



THE GLOBAL ECONOMY





MAIN DEVELOPMENTS IN THE WORLD ECONOMY

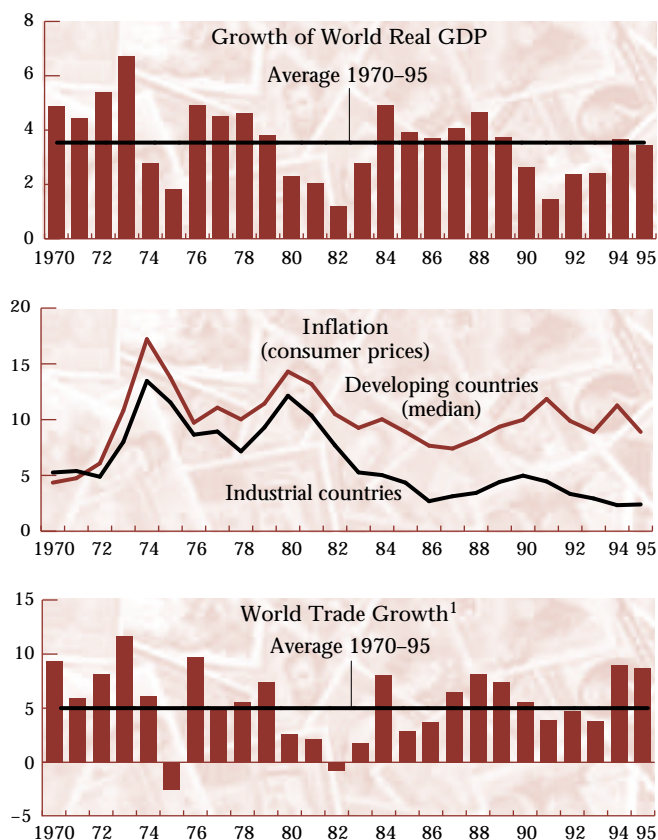
World economic growth moderated slightly in 1995, to 3½ percent—marginally below its long-term trend rate, but above growth rates during the 1990–93 global slowdown (Chart 1). The minor change in global average growth, however, masked a slowing of expansion in most industrial countries and in the developing countries of the Western Hemisphere, which largely offset improvements in growth in the countries in transition, Africa, and the Middle East. Asia's emerging market economies continued to grow at impressive rates.

Several developments in 1995 and early 1996 indicated that global growth prospects remained favorable and that any prolonged or generalized slowdown was unlikely (Table 1). Inflation in the industrial countries remained subdued at about 2½ percent, allowing monetary authorities to lower short-term interest rates substantially; in addition, inflation moderated in the developing countries and countries in transition. Long-term interest rates declined considerably during 1995, in some countries almost fully reversing increases that had occurred in 1994; although rates turned upward again in early 1996, they remained below the levels seen during most of the previous two years. Exchange rates among the major currencies returned to levels more consistent with fundamentals following the misalignments that arose in the spring of 1995. Moreover, equity markets in general rose significantly, reflecting strong profit performance in many countries and lower interest rates.

There were other positive developments as well. World trade in 1995 continued to expand at more than twice the rate of growth in world output, reflecting the liberalization of trade in recent years, the trend toward currency convertibility, and the dynamic forces of globalization. Furthermore, capital flows to developing countries were generally well sustained once the spillover effects from the Mexican crisis had been contained.

Large actual or prospective fiscal imbalances and structural rigidities inhibiting the efficient working of markets, however, continued to prevent many countries

Chart 1
WORLD INDICATORS
(In percent)



¹ Goods and services, volume.

from attaining higher growth. Recent increases in unemployment in a number of European countries have drawn attention not only to the importance of resuming solid and sustainable expansion, but also to the urgency of pursuing labor market reforms more vigorously.

