003 are based on May consensus forecasts and IMF, *World Economic Outlook*.

[1] Annual percentage changes. [2] As a percentage of GDP. [3] Weighted average of the countries shown, based on 2000 GDP and PPP exchange rates. [4] Wholesale prices. [5] Simple average of Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia.

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

Large budget deficits in several CEE countries represent a major challenge, particularly in view of EU accession. A number of Latin American countries also face difficult policy issues. In some countries, high and rising debt burdens require fiscal adjustment. In others, the main task will be to contain rising inflation expectations, particularly where inflation targets have recently been breached. In both respects, the room available to stimulate domestic demand in the face of negative shocks will be very limited.

Balance of payments developments

Surpluses and capital flows grew in Asia ...

The current account surpluses of emerging market economies as a group increased by $30 billion in 2002. Surpluses in Asia rose sharply, while in Latin America deficits fell. At the same time, private capital flows to emerging economies more than doubled (Table III.2). Capital inflows rose in Asia and the transition economies (including the Commonwealth of Independent States and Mongolia), although they fell sharply in Latin America, leading to significant external financing constraints for a number of economies in the region.

… as did foreign reserves

The main counterpart of larger current account surpluses and increased capital inflows was a substantial rise in international reserves in emerging markets, of $90 billion. Reserves in Asia nearly doubled to $167 billion in 2002 (Table III.2). In contrast, there was almost no change in foreign reserves in Latin America. This is broadly in line with trends since the Asian crisis of 1997. Among the Asian countries listed in Table III.1, the median ratio of foreign reserves to GDP increased from 12% in 1996 to 26% in 2002. Reserves calculated on a similar basis for Latin America remained unchanged at 10%. Reserve accumulation is the outcome of diverse macroeconomic forces and policies; few central banks have an explicit target for reserves. Nevertheless, the large accumulation of foreign reserve holdings in Asia appears to reflect efforts by Asian monetary authorities to limit exchange rate fluctuations and reduce economic vulnerability.

Balance of payments in emerging economies[1]

In billions of US dollars

	Average 1995–96	Average 1997–2000	2001	2002
Current account balances	92	9	84	114
Asia	–34	77	78	102
Latin America	–39	–65	–53	–17
Transition economies	–9	–8	12	10
Middle East and Turkey	1	15	48	26
Africa	–11	–9	–0	–8
Private capital flows	218	69	39	86
Asia	111	–11	16	70
Latin America	52	56	35	2
Transition economies	36	14	21	34
Middle East and Turkey	9	1	–38	–25
Africa	11	10	6	6
Changes in reserves[2]	–114	–79	–119	–209
Asia	–45	–53	–85	–167
Latin America	–26	0	1	–1
Transition economies	–21	–9	–18	–31
Middle East and Turkey	–17	–11	–5	–8
Africa	–5	–6	–12	–1
Memo: Private capital flows by type	*218*	*69*	*39*	*86*
Foreign direct investment	*102*	*148*	*171*	*139*
Portfolio investment	*72*	*26*	*–39*	*–37*
Other[3]	*44*	*–105*	*–93*	*–17*

Note: Official financing is not included.

[1] Includes developing countries, Israel, Korea, Singapore and Taiwan (China), but not Hong Kong SAR. [2] A negative value indicates an increase in reserves. [3] Includes banking flows.

Source: IMF, *World Economic Outlook*. Table III.2

Conditions in developed markets influenced flows …

The direction of capital flows partly reflected conditions in developed financial markets, where ample liquidity, in the form of low policy interest rates, was countered for much of the period by declining investor risk appetite (see Chapter VI). This led, from mid-2002, to a widening in the spreads on high-yield and sovereign bonds, a trend that reversed towards the last quarter of 2002 as the cost of sovereign financing eased significantly.

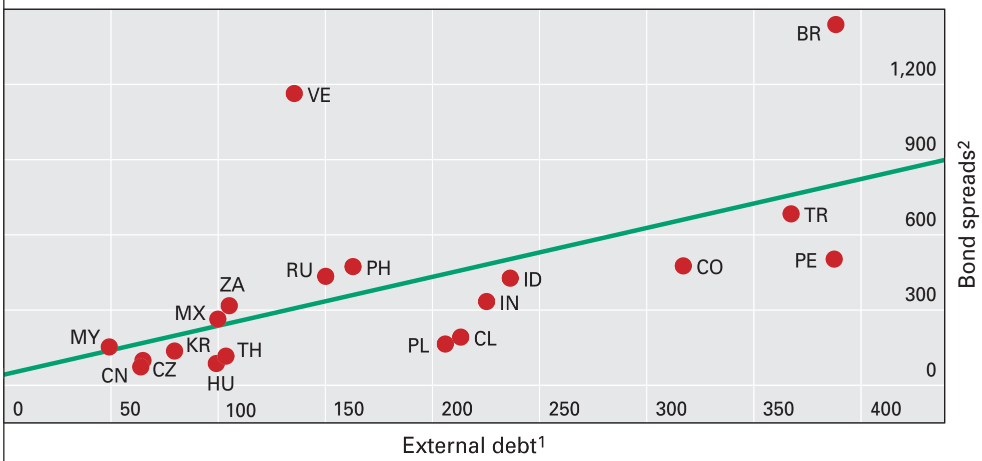
… as did domestic fundamentals

Although the changes in sentiment in international financial markets were a common driving factor, it was the fundamentals of the domestic economy that determined the magnitude of the spreads on a particular country's bonds. Concerns about external debt sustainability were particularly important: average spreads on international bonds in 2002 were positively related to the ratio of external debt to exports (Graph III.2). Brazil and Venezuela were outliers, with much higher spreads that primarily reflected growing political uncertainty. The sharp rise in Brazilian spreads began in May 2002, about a month before spreads widened in the US high-yield bond market. However, Brazilian spreads began showing a downward trend in the last quarter of 2002, as a newly elected administration took steps to reassure investors of its intention to pursue prudent policies. In Venezuela, spreads remained high because of continuing uncertainty about government policies and disruptions in oil production.

FDI also reflected fundamentals

The direction of foreign direct investment (FDI) and other flows also reflected country-specific fundamentals. Most of the FDI flows to East Asia (some from other East Asian economies) were concentrated in China, attracted by the opportunities offered by WTO accession and China's transformed role in the world economy. There were also sharp increases in other flows to Asian countries, partly reflecting a drawdown in their deposits with international banks. These funds may have found more profitable use within the rapidly growing Asian region. The opportunities offered by accession to the European Union also increased FDI in the economies concerned. Reduced growth and profit opportunities contributed to lower FDI in Latin America.

Bond spreads and external debt



BR = Brazil; CL = Chile; CN = China; CO = Colombia; CZ = Czech Republic; HU = Hungary; ID = Indonesia; IN = India; KR = Korea; MX = Mexico; MY = Malaysia; PE = Peru; PH = Philippines; PL = Poland; RU = Russia; TH = Thailand; TR = Turkey; VE = Venezuela; ZA = South Africa.

[1] As a percentage of exports; 2001. [2] Over benchmark US Treasury bonds, in basis points; 2002 average.

Sources: Datastream; IMF. Graph III.2

Asia

Growth in most Asian economies in 2002 exceeded expectations. It increased in both China and Korea and resumed in Hong Kong SAR (hereafter, Hong Kong) and Malaysia, while large output declines were reversed in Singapore and Taiwan, China (hereafter, Taiwan). Growth was also strong in Thailand, the Philippines and Indonesia. In contrast, India's growth slowed somewhat, as a drought depressed agricultural production. The regional recovery was led by domestic demand supported by expansionary policies (Table III.3), as well as a strong recovery in exports during part of 2002.

Growth exceeded expectations in Asia ...

Uncertainty about the outlook for Asia increased in the first quarter of 2003, following signs of weakness in external demand. It was greatly accentuated in April and May by the spread of severe acute respiratory syndrome (SARS) in China, Hong Kong and some other economies in Asia. Finally, growth prospects in South Korea were affected by tensions with North Korea and the failure of a major conglomerate with spillover effects on the financial sector.

... but uncertainty increased

Notwithstanding the uncertainty, China grew very rapidly in the first quarter of 2003, reflecting continued public spending on infrastructure, as well as strong increases in private consumption and investment spending. Private investment was stimulated by the increase in foreign investment flows following China's accession to the WTO in 2001. At the same time, rising urban incomes spurred household expenditures on high-value consumer durables and services. Such spending boosted industrial production in the first quarter of 2003, while a sharp increase in exports also contributed to the expansion.

In China private spending rose ...