Table 1

OVERVIEW OF THE WORLD ECONOMY

(Annual percent change unless otherwise noted)

	1992	1993	1994	1995
World output	2.4	2.4	3.7	3.5
Industrial countries	1.7	0.8	2.8	2.1
United States	2.7	2.2	3.5	2.0
Japan	1.1	0.1	0.5	0.9
Germany	2.2	-1.2	2.9	1.9
France	1.3	-1.5	2.9	2.4
Italy	0.7	-1.2	2.2	3.2
United Kingdom	-0.5	2.3	3.8	2.4
Canada	0.8	2.2	4.6	2.2
Seven countries above	1.8	1.0	2.8	2.0
Other industrial countries	1.1	0.1	3.0	2.8
<i>Memorandum</i>				
European Union	1.1	-0.5	2.8	2.6
Developing countries	6.3	6.2	6.4	5.9
Africa	0.7	0.7	2.4	3.2
Asia	8.7	8.9	8.8	8.4
Middle East and Europe	6.2	3.7	0.7	3.7
Western Hemisphere	2.9	3.1	4.7	0.9
Countries in transition	-14.7	-8.5	-8.8	-1.3
Central and eastern Europe	-10.0	-5.0	-2.9	1.4
Excluding Belarus and Ukraine	-7.0	-0.1	3.4	5.2
Russia, Transcaucasus, and central Asia	-18.7	-11.7	-14.8	-4.3
World trade volume (goods and services)	4.8	3.8	9.0	8.7
Imports				
Industrial countries	3.7	0.8	9.1	7.3
Developing countries	9.9	8.9	9.0	11.8
Countries in transition	-13.1	19.9	4.3	10.9
Exports				
Industrial countries	4.3	2.4	8.2	7.1
Developing countries	9.9	7.5	12.0	12.2
Countries in transition	-9.4	18.1	5.3	11.8
Commodity prices in U.S. dollars				
Oil ¹	-1.6	-11.6	-5.5	8.0
Nonfuel ²	0.1	1.8	13.6	8.5
Consumer prices				
Industrial countries	3.3	2.9	2.3	2.4
Developing countries	35.3	42.5	48.0	19.9
Countries in transition	674.4	614.3	264.8	128.2
Six-month LIBOR (in percent)³				
On U.S. dollar deposits	3.9	3.4	5.1	6.1
On Japanese yen deposits	4.3	3.0	2.4	1.3
On deutsche mark deposits	9.4	6.9	5.3	4.6

Source: International Monetary Fund, *World Economic Outlook* (May 1996).¹Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.²Average, based on world commodity export weights.³London interbank offered rate.**Economic Activity and Employment**

Economic growth slowed in 1995 in most *industrial countries* other than Japan, with average growth declining to 2 percent from 2¾ percent in 1994 (Chart 2).

In Japan, growth was sluggish, and the margin of eco-

nomie slack remained wide. By the end of the year, however, there were clearer signs of recovery following the easing of monetary and fiscal policy during the summer and early fall, the reversal of the earlier sharp appreciation of the yen that began in April, and

progress toward resolving problems in the financial sector.

For some countries at relatively advanced stages of recovery—including Australia, New Zealand, the United Kingdom, and the United States—the slowing of growth in 1995 represented a necessary moderation from rates of expansion higher than capacity growth and followed monetary tightening intended to prevent the buildup of inflationary pressures. The United States saw a marked slowdown of growth in the first half of the year, owing to a sharp inventory correction and a decline in real net exports that reflected the effects of the recession in Mexico. Growth rebounded strongly in the third quarter, owing to the continued strength of investment and a pause in inventory adjustment, but then slowed to below $\frac{1}{2}$ of 1 percent (annual rate) in the fourth quarter before picking up again in early 1996. Throughout the period the unemployment rate in the United States remained at the lower end of the range of most estimates of the natural rate. Economic growth slowed in Canada because of a marked rise in interest rates in 1994 and early 1995 and weaker exports, reflecting the slowdown in the U.S. economy.

In Europe, growth weakened generally during 1995, but the extent of the slowdown varied among countries. In some countries—including Italy, Spain, and the United Kingdom—expansion was maintained, and the moderation of growth during the year helped to allay concerns about inflation, prompted in part by earlier exchange rate depreciations. The relatively good growth performance in a number of these countries can be traced to substantial progress in fiscal consolidation, which helped to narrow interest rate differentials vis-à-vis Germany, and to gains in international competitiveness. The slowdown was more pronounced in Germany, France, other countries closely linked to the deutsche mark, and Switzerland. This slowdown was a cause for concern because recovery had barely taken hold and because unemployment increased from already high levels. Strong currencies appeared to have exacerbated the already negative effects on aggregate demand of weak consumer and business confidence.

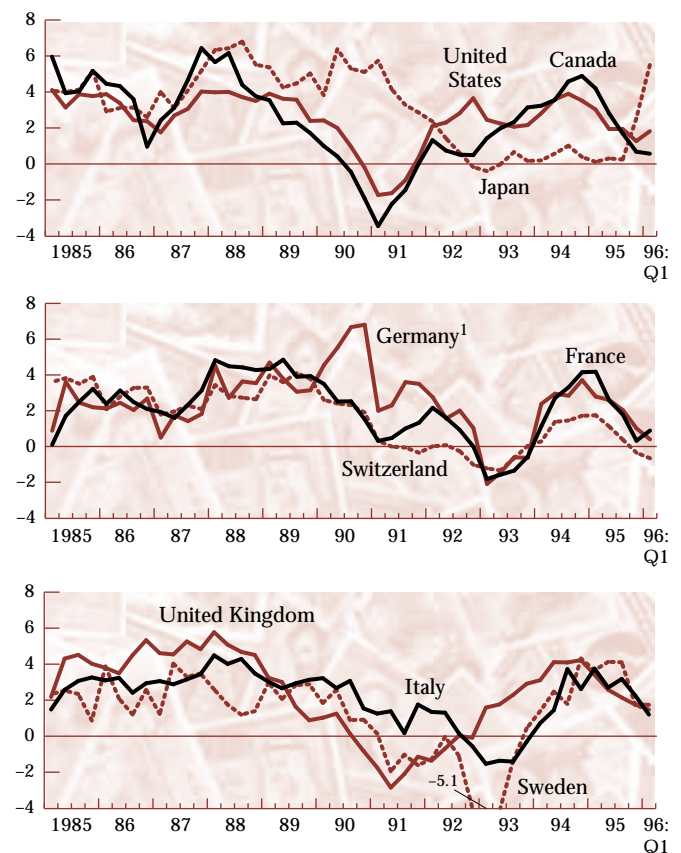
In response to the slowdown, monetary conditions in most European countries were eased in late 1995 and early 1996. The correction of earlier appreciations of a number of currencies, especially the deutsche mark and Swiss franc, also provided support for resumed growth.

In the *developing countries*, output increased by about 6 percent in 1995 for the fourth consecutive year. Performance varied considerably among regions (Chart 3). In the Western Hemisphere, growth slowed sharply to about 1 percent from $4\frac{1}{2}$ percent in 1994 because of recessions in Mexico, Argentina, and Uruguay and the effects of the Mexican financial crisis on a number of other countries. In Mexico, output fell

Chart 2

**SELECTED INDUSTRIAL COUNTRIES:
REAL GDP GROWTH**

(Percent change from four quarters earlier)

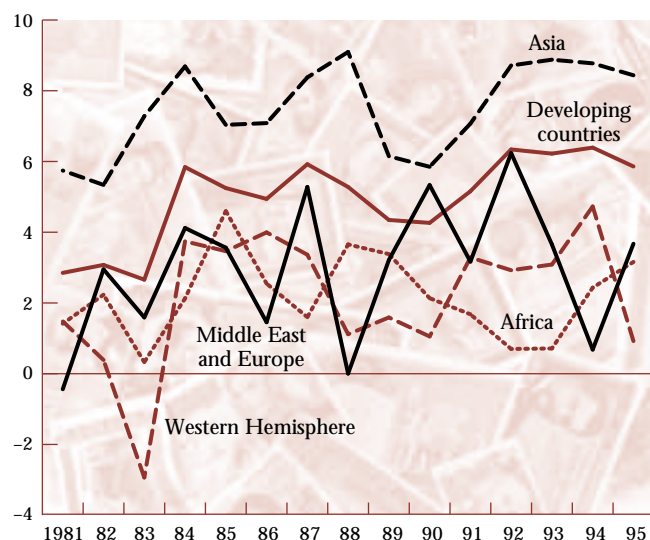


¹ Data through the fourth quarter of 1990 cover west Germany only; data beginning with the first quarter of 1991 are based on a revised methodology and are not comparable with earlier data.

by 7 percent in 1995 following a sharp decline in net capital inflows and a substantial depreciation of the peso which, in the context of tight financial policies, brought about a major adjustment of the economy. The current account deficit fell by $7\frac{1}{2}$ percent of GDP. Argentina, which had experienced average annual growth of $7\frac{3}{4}$ percent in the four previous years, was affected severely by the repercussions of the Mexican crisis and also adopted significant adjustment measures that turned growth negative for the year. Both Mexico and Argentina began to see signs of recovery toward the end of the year. Many other countries of the region—including Chile, Colombia, and Peru—were little affected by the crisis and registered strong growth rates.