In India, a decline in agricultural output lowered growth to a little below 4½% last year, even as the industrial sector staged a recovery and domestic demand remained strong. Exports of goods and services were boosted by very fast growth in software output, and by the expanded outsourcing to India of information technology (IT) and business services. Together with rising non-resident remittances, services exports contributed to a current account surplus

... while high-tech exports grew in India

Asia: domestic demand (DD) and net exports (NEX)

Percentage contribution to GDP growth

	China		Hong Kong SAR		India		Indonesia		Korea	
	DD	NEX	DD	NEX	DD	NEX	DD	NEX	DD	NEX
1996–2000	7.5	0.8	1.5	1.9	7.0	–1.2	–0.6	1.4	–0.4	4.9
2001	7.3	0.0	0.8	–0.2	5.3	0.1	4.9	–1.5	1.7	1.6
2002	7.3	0.7	–1.3	3.6	4.5	–0.2	1.9	1.8	4.5	2.0
	Malaysia		**Philippines**		**Singapore**		**Taiwan, China**		**Thailand**	
	DD	NEX	DD	NEX	DD	NEX	DD	NEX	DD	NEX
1996–2000	–0.3	4.9	2.6	1.1	4.9	1.4	5.1	0.7	–7.0	5.0
2001	0.1	0.3	5.2	–2.0	–6.3	3.9	–4.9	2.7	1.8	0.1
2002	6.3	–2.1	5.5	–1.0	–1.9	4.1	1.2	2.3	3.8	1.4

Sources: JPMorgan, *World Financial Markets*; national data. Table III.3

for the second year in a row. The government also introduced a number of important reform measures, which boosted investor confidence in the economy. These include the sale of some strategic companies to the private sector and laws to facilitate the recovery of bank loans.

Domestic demand led growth

Elsewhere in the region, domestic demand generally led growth in 2002 (Table III.3). In Korea, domestic demand was supported in the first half of the year by increased bank lending to the household and property sectors, but household spending has since slowed in the wake of policy tightening. Increased public and consumer spending also drove demand in Malaysia, the Philippines and Thailand. In Indonesia, consumer confidence rebounded following the resolution of some political uncertainties and the introduction of a number of important structural reforms. Stronger oil prices also boosted Indonesia's real income. In sharp contrast, the contribution of domestic demand to growth continued to be negative in Singapore and turned negative in Hong Kong. Both economies relied more on external demand to support recovery.

Explaining disinflation and deflation

Low inflation reflected the end of the regional boom ...

Average inflation in the region fell to 1.1% last year, well below the average in 1998–2001 (Table III.1). Deflation deepened in Hong Kong, and price declines reappeared in China and Singapore. India, the Philippines and Thailand also experienced among their lowest inflation rates in recent years. In some cases, downward pressures on prices seemed to be the result of such temporary factors as food prices. More generally, however, disinflation or deflation in a number of Asian economies could be seen as a by-product of the end of the regional economic boom of the 1990s, which was followed by persistent weakness in private demand. This may be partly the result of headwinds associated with financial strains in the wake of the Asian financial crisis, or capital overhangs from the rapid growth in capacity during the boom period.

... centred on property markets ...

In some economies property prices, which peaked in 1996–97, collapsed and depressed demand, leading to rising unemployment and disinflation. This effect was strongest in Hong Kong, which in addition faced other deflationary pressures. A slowdown in China's international trade affected activity in Hong Kong in 2001. Moreover, there was some tendency for prices to move towards the much lower prices in mainland China. Declines in property prices or rental values also occurred in some other Asian economies, such as Singapore and Thailand.

... and the high-tech sector

Capacity overhangs have also been a problem throughout the region, particularly in the high-tech sector. In many Asian economies, gross fixed investment fell sharply after 1997 and recovery in the years that followed was generally weak. In Singapore and Taiwan, currently experiencing mild deflation, the boom period was associated with surging exports in the high-tech sector which continued up to around 2000. The disinflationary impact of the collapse in demand in this sector in 2001 was significant, and the recovery since has been uneven. The hesitant recovery in the United States, persistent weakness in the Japanese economy and the continuing excess capacity in the IT and telecommunications sectors have all played a restraining role. These economies have faced challenges in compensating for these factors by expanding their market shares in other sectors. In part this is because of the growing competitive challenge posed by China (see below).

Deflation in China is puzzling

Deflation in China is more puzzling. Massive increases in public expenditure and strong growth failed to trigger increases in the overall price level, particularly in manufacturing. One explanation is that deflation reflects excess capacity and a very elastic supply of low-cost labour. Excess capacity may also be the result of unprofitable state-owned enterprises that remain in production. The acquisition of technological and managerial know-how and improved skills associated with surging FDI has sharply increased productivity in China, and this also tends to lower prices. (Chapters II and IV provide additional perspectives on deflation.)

Domestic demand growth in Asia

Can policies support demand?

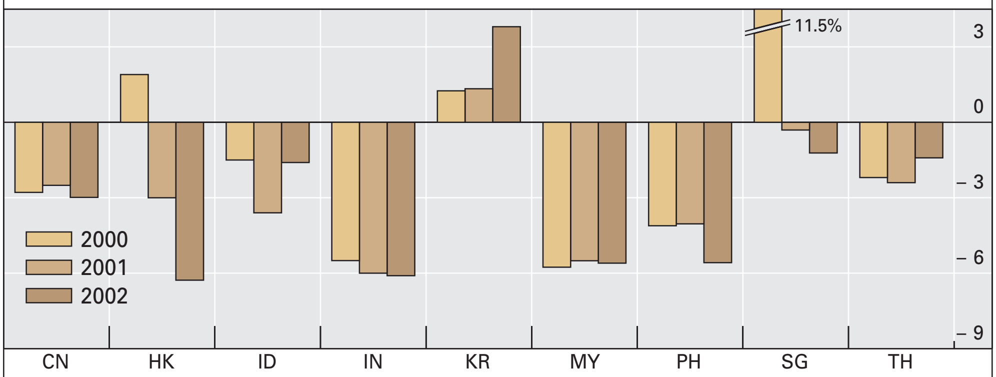
Asian economies have generally succeeded in increasing domestic demand, thanks not only to fiscal and monetary stimulus but also to a strong credit-financed expansion in household spending, including on housing, in a number of countries.

Fiscal stimulus has been important

Fiscal stimulus has been an important element of Asia's recovery from the crisis of the late 1990s. With the notable exception of Korea, economies in the region have run fiscal deficits since 2000 (Graph III.3). As a result of these developments, public debt ratios in some Asian economies have risen significantly since the mid-1990s (Table III.4). In India, Indonesia, the Philippines and to a lesser extent in Thailand debt ratios are relatively high. In contrast, some economies have low public debt ratios (Korea), or even no net public debt (Hong Kong). A low public debt ratio has this year given Korea the scope to offset sluggish growth with expansionary policies.

Asia: central government budget balances[1]

As a percentage of GDP



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

[1] For China and Hong Kong SAR, general government.

Sources: IMF; Institute of International Finance; JPMorgan; national data. Graph III.3

Debt indicators

	Public debt[1]			External debt[2]		
	1996	2000	2002	1996	2000	2002
China	7	15	16[3]	85	60	54
India	57	67	73	283	236	216
Indonesia	24	82	92[3]	259	217	231
Korea	8	17	22	126	78	82
Malaysia	35	37	46	51	43	49
Philippines	53	66	74	197	134	158
Thailand	15[4]	57[4]	54[4]	194	115	95
Argentina	36	45	146	468	554	530
Brazil	33	49	57	379	432	395
Chile	15	14	16	144	198	226
Colombia	14	37	51	273	261	313
Mexico[5]	37	37	40	164	90	100
Peru	49	45	47	492	406	364
Venezuela	49	27	40	150	120	162

[1] As a percentage of GDP. [2] As a percentage of exports. [3] 2001. [4] Includes Financial Institutions Development Fund liabilities. [5] Includes debt issued by Instituto para la Protección al Ahorro Bancario (IPAB).

Sources: IMF; World Bank; national data. Table III.4

Market perceptions do not stand in the way

Market perceptions also condition the feasibility of expansionary fiscal policies. In most Asian countries, markets seem inclined to accept even large deficits because these countries have an excellent track record in servicing their public debt, strong growth in output and exports, high private saving rates, relatively high foreign reserves and low ratios of external debt to exports. Nevertheless, perceptions can be fragile. For example, in Hong Kong the scope for additional expansionary policy has been limited by concerns about how this would be perceived by markets, notwithstanding substantial fiscal reserves.

Short-run fiscal stimulus possible

Fiscal stimulus has been possible in China in part because capital controls continue to keep high domestic savings invested at home. Nevertheless, there are medium-term reasons for limiting reliance on fiscal policy. Public spending is less efficient than private spending. In addition, problems of debt sustainability, while not apparent at present, could become more visible over time, and adversely affect confidence in banks that hold large quantities of government bonds. Indeed, the government has already expressed concerns about long-run debt sustainability influenced by implicit liabilities arising from financial sector losses or pension claims that are not reflected in reported public debt.

Interest rates fell, credit growth was robust ...

Domestic demand growth in Asia was also supported by easier monetary policies last year as policy interest rates were mostly stable or fell. Longer-term interest rates also tended to decline, and in some cases are now at their lowest levels in years. Falling or low interest rates were associated with robust credit growth in 2002 in China, India and Korea (17–25%) and a significant increase in credit in Thailand (8.5%, up from a decline of 7.5% in 2001). In

Asia: interest rates and real exchange rates

	Short-term interest rates[1]			Long-term interest rates[1]			Real effective exchange rates[2]		
	End-01	End-02	April 03	End-01	End-02	April 03	End-01	End-02	April 03
China	2.3	2.0	2.0	…	…	…	4.2	–2.9	–3.3
Hong Kong SAR	2.0	1.4	1.5	6.2	4.4	4.3	–0.2	–8.9	–11.0
India	7.2	5.5	4.9	7.9	6.1	5.9	2.3	6.6	–1.7
Indonesia	17.9	13.8	11.7	…	…	…	6.7	21.3	3.9
Korea	4.9	4.9	4.5	7.1	5.9	4.9	0.9	4.0	0.8
Malaysia	3.3	3.2	3.2	3.8	3.8	3.7	5.6	–4.2	–6.4
Philippines	8.9	5.2	7.4	15.8	12.0	12.6	3.3	–6.4	–8.4
Singapore	1.1	0.9	0.9	4.0	2.6	2.1	–2.1	–2.0	–6.2
Taiwan, China	2.6	1.8	1.4	3.8	2.3	1.6	–2.6	–6.1	–9.1
Thailand	2.9	1.9	1.8	3.4	3.5	3.4	4.0	–3.6	–6.3

[1] In percentages; end of period. [2] Annual percentage changes; in terms of relative consumer prices. An increase indicates an appreciation.

Sources: Bloomberg; Datastream; IMF; national data. Table III.5

some cases credit growth was associated with large increases in credit to the household sector. Easy money appears to have had more limited effects in some of the slower-growing economies, where interest rates were already very low or there was outright deflation. For example, while there was ample liquidity in Hong Kong last year, credit growth was negative. (See the discussion of a similar problem in Chapter IV.)

… and real exchange rates depreciated

The combination of monetary stimulus and only moderate inflation resulted in a depreciation of the real effective exchange rate in the Philippines, Thailand, Singapore and Taiwan. All these economies maintain floating exchange rate regimes. The first two economies maintain an inflation target, while Singapore targets a nominal effective exchange rate. A similar decline occurred in China, Hong Kong and Malaysia, whose currencies in effect are pegged to the US dollar. This decline reflected the depreciation of the dollar against other major currencies (Table III.5). These lower currency values contributed to the recovery in exports in the region.

Limits to credit-financed household spending?

Low inflation should allow more monetary stimulus

Low inflation in much of Asia increased the scope for additional monetary stimulus. Monetary ease in several countries has generated high levels of credit-financed household spending on housing and consumer durables. Faced with weak corporate demand for loans following the Asian crisis, banks were thus able to reduce risks through diversification by lending more to households. It is an open question how far this has created new risks for the banks themselves.

In Korea banks increased credit to households …

Potential problems are well illustrated by the recent experience of Korea, where banks have greatly increased the credit extended to households. The share of bank credit to households (personal loans, mortgages and credit card receivables) rose to over 40% of total assets by the end of June 2002, up sharply from 24% at the end of 1999. By June 2002, household debt to banks had reached 109% of disposable income, with mortgages accounting for 49 percentage points and credit cards for 21 percentage points.

… but the pace was not sustainable

It could be argued that, over the medium term, there is still scope for further increases in mortgage credit to households in Korea. The home ownership ratio in Korea is still relatively low, and household credit normally becomes a more important component of lending as incomes grow. However, in response to the very rapid growth in mortgage financing accompanied by a real estate and construction boom, the government adopted a series of measures to limit housing price increases in "speculation zones". These included reductions in banks' loan-to-value ratio from 80% to 60%, increased risk weights in the calculation of regulatory capital for mortgages, the banning of additional purchases by previous buyers, the threat of tax evasion investigations for frequent buyers, tougher criteria for capital gains tax exemptions and higher property tax rates on costlier homes. In addition, the government put forward a plan to build additional housing around Seoul in order to slow the rise in housing prices. These measures were effective in containing the exposure of the banking sector, and consumer sentiment and spending declined in late 2002. They have also, however, dampened Korea's growth prospects for 2003.

Credit card companies were rescued

As would soon become apparent, the increased exposure of financial institutions to other types of household credit also implied significant costs. Credit card delinquency rates rose by half to over 11% between December 2001 and January 2003. Moreover, in April 2003, a flight to quality followed accounting irregularities at the country's fourth largest conglomerate. This caused a sudden interruption in financing to Korea's financially vulnerable credit card companies. The result was a government-arranged multibillion dollar rescue in which ailing credit card companies were recapitalised by their owners and bridge loans were supplied by financial institutions to help investment trust companies, which hold large amounts of securitised credit card debt.

Household credit supported growth in Thailand

An expansion in household credit and spending has also supported growth in Thailand. The value of land transactions increased by 71% in the year to January 2003, and housing credit outstanding was up 12% over the same period. However, household debt is a much smaller proportion of disposable income in Thailand than in Korea, and the exposure of the private financial sector is partly limited by the fact that government financial institutions account for almost half of housing credit. Nevertheless, the authorities remained concerned about the rapid growth in credit card debt and in November 2002 reimposed minimum income requirements for credit card holders.

Property markets are a concern in China

Property market financing has even become a source of concern in deflationary China, where there has been a boom in property prices in the areas around Shanghai and in Qingdao. However, the Chinese authorities are having to weigh any potential risks from this boom against the long-term goal of promoting private home ownership, which was only recently allowed. This objective is seen as very important for the economic and social transformation of China.

The evolving role of China

China's growing economic importance ...

China's influence in the Asian region has expanded significantly due to its rapid growth and integration into the world economy. Between 1991 and 2002, its share of Asian GDP and exports more than doubled, to over 17% and 20% respectively. Imports rose at least as much, so that China now has a current account deficit with its neighbours.

... is changing Asian trade and investment

The country's structural transformation is changing the patterns of Asian trade and investment. China's exports have recently grown much faster than those of the rest of emerging Asia (Graph III.4, left-hand panel), in part by focusing on the US market. Between 1998 and 2002, the share of exports to the United States in China's total exports increased by over 6 percentage points to 27%, while the corresponding shares in other Asian economies declined. The reductions were large in Hong Kong, the Philippines, Singapore and Thailand.

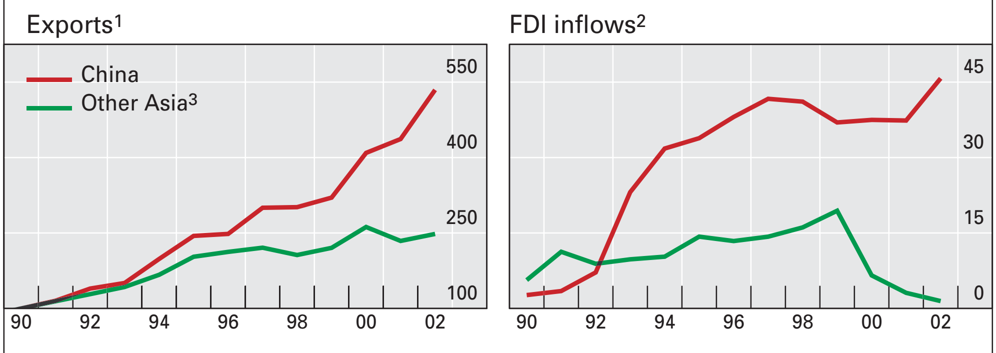
China attracted more foreign investment

At the same time, a larger portion of the foreign investment flow to the region has gone recently to China. One objective has been to exploit international trade opportunities but, increasingly, the aim is to tap China's growing domestic market. For example, major German, US and Japanese firms have made investments targeting China's automobile market, which is the fastest-growing in the world. In contrast, FDI flows to the rest of emerging Asia have fallen (Graph III.4, right-hand panel). Indeed, reinforcing a trend apparent since the 1997–98 crisis, net FDI flows to the rest of emerging Asia fell to zero last year even as net inflows to China rose to $46 billion.

Will China "hollow out" its neighbours?