In Africa, growth improved to above 3 percent, its highest rate in six years, but in most countries remained insufficient to raise living standards signifi-

Chart 3
DEVELOPING COUNTRIES: REAL GDP GROWTH
 (Annual percent change)



cantly. The continued improvement in Africa's growth performance reflected the stronger macroeconomic and structural policies implemented by a number of countries in recent years, as well as buoyant commodity prices in 1994 and early 1995. In the CFA franc countries, improved external competitiveness following the devaluation in 1994, along with supporting policies, helped to raise growth to 4½ percent, the highest rate in ten years.

Growth in the developing countries of Asia remained above 8 percent in 1995 despite the tightening of financial policies to restrain inflationary pressures in a number of countries, including Malaysia and Thailand. In China, after a prolonged period of overheating, monetary restraint slowed output growth to a more sustainable rate and reduced inflation to about 10 percent. Economic activity in the Philippines continued to recover following the implementation of a successful stabilization program. Growth remained strong in India, reflecting a surge in investment and buoyant exports. In Indonesia, rapid growth of bank lending and a rise in foreign investment continued to support a healthy pace of activity. Rapid urban growth, fueled by high levels of foreign investment, pushed growth in Vietnam above 9 percent.

After barely increasing in 1994, output in the developing countries of the Middle East and Europe² expanded by 3¼ percent in 1995. This pickup in growth is accounted for largely by developments in

²The developing countries of Europe are Cyprus, Malta, and Turkey.

Turkey, where a rebound from a severe recession took growth to 7 percent. Improved regional stability helped to sustain buoyant growth in a number of countries, including Israel, Jordan, and Lebanon. In Saudi Arabia, however, activity remained depressed by weak oil exports and tight financial policies. Growth in Egypt was sustained partly by strong export performance, with increases in industrial production and tourism offsetting a decline in cotton production. In the Islamic Republic of Iran, growth and investment remained weak owing to tight credit and import controls and a slowdown in non-oil exports.

In 1995, for the first time, a majority of the *countries in transition* had positive growth, although output in the group as a whole suffered a further decline of about 1½ percent. The recovery in central and eastern Europe (excluding Belarus and Ukraine) gained further momentum. Growth is most firmly established in those countries—including Albania, the Czech Republic, Poland, the Slovak Republic, and Slovenia—that started earliest and moved most decisively with stabilization and structural reforms. Rapid growth of trade, especially with western Europe, and inflows of foreign direct investment have been important factors sustaining growth. Among the central Asian transition countries, economic performance in Mongolia also benefited from stabilization and reform efforts.

Growth performance was mixed in those transition countries that have been slower or less consistent in stabilization and reform. In Armenia growth exceeded 5 percent for the second consecutive year, and inflation declined significantly. Progress with stabilization during 1995 reduced inflation and helped to arrest the steep declines in output in Russia and Georgia and resulted in modest growth in the Kyrgyz Republic and Moldova. Although tight financial policies were implemented during 1995 in Azerbaijan and Kazakhstan, they were not in place long enough to translate into growth. In contrast, policy slippages during the year in Belarus, Tajikistan, and Ukraine contributed to further sharp declines in output and undermined prospects for recovery in the near term.

Consumer and Commodity Prices

A major achievement during 1995 was the maintenance of reasonable price stability in much of the world economy as solid growth in activity continued. This success hinged on monetary authorities' resolve to resist inflationary pressures.