Some observers are concerned that these developments imply that China will "hollow out" manufacturing production in other Asian emerging economies. China is already a major producer of labour-intensive manufactures. Moreover, as a result of its accession to the WTO, it is expected to capture a large share of the liberalised global market in textiles and apparel when the WTO Agreement on Textiles and Clothing expires in 2005. China thus poses major challenges for current producers of textiles and other labour-intensive manufactures in Southeast Asia. In addition, the country has moved steadily up the value added chain, and its exports of machinery and high-tech

Asian exports and FDI inflows



[1] In US dollar terms; 1990 = 100. [2] In billions of US dollars. [3] Hong Kong SAR (except for FDI), India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand.

Sources: IMF, *Balance of Payments Statistics*; national data. Graph III.4

products have increased rapidly. China's share in Asia's total electronics exports has more than doubled during the past five years to 30% in 2002. In contrast, the shares of Malaysia and Singapore have fallen off sharply. Anecdotal accounts also suggest that production facilities in high-tech sectors are being relocated to China from emerging East Asia as well as Japan.

Past structural shifts have not reduced welfare

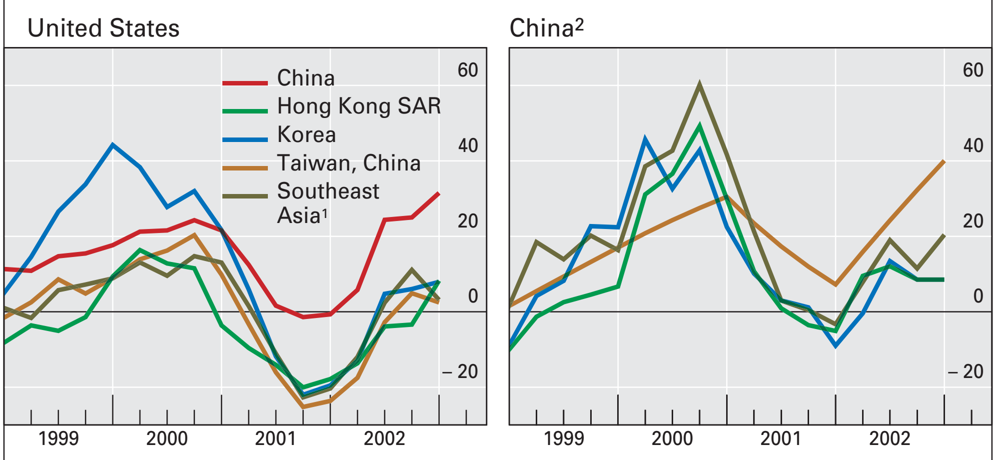
To put these developments in perspective, however, it is worth recalling that the region has seen major structural shifts in the past. These have not visibly reduced welfare in the countries whose production was "displaced". For example, China and Southeast Asia displaced much of the labour-intensive manufactures of the newly industrialised economies of the region (Hong Kong, Korea, Singapore and Taiwan). While this created difficulties for some, there were no adverse consequences for their prosperity overall. Starting in the early 1980s, most of Hong Kong's manufacturing production relocated to southern China. Nevertheless, Hong Kong prospered by providing much higher-value financial, trade and investment services, benefiting from its close proximity to the mainland.

China's neighbours may differentiate their products ...

In the present context, East Asia might be able to exploit its proximity to China in at least two ways. First, most international trade in final goods is between developed economies trading similar products that are differentiated in some way. This suggests that the more developed economies in East Asia and in the rest of the world can trade with China by differentiating their products on the basis of specific attributes. These could include quality or design, or specialisation in certain more advanced technologies. For example, Singapore has concentrated its recent efforts on diversifying into the biomedical and services sectors. Likewise, Hong Kong is seeking to go beyond its traditional financial sector niche to emerge as a knowledge-intensive economy. As these strategies require highly skilled workers, both Singapore and Hong Kong are seeking to improve their education systems and have

US and Chinese imports from Asia

Annual percentage changes



[1] Indonesia, Malaysia, the Philippines, Singapore and Thailand. [2] For 2002, provisional data.

Sources: IMF, *Direction of Trade*; national data. Graph III.5

maintained liberal residence policies for foreign professionals and skilled workers. For the less developed economies in Southeast Asia, adopting this strategy may take more time. However, it is apparent that there is already scope for this type of trade, for example in automobiles, which are already manufactured and exported in the region. It may also be possible for economies in Southeast Asia to concentrate on services such as tourism.

… and supply intermediate goods

Second, much international trade involves intermediate products, exploiting differences in costs, skills and resource endowments. Similarly, Asian economies could supply China with intermediate products that could then be used to produce goods for domestic or export markets. The potential for integration will grow as costs in China's coastal areas rise due to increasing real wages and congestion.

US import demand gets redistributed through China

Recent developments highlight the importance of such intermediate products in China's imports. A large part of China's exports are driven by import demand in the United States (Graph III. 5, left-hand panel), which is redistributed across the region through Chinese demand for imported inputs for its export industries. This is reflected in increasing Chinese imports from Asia (Graph III.5, right-hand panel). For example, while China's electronics exports grew by 33% last year, its (export-intensive) imports of electronic goods from the rest of Asia rose by over 49%. In contrast, the share of consumer goods as a proportion of China's imports has fallen steadily, from about 25% in the mid-1990s to 20% in 2002.

Latin America

Recent economic developments

Last year was difficult …

Last year was perhaps the most difficult in Latin America since the debt crises of the 1980s. Real GDP fell after being nearly stagnant in 2001. Among the larger economies, Argentina and Venezuela experienced outright crises, while Brazil found itself under severe external financing pressures for most of the period. Even Mexico and Chile – in recent years the region's better performers – did less well than in the past. In both economies, growth and export revenues were sluggish and capital inflows declined. One exception to this flagging growth performance was Peru, where growth at over 5% was the highest in five years as a result of very strong metal exports and increases in consumption.

… but growth recovered in late 2002

A generalised recovery became apparent starting in the second half of 2002. While private capital flows to Latin America declined for the year as a whole, external financing conditions eased considerably in the latter part of the year, and even more sharply in the first quarter of 2003. This was reflected in significant declines in the spreads on emerging market bonds (see Chapter VI). In addition, exports of goods and services also recovered in the second half of 2002, reflecting higher demand both inside and outside the region.

Improved external conditions support growth

Improved external conditions are expected to contribute to a modest recovery in Latin American growth in 2003, as are recoveries in investment and consumption spending. Investment and consumption spending will be boosted in 2003 if supportive policies and economic recovery succeed in encouraging the return of FDI.

Debt sustainability and fiscal adjustment

The sustainability of public debt ...

The key question in many Latin American economies is whether the fiscal adjustment that is currently under way will suffice to ensure a return of confidence. This depends in part on the extent to which an individual country is integrated with world capital markets, and on the size of its external debt.

... partly depends on external debt

An economy with an open capital account is, other things equal, more vulnerable the larger is the proportion of its debt denominated in foreign currency and the smaller its export revenues. The level of external debt matters for public debt sustainability, even if the external debt is largely private, because external debt servicing problems of the private sector may affect the exchange rate and the cost of financing of the government. Moreover, there have been cases in which the government has, for various reasons, assumed the external debt obligations of the private sector. The ratio of external debt to exports in Latin America is much higher than in Asian countries with comparable ratios of public debt to GDP (Table III.4). This is because national saving rates and the degree of trade openness in Latin America are much lower than in Asia (for a discussion of saving in different regions, see Chapter II).

Debt size influences perceptions

Perceptions of the sustainability of public debt seem to be influenced by its size, as measured by the public debt ratio, and by its trend. In Mexico and Chile, public debt ratios have broadly remained stable since the mid-1990s. In Brazil, Colombia and Peru, however, debt ratios have increased significantly since about 1996 and are now higher than in Mexico and Chile. Argentina's public debt ratio currently stands at 146%, but is not comparable to that of other countries because the country defaulted on this debt in December 2001.

Public debt ratios have risen ...

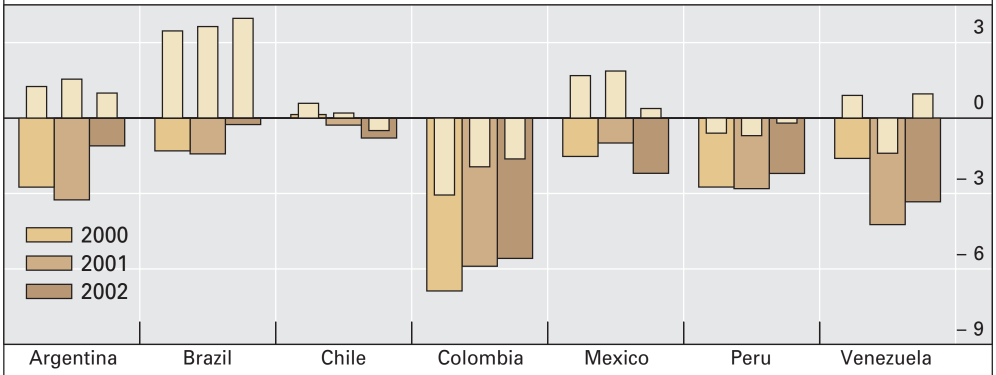
Public debt ratios have risen because primary balances have not been large enough to cover the interest payments on the public debt. High real interest rates combined with sluggish growth, which in part reflect financing constraints and the moderate pace of global economic activity, have also contributed to rising public debt ratios. Still another factor is currency depreciation, because much public debt is foreign currency denominated or linked and exports have not risen fast enough to offset this.

... reflecting fundamentals and perceptions

In the long run, the factors that influence public debt ratios reflect the underlying economic fundamentals. For example, the exchange rate depreciation that has contributed to rising public debt ratios in Brazil since the mid-1990s is due in part to the relatively low rate of saving in the economy and the country's high external debt. In the short run, however, these determinants of public debt ratios can also reflect perceptions of public debt sustainability that are partly self-fulfilling. Worries about a country's ability or will to service its debt can raise interest rates or depreciate the exchange rate so much that the debt becomes unsustainable. For this reason, policymakers in a number of Latin American economies have taken steps to reassure investors of their commitment to fiscal consolidation, which can be seen to some extent in the recent data on budget balances. As illustrated in Graph III.6, budget deficits have declined in some countries, and the primary surplus in Brazil has risen.

Latin America: central government budget balances

As a percentage of GDP



Note: The wide bars show the overall balance and the narrow bars the corresponding primary balance.

Sources: IMF; national data. Graph III.6

Governments have sought to reassure markets

Some governments have also sought to reassure markets through forward-looking policy or legislative initiatives. For example, in Brazil, the new government has increased its primary surplus target from 3.75% in 2002 to 4.25% in 2003; in fact this surplus exceeded 6% in the first quarter of 2003. It is also seeking to reform the tax and social security systems, since the latter accounts for a large proportion of the fiscal deficit. In Colombia, fiscal deficits are expected to fall because of reforms adopted in 2002 affecting taxes, pensions, social security and the labour market. Also expected are a fiscal responsibility law limiting public debt ratios in Colombia and a referendum that would reform the public sector, yielding further substantial savings. Peru has also committed itself to fiscal deficit reductions in 2003 and 2004 under its programme with the IMF.

Inflation's impact on primary balances

The adequacy of these adjustment efforts must be assessed in the light of at least three factors. First, inflation has contributed to the recorded increase in the primary balances in some economies, but this effect will gradually erode if inflation persists. For example, central government tax revenues in Brazil rose by around 29% in the year to January 2003 (excluding an extraordinary item in January 2002), about as much as one widely followed measure of inflation. Because expenditures did not increase commensurately, the central government's primary fiscal surplus rose, more than offsetting the widening of the social security deficit. While an extended period of moderate inflation has significantly reduced inflation expectations and wage demands in a number of countries in the region, past experience suggests that the widespread use of indexation could increase if high inflation were to persist.

Certain taxes could impair growth

Second, revenues have been raised in part by relying on certain taxes, some distortionary, which could actually impair long-run growth prospects. For example, in Argentina, an export tax imposed in early 2002 generated 15% of government revenues. While this tax offsets the windfall gains to agricultural exporters arising from the sharp depreciation of the currency in 2002, taxes on international trade transactions are not a long-run solution. Brazil has relied heavily on a financial transactions tax, and a "cascading" system of indirect taxes in which taxes on outputs are charged on top of (non-deductible) taxes on inputs. This last system is seen as reducing the competitiveness of Brazilian firms.

Non-discretionary expenditures limit cuts

Third, in many countries the high shares of non-discretionary expenditures make it hard to cut overall spending. Interest payments accounted for 18% of total expenditures in Brazil, and for 12–15% in Peru and Colombia. Changes to government budgets are also commonly restricted by contractual obligations or fixed rules for allocating such resources as social security and healthcare that many believe could be delivered more efficiently. In a number of countries, 35–50% of government spending is at the sub-national government level, and such spending has been particularly difficult to control. Spending cuts thus typically fall on a relatively small proportion of public spending. Moreover, because the immediate effects are less obvious, capital spending and maintenance by state-owned enterprises have sometimes been the first to be cut back. This could also reduce future growth.

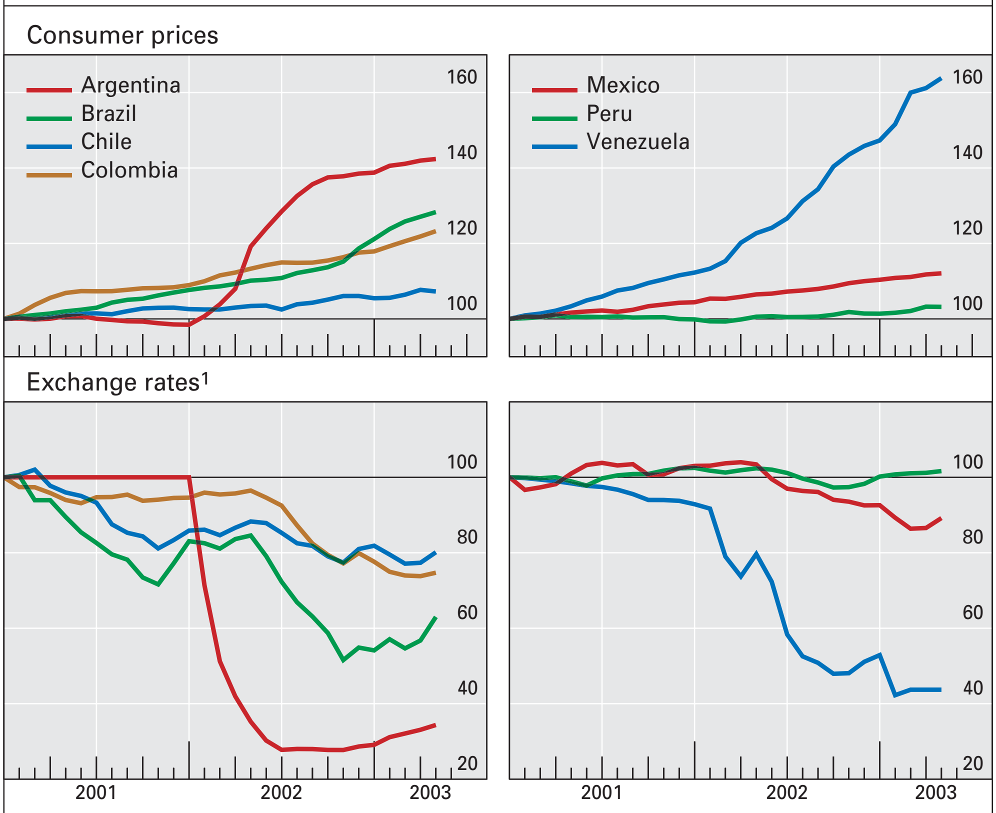
The challenges of curbing inflation

Notwithstanding external financing difficulties …

In 2002, a number of countries faced external financing difficulties, which resulted in sharp currency depreciation followed by increases in inflation (Graph III.7). The assessment of monetary conditions in this environment is particularly difficult.

Latin America: consumer prices and exchange rates

End-2000 = 100



[1] US dollars per unit of local currency; an increase indicates an appreciation.

Sources: IMF, *International Financial Statistics*; national data. Graph III.7

On the one hand, while exchange rates have depreciated sharply in some countries, cycles of accelerating inflation and depreciation that were observed in the region in the past have been avoided. Indeed, exchange rates have generally stabilised or appreciated and spreads on sovereign debt have narrowed since late 2002. This suggests that markets have a degree of confidence in present policies in some countries.

… exchange rates stabilised …

On the other hand, inflation rates have risen and some of the explicit inflation targets have been breached. With inflation at 12.5% in December 2002, Brazil missed the upper bound (5.5%) of its inflation target by a wide margin. While the central bank raised its 2003 inflation target to 8.5%, to reflect regulated price increases and inflation inertia, inflation rose further to almost twice the revised target by the end of the first quarter of 2003. The inflation target was also exceeded in Colombia, although the central bank continues to target a declining path for inflation. In Venezuela, price and exchange controls imposed starting in January 2003 allowed the authorities to peg the exchange rate. Inflation has nonetheless risen significantly. Mexico's 2002 inflation rate exceeded the target of 4.5%. The government nevertheless reaffirmed its commitment, made in July 2002, to meet an inflation target of 3% in 2003, with a 2–4% band around it. In Chile, inflation came in below target in 2002 due to moderate cost pressures, as a result of foreign price reductions and favourable labour cost conditions, but had risen above the upper bound of the 2–4% target range by the end of the first quarter of 2003. More recent data suggest that inflationary pressures were moderating in a number of countries. The decline has been particularly dramatic in Argentina, where the government cut its inflation forecast for end-2003 to 8%. This was down sharply from the 35% originally anticipated in Argentina's standby agreement with the IMF and the 41% actually recorded at the end of 2002.