Among the *industrial countries*, the pre-emptive actions taken in 1994 in the countries most advanced in the expansion forestalled the buildup of inflationary pressures. Thus in the United States, modest wage increases and slower growth in nonwage costs helped to keep inflation under 3 percent, despite the high level of resource utilization. In Canada and the United

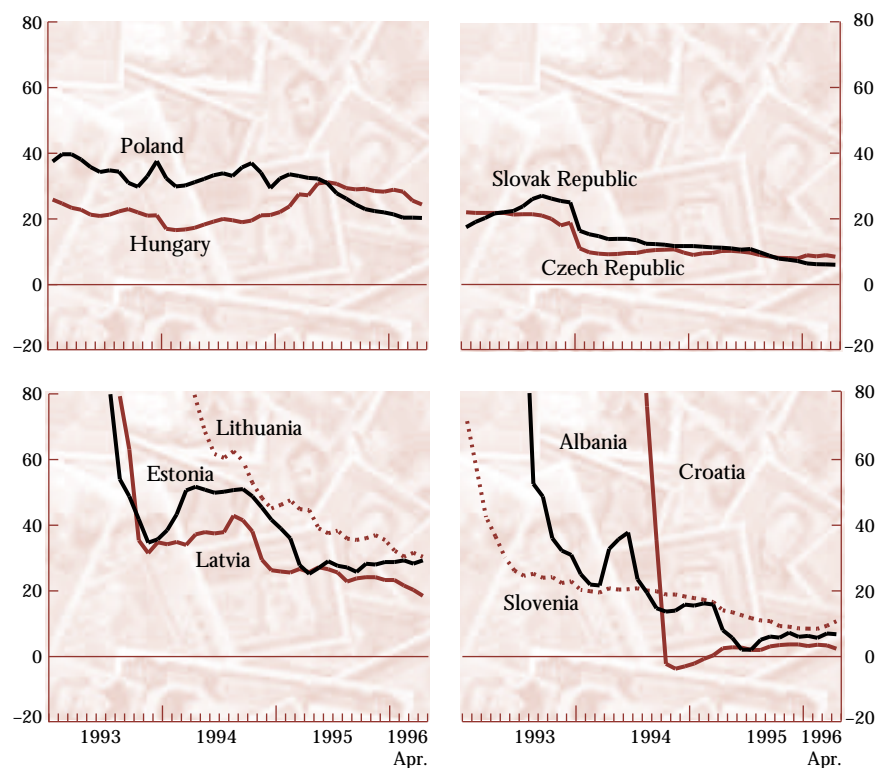
Kingdom, inflation firmed temporarily following exchange rate depreciations but also remained low. In most of continental Europe, including Germany and France, inflationary pressures were limited by continuing significant margins of slack, and in some countries also by exchange rate appreciations. In Italy, however, inflation rose above 5 percent as a consequence of the continued weakness of the lira and indirect tax increases. In Japan, the protracted period of slow growth and the appreciation of the yen resulted in a moderate decline in prices.

In the *developing world*, a majority of countries registered a moderation of inflation in 1995, and the mean rate of increase in consumer prices fell to 20 percent, from 48 percent in 1994. The most marked decline in inflation, to 38 percent in 1995 from 224 percent in the preceding year, occurred in the Western Hemisphere. This was largely owing to a dramatic slowing of inflation in Brazil following the introduction of the real plan in 1994, together with the maintenance of a strong stabilization program. Also, inflation fell further in Argentina in 1995, to its lowest levels in more than 50 years, reaching 1½ percent on a 12-month basis at the end of the year. In Mexico, by contrast, the steep decline in the peso contributed to a sharp rise in inflation in 1995; the country's tight financial policies were designed to restore reasonable price stability in 1996. In a number of African countries, strengthened stabilization efforts contributed to declines in inflation. Inflation in the CFA franc countries fell to 15 percent in 1995 after increasing to 28 percent in 1994 in the wake of the 50 percent currency devaluation. In Asia, inflation moderated to 11 percent in 1995, but concerns about overheating persisted in a number of countries. In the Middle East and Europe region, inflation remained low in most countries, but the average remained above 30 percent largely because of price performance in Turkey and, to a lesser extent, the Islamic Republic of Iran.

Hard-earned progress in bringing down inflation was sustained in most of the *transition countries* during 1995 (Chart 4). Among the countries more advanced in the transition process, the Czech Republic and Slovak Republic, as well as Albania and Croatia, contained inflation to under 10 percent. Other countries, such as Poland, Hungary, and the Baltic countries, registered

Chart 4

SELECTED COUNTRIES MORE ADVANCED IN TRANSITION: INFLATION (Twelve-month percent change in the consumer price index)