… but inflation is a concern

Monetary authorities in countries with heavy debts faced several difficult trade-offs. Perhaps most important, it could be necessary to raise interest rates high enough to prevent destabilising spirals of depreciation and

High interest rates could impair sustainability …

Latin America: interest rates and real exchange rates

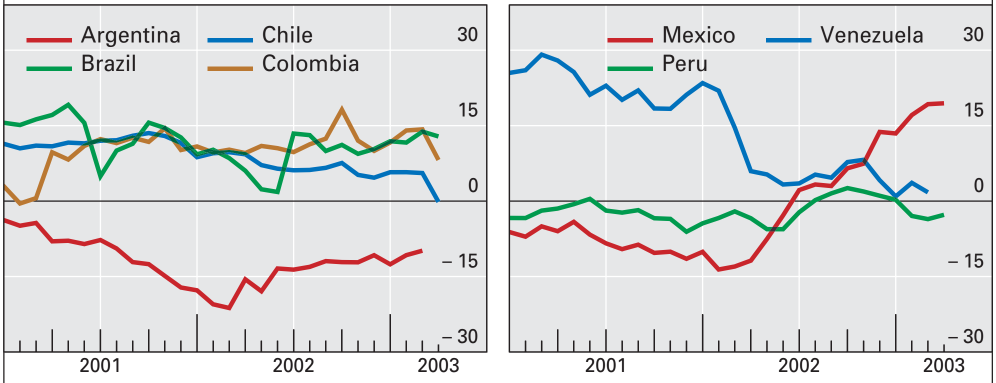
	Short-term interest rates[1]			Real short-term interest rates[1, 2]			Real effective exchange rates[3]		
	End-01	End-02	April 03	End-01	End-02	April 03	End-01	End-02	April 03
Argentina	6.1	34.1	22.2	7.8	–4.9	2.3	1.6	–58.6	11.1
Brazil	19.1	24.9	26.3	10.6	11.0	8.4	–10.1	–31.7	–21.4
Chile	6.2[4]	4.4[4]	1.9[4]	6.2	4.4	1.9	–9.6	–6.4	–15.5
Colombia	10.7	7.5	7.6	1.6	–0.6	1.0	5.5	–16.1	–21.8
Mexico	7.6	7.6	6.7	3.0	1.8	1.4	8.0	–9.5	–14.0
Peru	4.8	3.6	3.3	5.0	2.1	0.7	6.8	–4.2	–6.4
Venezuela	19.7	25.1	16.0	6.6	–4.7	–13.1	5.0	–30.8	–34.4

[1] In percentages; end of period. [2] Deflated by the annual rate of inflation. [3] Annual percentage changes; in terms of relative consumer prices. An increase indicates an appreciation. [4] Real rate linked to the Unidad de Fomento.

Sources: Bloomberg; Datastream; IMF; national data. Table III.6

Latin America: domestic credit to the private sector

Annual percentage changes



Sources: IMF, *International Financial Statistics*; national data. Graph III.8

inflation. At the same time, raising rates too much could accentuate doubts about the sustainability of public debt and possibly increase financial fragility. This outcome could also exacerbate depreciation pressures, again with adverse effects on inflation.

... and depreciations could be contractionary

Another complication in Latin America is that nominal exchange rate depreciation can be contractionary in the short run since it increases the debt burden of domestic residents who borrow in foreign currencies, and also reduces domestic purchasing power. These forces act in opposite directions from traditional trade substitution effects. The depreciation would stimulate the economy in the medium run, but only if the real exchange rate also depreciated. This has recently been the case in a number of Latin American economies (Table III.6), a welcome change from earlier experience where inflation rose more sharply. The case of Argentina illustrates the mixed effects of depreciation in some emerging economies: the collapse of the Argentine peso in 2002 was initially followed by a steep contraction in output and only later by a recovery in exports of goods and services.

Low real interest rates did not boost credit

Partly to offset the contractionary influences cited above, central banks limited increases in nominal interest rates, so that real rates fell. In Brazil, the real interest rate declined but was still over 8% in April 2003, while in some cases (Argentina, Colombia, Venezuela) real rates became negative for an extended period. However, lower or negative real interest rates were not always associated with rapid growth in credit (Graph III.8). In spite of high inflation, nominal credit to the private sector fell in Argentina in 2002, owing to the problems of the banking sector, while credit growth decelerated to close to zero in Venezuela. Credit growth was in the neighbourhood of 10% in Brazil, but this was still less than the rate of inflation. In Chile and Mexico, where external credit constraints were less significant, policymakers responded to weak external demand by easing monetary policy. While real interest rates in both economies fell, credit growth remained moderate in Chile, although it increased significantly in Mexico.

Central and eastern Europe

Growth remained resilient to the slowdown in western Europe

Growth in central and eastern Europe (CEE) was remarkably resilient to the slowdown in western Europe over the past year. The shift towards domestically driven growth, supported by the rapid increase in consumer credit and fiscal expansion in several countries, strengthened during 2002 (Graph III.9). On the external side, greater diversification of export markets and productivity improvements have led to better than expected export performance (Graph III.1). Output in southeast Europe and the Baltic countries thus expanded by 5–5½% on average, and in central Europe by around 3%. Growth in Russia remained solid, while the Turkish economy rebounded strongly after a sharp contraction in 2001. These trends were broadly maintained in the first quarter of 2003.

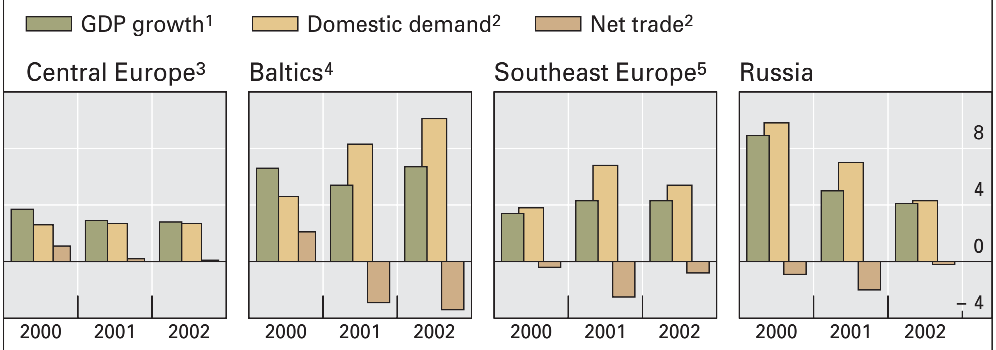
Inflation fell further ...

Continued disinflation has been another positive aspect of recent macroeconomic performance. Towards the end of 2002, average inflation in the region's eight EU accession countries and Croatia reached just over 2.5%, the lowest rate since the beginning of transition. Inflation remained in double digits in Romania, Russia, Serbia and Montenegro, and Turkey, but even there price increases slowed during the year. However, in most countries lower inflation did not result from more moderate domestic cost and demand pressures but rather from good harvests and the appreciation of exchange rates, which led to lower food and imported fuel prices. Indeed, disinflation was slower and more costly than in previous episodes. The cumulative change in the rate of unemployment required to lower inflation by 5 percentage points (the so-called sacrifice ratio) averaged 1.6 percentage points in 2000–02, up from 0.5 points in 1998–99.

... but the trend may not continue

Against this background, several factors suggest that recent low rates of inflation may not be maintained in the near term. First, the impact of declining food prices is likely to fade. Second, most countries have scheduled a series of one-off adjustments in administered prices. Third, rising oil prices started to affect inflation in early 2003. And fourth, public sector wage

CEE: GDP growth and its contributing factors



[1] In percentages. [2] In percentage points. [3] The Czech Republic, Hungary, Poland, Slovakia and Slovenia. [4] Estonia, Latvia and Lithuania. [5] Bulgaria, Croatia and Romania.

Source: UN Economic Commission for Europe. Graph III.9

increases have begun to spill over to the private sector. Partly as a result, interest in incomes policies has revived in some countries.