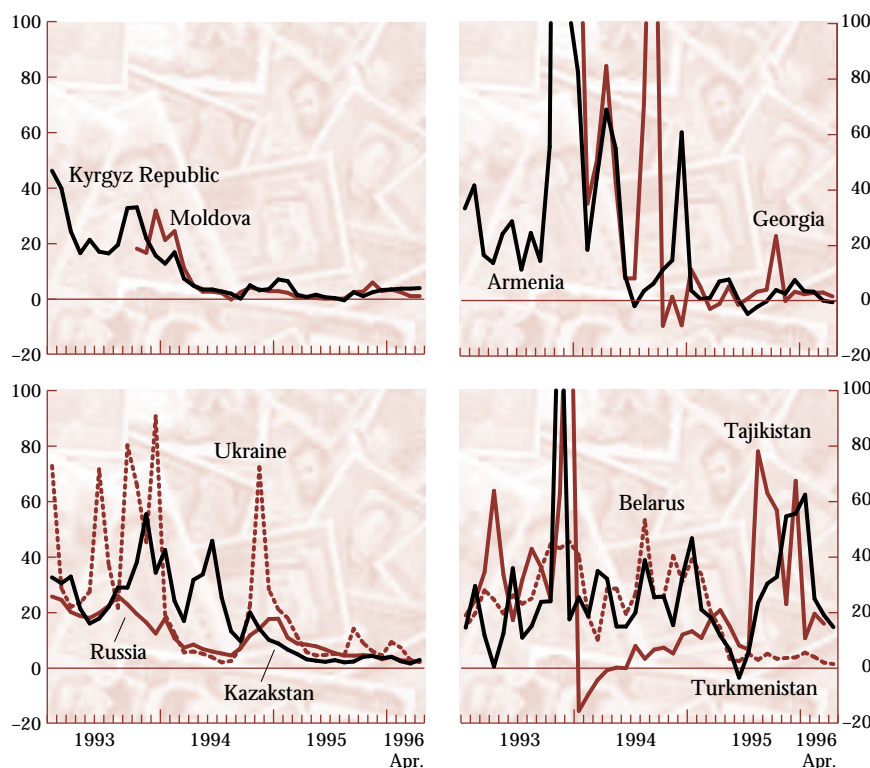
inflation in the 20–40 percent range. There was also noteworthy progress in 1995 in reducing inflation in many countries less advanced in the transition process (Chart 5). Russia made substantial headway, reducing monthly inflation from 18 percent in January to 3¼ percent by year's end through tighter financial policies. In Armenia, Azerbaijan, Bulgaria, Kazakhstan, the Kyrgyz Republic, Moldova, and Uzbekistan, monthly inflation was kept in the low single digits. After some progress earlier in the year, inflation worsened in Turkmenistan and, most notably, in Tajikistan, owing to slippages in financial policies.

Prices of nonfuel *commodities* in U.S. dollar terms increased by 8½ percent in 1995, rising sharply early in the year as the dollar depreciated and declining by small amounts in the remainder of the year. Overall, increases in the prices of cereals, soybeans, and soybean meal largely offset declines in coffee prices. In the first four months of 1996, nonfuel commodity prices increased by 3 percent because of a sharp increase in the price of cereals and feedstuffs owing to low world stock levels. The average dollar price of crude petroleum rose by 9½ percent in 1995—owing in the first half of the year to unexpectedly high demand and the decline of the dollar, and in the second half of the year

Chart 5

SELECTED COUNTRIES LESS ADVANCED IN TRANSITION: INFLATION

(Monthly percent change in consumer price index)



to a drop in Mexican production, low stocks of heating oil, and the disruption of Russian supplies to western Europe. Crude petroleum prices fluctuated widely in early 1996, strengthening because of severe winter weather conditions, and weakening whenever cold weather abated or there were signs that shipments of oil from Iraq might resume.

Financial and Foreign Exchange Markets

The early months of 1995 were a period of significant movements of the major currencies, with the dollar declining especially against the yen but also against the deutsche mark and other European currencies. As a result, a considerable misalignment of exchange rates emerged among the major currencies. Subsequently, these exchange rates moved to levels more consistent with fundamentals. The year also saw a reversal of the rise in global bond yields that had occurred in 1994; although bond yields turned upward again in early 1996, in most cases they remained lower than in most of the preceding two years. In 1995 and early 1996 there were also large declines in short-term interest rates in most industrial countries and strong upward movements in equity prices. Thus financial and foreign exchange market developments in late 1995 and early

1996 were generally favorable for global growth.