FDI inflows financed large external deficits

Current account deficits remained large during 2002 (5.7% of GDP on average, excluding Russia) but were easily financed. In the Czech Republic, Slovakia and Slovenia, FDI inflows were two to five times higher than the deficits themselves, while in the remaining countries they covered on average 60% of the deficits. In addition, the approaching EU accession and investors' perceptions of relative risk in emerging markets led to a surge in short-term capital inflows. As a result, most central European currencies appreciated against the euro or in nominal effective terms during 2002. An important exception was the Polish zloty, which has been under pressure for some time as a result of weak domestic growth and a delayed response to large interest rate cuts. Russia maintained a current account surplus of close to 10% of GDP, thanks to rising oil exports. In Turkey, the strong recovery led to higher imports and, with export growth unchanged, a small current account deficit of 1% of GDP.

Faced with capital inflows and appreciating exchange rates ...

In this relatively favourable environment the monetary authorities in countries with inflation targeting regimes largely sought to balance the disinflationary effects of appreciating currencies against the expansionary effects of capital inflows on the domestic money supply. At the same time, central banks had to consider the expansionary stance of fiscal policy, the possibility that appreciating exchange rates would hurt the export industries, and the low interest rate environment in global capital markets. Faced with these challenges, most central banks used a combination of interest rate cuts and market intervention to slow capital inflows and alleviate the upward pressure on exchange rates.

... central banks cut interest rates and intervened

The Czech National Bank intervened on several occasions in 2002, lowering its main policy rate below the key ECB rate in July. The Polish National Bank has lowered its key policy rate by 5.75 percentage points since the beginning of 2002. In part, these moves have been aimed at weakening the zloty but also at lowering high real interest rates, which had been partly blamed for slow growth in 2001–02. Faced with FDI inflows equivalent to 20% of GDP in the first nine months of 2002, the Slovak government and central bank agreed to sterilise all capital inflows associated with privatisation and to use the proceeds only for public debt repayment and pension reform.

In Hungary, temporary controls were used to limit short-term inflows

Hungary's experience has been even more dramatic. Short-term capital inflows of approximately €4–5 billion, equivalent to several per cent of annual GDP, entered the country within a few hours on 15 and 16 January 2003. The inflows were fuelled by speculation that the 15% limit for appreciation of the forint above its central parity against the euro would be lifted. To quell the attack, the National Bank cut policy rates by 200 basis points, introduced a quantitative restriction on short-term deposits and intervened heavily in the foreign exchange market. These extraordinary measures calmed speculation. However, lower interest rates combined with the ensuing depreciation of the forint aggravated inflationary pressures, forcing the National Bank to raise its inflation forecast for end-2003.

Sustainability of recent performance

Can the good performance be maintained?

The contrast between the generally favourable developments in CEE and the uncertain outlook for western Europe raises a basic question: will CEE economies be able to sustain their recent growth performance and thus continue to catch up gradually with the living standards in the European Union? Strong growth is also needed to alleviate pressures stemming from stubbornly high unemployment, the least successful aspect of the overall macroeconomic picture in the region.

Several factors might seem to argue against the continuation of recent favourable trends. First, the outlook for western Europe has not improved, so export growth could slow. Second, high current account and fiscal deficits rule out an extended reliance on domestic demand as the main source of growth. Third, the recent expansion in domestic credit, a major factor contributing to the dynamism of domestic demand, may not be sustainable in the near term.

Exporters have diversified markets and remain competitive

However, upon closer examination, some of these arguments hold up less well than others. As to the first argument, some recent developments suggest that CEE may have actually become less reliant on exports to the European Union. Foreign companies now own a sizeable part of the enterprise sector in the region. These have often relocated production to CEE in order to establish a lower-cost export base, not only for the European Union, but also for non-EU markets (including CEE itself and Asia). This has been reflected in a rising share of non-EU markets in the total exports of the region, and a declining correlation since 1999 between exports of the accession countries and industrial production in the euro area. Admittedly, it is still not clear whether the decline is cyclical or more permanent, but it does stand in contrast to the rising correlation between these indicators during most of the 1990s. At the same time, labour costs in Slovenia, the highest in the region, were still only 25% of those in western Germany, the highest among EU countries. This cost advantage will probably lead to further, albeit smaller increases in the share of exports from CEE to markets outside as well as inside western Europe.

Current account deficits have been stable ...

To what extent could external imbalances pose a constraint on growth? With the exception of Russia and Slovenia, most CEE countries have been running large current account deficits since the beginning of transition. Such deficits are to be expected for countries in the process of catching up, as domestic investment is likely to exceed domestic saving. FDI inflows on average financed 90% of the current account deficits from 1994 to 2002. In general, the size of the current account deficits has been stable. Indeed, excluding Russia, the rise in the aggregate current account deficit since 2000 has been less than ½% of GDP. Moreover, save for a few exceptions, past episodes of large reversals of current account imbalances generally did not affect GDP growth for a prolonged period of time. Nevertheless, some concerns about external vulnerabilities remain. Annual FDI flows are often volatile because of large privatisation projects. Furthermore, countries in the region have recently become more exposed to short-term capital inflows, a development that may become even more pronounced after EU accession (see below).

... but further expansion of domestic credit poses risks

The third potential constraint on near-term growth could be the need to moderate the expansion of consumer lending. Most banks have been privatised and the high degree of openness to foreign ownership and control has done much to enhance both financial system efficiency and effective risk management. In the last two years, the strong growth of personal incomes, accompanied by lower interest rates and greater competitive pressures, has encouraged banks in Bulgaria, Croatia, the Czech Republic, Hungary and Romania to expand their lending to households at annual rates ranging from 20 to 60%. This high growth partly reflects the low share of household lending in bank credit. However, were it to persist, it might expose banks to significant credit risk, as most household lending is not properly secured due to deficiencies in legislation governing the use of collateral. Another potential concern is that greater competition among banks has resulted in a visible contraction of intermediation margins that may not be sustainable.

Sustainability of fiscal positions is a major concern

Of greatest concern, however, is the sustainability of fiscal positions. In Croatia, the Czech Republic, Hungary, Poland and Slovakia budget deficits have increased to 5% of GDP or higher since 2000. Most of this deterioration has been structural, that is, related to changes in legislation that have permanently raised social transfers and public sector wages. Accession to the European Union will also bring new claims on public spending to comply with EU regulations in areas such as environmental protection. A further difficulty is that up to two thirds of total spending in some countries is governed by legislation outside the budget. As a result, discretionary spending measures have often been implemented through quasi-fiscal activities (guarantees, extra-budgetary funds), which are not transparent and can create considerable uncertainty for monetary policy.

Turkey also needs to tackle debt problems

Turkey is grappling with a level of public sector debt that now exceeds 80% of GDP, above that of most other large emerging economies (Table III.4). To achieve the goal of reducing the debt ratio below 70% by the end of 2004, the authorities have committed to generate a primary budget surplus of 6½% of GDP (compared with 4½% in 2002) and to reduce inflation to 20% by the end of 2003 (from 30% in the first quarter). However, debt payments are heavy since real interest rates are around 20%. Moreover, most of the debt, even though domestically issued and held, is linked to short-term interest rates or to the exchange rate, and debt sustainability is very sensitive to movements in these variables. A further risk is that ambitious targets for revenue increases and expenditure cuts will not be achieved if privatisations and politically difficult reforms of the civil service and the banking system do not go forward as planned.

Challenges of EU accession

Next phases of integration are already having an impact

Following entry into the European Union in May 2004, the accession countries plan to join the exchange rate mechanism of the European Monetary System (ERM II). After a two-year period in ERM II, and subject to meeting the other Maastricht criteria, EMU membership would follow. Although the first of the new members are unlikely to join EMU before 2007 or 2008, the prospect of joining the euro area is already affecting market expectations, as long-term bond rates are converging to euro area levels. Moreover, the policy environment has also been affected, as macroeconomic policies have to satisfy the Maastricht criteria and to manage large capital inflows at the same time.

Fiscal consolidation will be key to smooth convergence

It is by now clear that the major problem in the run-up to EMU will be large budget deficits and, in some countries, relatively high inflation (Table III.7). Although the medium-term goal is to reduce the budget deficits below the Maastricht norm of 3% in two years, entering ERM II with a budget deficit of 5–6% of GDP would put pressure on central banks to keep short-term interest rates higher than in the euro area. As illustrated by the Hungarian experience noted above, this differential would attract short-term capital inflows and could well increase exchange rate volatility. A particular concern is what might happen if the ambitious fiscal deficit reduction strategies were to go off track. Since non-residents are expected to become major buyers of newly issued public debt, given the promise of medium-term sustainability, such an event could lead to a sudden reversal of portfolio capital flows, causing the currency to depreciate sharply.

Capital inflows will challenge monetary policy

Capital inflows could challenge monetary policy even in countries that follow adequate fiscal policy and have achieved low inflation. One reason is that appreciation pressures are likely to remain strong in the presence of higher intersectoral productivity growth in CEE relative to the euro area and are likely to attract short-term inflows. Furthermore, the high marginal

EMU convergence criteria

	Price stability[1]		Long-term interest rate[2]		Exchange rate stability[3]		Budget deficit[4]		Public debt[5]	
	1999	2002	1999	2002	1999	2002	1999	2002	1999	2002
Reference value[6]	0.5 + 1.5	1.5 + 1.5	5.3 + 2	4.4 + 2	±15	±15	–3.0	–3.0	60	60
Czech Republic	2.1	1.8	7.0	4.3	–1.0	–2.6	–6.3	–5.8	15	23
Hungary	10.0	5.3	8.8	6.5	3.2	–5.4	–5.2	–6.7	60	50
Poland	7.3	2.0	9.7	5.6	2.1	6.8	–2.0	–6.3	43	48
Slovakia	10.5	3.4	…	7.4	1.3	–3.5	–6.4	–5.8	30	34
Slovenia	6.2	7.5	…	8.9	4.6	3.7	–2.2	–1.8	26	31
Estonia	3.3	3.6	…	3.9	–0.1	0.0	–4.6	0.7	7	5
Latvia	2.4	1.9	…	4.4	–3.2	7.6	–3.9	–1.8	11	14
Lithuania	0.8	0.3	…	5.9	–8.5	–1.9	–8.5	–1.8	28	28
Bulgaria	2.6	5.9	9.3	5.7	–0.6	0.0	–1.0	–0.6	94	57
Croatia	4.1	2.2	12.7	6.5	4.0	0.4	–8.2	–5.0	49	52
Romania	45.3	22.8	…	…	39.2	22.7	–3.6	–2.9	31	29
Average[7]	*8.6*	*5.1*	*9.5*	*5.9*	*3.7*	*2.5*	*–4.7*	*–3.5*	*36*	*34*

[1] Annual percentage changes of consumer prices. [2] On 10-year local currency government bonds, end-year; for Bulgaria and Latvia, a five-year maturity. [3] Deviation of end-year exchange rate (in units of local currency per euro) from the average exchange rate for 1998–99 and 2001–02, respectively. An increase indicates a depreciation. [4] General government deficit (accrual basis) as a percentage of GDP. Data are OECD estimates for OECD members, and IMF and national sources for other countries. [5] Domestic and external public sector debt (general government basis) as a percentage of GDP. [6] Inflation and interest rate data for the three EU and euro area countries, respectively, with the lowest inflation; other reference values based on the Maastricht Treaty. [7] Unweighted average.

Sources: ECB; European Commission; IMF; OECD; Bloomberg; national data; BIS estimates. Table III.7

productivity of capital will continue to attract FDI inflows. Consequently, the monetary authorities in these countries will have to conduct a very careful policy aimed at setting interest rates at an appropriate level: setting them too high would invite excessive short-term inflows, while setting them too low would lead to excessive investment and thus inflation.

Prudent policies are essential for convergence

To minimise the associated risks, the accession countries might find it advantageous to try to satisfy the Maastricht criteria as soon as they join ERM II. However, the experience of countries such as Italy and Spain in the early 1990s indicates that convergence can prove most difficult when it appears most within reach. Achieving nominal convergence in the next two to three years may thus prove more challenging for policymakers in CEE than is suggested by the current data. This highlights the need for continued prudent macroeconomic policies.

Africa and the Middle East

African growth slowed in 2002

More prudent fiscal and monetary policies and a small exposure to foreign trade helped Africa weather the global slowdown in 2001. Nevertheless, growth slowed last year (Table III.8) because of continued weakness in the euro area (the main trading partner) and a variety of local problems. These included difficulties in controlling budget deficits and constraints on growth imposed by oil production quotas in Nigeria, large budget deficits and the seizure of commercial farms in Zimbabwe, lower tourist incomes as a result of terrorist attacks, severe droughts in northern and southern Africa and increased adverse effects stemming from the HIV/AIDS pandemic. At the same time, the median rate of inflation was only 4½% last year, close to that of Latin America and Asia, and was even lower in the three Maghreb countries (Algeria, Morocco and Tunisia), which target monetary aggregates. Among

Output growth and inflation in Africa and the Middle East

Percentage changes, annual rates

	Real GDP				Consumer prices			
	1995–2000	2001	2002	2003[1]	1995–2000	2001	2002	2003[1]
Africa	3.4	3.6	3.4	3.9	18.9	13.0	9.3	10.1
Maghreb[2]	3.1	4.1	3.3	4.4	6.4	2.6	2.2	3.3
CFA countries	4.1	3.9	3.7	3.4	4.4	4.2	3.4	3.0
Nigeria	3.1	2.8	0.5	6.7	20.4	18.9	12.9	15.3
South Africa	2.7	2.8	3.0	3.0	7.0	5.7	9.9	8.0
Middle East	4.0	2.8	2.7	4.2	9.9	3.8	6.3	7.0
Egypt	5.2	3.5	2.0	3.0	5.6	2.4	2.5	3.0
Iran	4.4	5.7	4.8	6.5	22.9	11.4	15.0	17.0
Israel	4.6	–0.9	–1.0	0.5	6.9	1.1	5.7	2.8
Saudi Arabia	1.9	1.2	0.7	3.5	0.6	–0.5	–0.6	1.0

[1] Forecasts. [2] Algeria, Morocco and Tunisia.

Sources: IMF, *World Economic Outlook*; national data. Table III.8

the Maghreb countries, Algeria's economic performance is expected to improve in 2003, supported by oil and gas exports.

In CFA countries, growth lower than anticipated

In CFA franc zone countries, growth was somewhat lower than anticipated in 2002 as a crisis in Côte d'Ivoire and unfavourable conditions in international commodities markets adversely affected a number of economies in the region.

In Nigeria, balances deteriorated

In Nigeria, the growth in fiscal spending had exceeded that of oil revenues in 2001, producing a deterioration of both the fiscal position and the current account balance. This was followed by exchange rate depreciation, rising prices and recession. In the second half of last year, Nigeria was forced to suspend debt service payments on bilateral official credits due to sharp reductions in foreign exchange reserves.

Fiscal policy supported growth in South Africa

In South Africa, the Reserve Bank helped reverse most of an earlier rand depreciation by pre-emptively raising its policy rate four times last year. Nevertheless, the rate of inflation significantly exceeded the target, and exports weakened in response to the decline in competitiveness. However, GDP still managed to advance by 3% in 2002 and is projected to grow at the same rate this year. In part, this is thanks to a growth-supporting fiscal policy made possible by several years of consolidation and debt reduction. In Tanzania and Uganda, exchange rate depreciation helped offset large terms-of-trade losses arising from steep falls in the prices of coffee and other traditional exports. Moreover, the depreciations, combined with stable prices, encouraged diversification into new export sectors that was supported by FDI inflows.

In Egypt, depreciation could raise inflation

In the Middle East, Egypt's low export competitiveness, as well as lower tourist incomes and capital inflows, contributed to deteriorating growth performance. The rapid growth of a parallel exchange market raised doubts about the sustainability of the pegged exchange rate, prompting the authorities to adopt a floating exchange rate regime in January 2003. Although the subsequent depreciation of the pound appears to have restored Egypt's external competitiveness, the outlook remains uncertain. The depreciation could raise inflation significantly in the absence of a new nominal anchor for monetary policy. Fiscal policy might also have to be tightened to halt the rise in public debt and prevent a further downgrading of Egypt's credit rating.

Prices rose in Iran but fell in Saudi Arabia

Iran's growth has increased in recent years and the current account balance has strengthened. However, high inflation (partly linked to a deteriorating fiscal position) remains a problem. By contrast, consumer prices in Saudi Arabia have fallen since 1998 despite a high fiscal deficit and a public debt/GDP ratio approaching 100%. While lower oil exports weakened GDP growth in 2002, the current account surplus remained close to 5% of GDP. This contributed to a further rise in foreign reserves and enabled the authorities to keep interest rates very low. An improvement in growth is anticipated in 2003, although the outlook remains highly dependent on developments in the oil market.

Israel in recession

In Israel, the recession which started with the bursting of the IT bubble deepened, and unemployment rose above 10%. The fiscal imbalance remained high and the deficit on the current account increased to over 2% of GDP. To counter the breaching of the inflation target and a surge in inflation expectations caused by the depreciation of the shekel, the central bank raised its lending rate by more than 500 basis points. This eventually arrested the depreciation of the exchange rate and stabilised the rate of inflation. With the security situation continuing to weigh on tourism and export earnings, business and consumer surveys suggest, at best, a weak recovery of GDP this year.