While it is difficult to explain fully the movements of the major currencies in *foreign exchange markets* in the early part of 1995, several factors appear to have contributed. The U.S. dollar depreciated owing in part to the effects of the Mexican crisis; diminished expectations of further U.S. interest rate increases, related to the marked slowdown in U.S. economic growth; the persistent U.S. current account deficit; and a shift in investor sentiment away from U.S. dollar-denominated assets. The deutsche mark appreciated partly as a result of concerns about prospects for Economic and Monetary Union (EMU), especially in light of fiscal developments in other European countries. Meanwhile, the yen's appreciation reflected in part concerns felt at that time about the apparently slow pace of adjustment of Japan's external surplus. By mid-April 1995, in nominal effective terms, the dollar had depreciated by 8½ percent from the end of 1994, while the yen and the deutsche mark had

risen by 17 percent and 6 percent respectively. Concerns were raised that the appreciation of the yen and the deutsche mark would impede economic recovery in Japan and Germany, and that the decline of the dollar would not help to contain inflationary pressures in the United States. Concerted intervention and reductions in interest rates in Japan and Germany helped to correct these misalignments in the remainder of the year. By the end of April 1996, in nominal effective terms, the value of the deutsche mark was about the same as its end-1994 level, and the value of the dollar was only about 1 percent lower, while the depreciation of the yen from its peak of April 1995 of 81 against the dollar to 104 at end-April 1996 took its nominal effective value to 6 percent below the end-1994 level.

Exchange rate tensions within the European Monetary System (EMS) also subsided after the spring of 1995, although concerns about fiscal policies and related uncertainties about EMU at times put downward pressure on the French franc and Italian lira in the latter part of the year. Between the end of 1994 and the end of April 1996, the French franc appreciated somewhat against the deutsche mark and rose by 2½ percent in nominal effective terms, while

the nominal effective value of the lira rose by 3 percent. The pound sterling depreciated by a further 4½ percent in nominal effective terms during this period, while the Swiss franc strengthened against both the U.S. dollar and other European currencies, mainly in the early part of 1995, owing, among other factors, to the attractiveness of the Swiss franc as a safe haven. Downward pressure on the Canadian dollar receded following the Quebec referendum in October, and at the end of April 1996 the currency was higher both against the U.S. dollar and in effective terms than at the end of 1994.

In most industrial countries, monetary authorities allowed *short-term interest rates* to decline during 1995 and early 1996 in the face of continuing low inflation and weakening growth. Short-term interest rates declined by close to 2 percentage points in this period in Canada, France, Germany, and Japan. In Japan, the Bank of Japan guided the short-term market rate lower, and reduced the official discount rate in April 1995 and again in September, to a historic low of ½ of 1 percent. In other countries, short-term rates declined mainly after mid-1995. In the United States, the Federal Reserve Board early in the year continued the process of tightening monetary conditions that it had begun in 1994; but in the second half of 1995 and in early 1996 it took easing actions that helped to reduce market rates by a full percentage point below their levels at the end of 1994. Key official rates were also lowered in late 1995 and early 1996 in Canada, France, Germany, and the United Kingdom. Comparatively high inflation did not provide scope for a similar reduction in Italy.

The general decline in *long-term interest rates* that began in late 1994 continued in most industrial countries up to late January 1996. By that time, the increases in long-term rates that had occurred in 1994 were almost fully reversed in several countries, including the United States. These declines appeared to result from the downgrading of projections for growth and inflation, the associated reductions in short-term interest rates permitted by monetary authorities, and improved prospects for fiscal consolidation in a number of countries. From late January 1996, however, long-term rates turned upward. This turnaround appears to have stemmed in part from revised market expectations about near-term monetary policy adjustments in the light of some buoyant economic and monetary indicators in key countries, but less optimistic assessments of fiscal prospects may also have played a role. Despite this upturn, in most countries long-term rates at the end of April were still more than 1 percentage point below their levels at the end of 1994.

Interest rate declines in 1995 and early 1996 underlay the rises in *equity markets* in most countries. Strong profit growth was an additional factor in some coun-

tries, including the United States, where stock market prices recorded gains of about 40 percent.

External Balances, Financing, and Debt

World trade in goods and services grew by 9 percent in 1995, more than twice the rate of growth of world output. The continued rapid growth of world trade can be traced to several factors: achievements in the area of trade liberalization, especially the increased openness of many developing countries and countries in transition; increasing international diversification of production, including outsourcing by multinational corporations; and the dynamic growth of trade among developing countries, especially in Asia and Latin America.

Developments in *current account balances* in 1995 are shown in Table 2. Among the industrial countries, the U.S. current account deficit remained slightly larger than 2 percent of GDP; a decline in official transfers to other countries and an improvement in net investment income offset a worsening in the trade balance, which resulted from a slowdown in exports and an increase in imports despite weak domestic demand. Japan's current account surplus narrowed further, to 2¼ percent of GDP in 1995 from 2¾ percent in 1994, in part owing to the effects of structural changes in industry and trade patterns and the lagged effect of the real appreciation of the yen in recent years. In Europe, Italy's current account surplus widened to 2½ percent of GDP, with exports buoyed by the depreciation of the lira during 1992–95 and the favorable evolution of unit labor costs. France's current account surplus also widened somewhat, while Germany and the United Kingdom continued to run small deficits.

The overall current account deficit of the developing countries was little changed in 1995, although there were variations among regions. In Asia, current account deficits widened substantially in Indonesia, Malaysia, and Thailand. Robust growth of domestic demand spurred import growth, particularly of machinery and equipment. In Indonesia, supply shocks also contributed to a large growth in food imports. In contrast, in China surging exports during the year contributed to an increase in the current account surplus.

In a number of countries in the Western Hemisphere, current account deficits narrowed in 1995. Imports declined in response to adjustment policies implemented in the wake of Mexico's financial crisis. Export earnings increased owing variously to exchange rate depreciations, productivity-enhancing structural reforms, measures aimed at reducing costs and eliminating structural distortions, and favorable movements in the terms of trade. In Mexico, the current account deficit was virtually eliminated in 1995, after reaching about 8 percent of GDP in 1994. Because of gains in competitiveness through falling wages and prices and

Table 2

SELECTED ECONOMIES: CURRENT ACCOUNT POSITIONS

(In percent of GDP)

	1993	1994	1995
United States	-1.5	-2.2	-2.1
Japan	3.1	2.8	2.2
Germany	-0.9	-1.0	-0.7
France	0.8	0.7	1.2
Italy	1.1	1.7	2.4
United Kingdom	-1.8	-0.3	-0.8
Canada	-4.0	-3.0	-1.7
Australia	-3.7	-4.8	-5.3
Austria	-0.4	-0.9	-1.8
Belgium-Luxembourg	5.4	5.6	6.0
Denmark	3.5	1.8	1.5
Finland	-1.3	1.3	3.5
Greece	-0.7	-0.1	-2.3
Netherlands	4.0	4.1	4.4
Norway	3.1	2.4	3.5
Spain	-0.8	-0.8	1.3
Sweden	-2.2	0.4	2.2
Switzerland	8.4	7.1	6.5
Algeria	1.6	-4.3	-7.3
Argentina	-2.9	-3.5	-1.3
Brazil	-0.2	-0.3	-2.7
Cameroon	-5.6	-3.1	-3.6
Chile	-4.6	-1.4	0.2
China	-2.0	1.5	2.3
Côte d'Ivoire	-8.9	-2.1	-3.1
Egypt	4.7	0.4	2.7
India	-0.4	-0.6	-1.5
Indonesia	-1.6	-1.7	-3.7
Israel	-2.1	-3.5	-5.6
Korea	0.1	-1.2	-2.0
Malaysia	-4.6	-5.9	-8.3
Mexico	-6.4	-7.7	-0.1
Nigeria	-2.9	-2.4	-0.7
Pakistan	-4.9	-3.3	-3.8
Philippines	-5.5	-4.4	-3.3
Saudi Arabia	-14.6	-7.5	-4.0
Singapore	9.1	17.3	18.3
South Africa	1.5	-0.5	-2.3
Taiwan Province of China	3.0	2.6	1.6
Thailand	-5.4	-5.7	-7.1
Turkey	-3.5	2.0	-1.0
Uganda	-1.6	-0.8	-3.0
Czech Republic	2.2	-0.1	-3.3
Hungary	-9.0	-9.5	-5.5
Poland	-0.1	2.3	2.9
Russia	3.4	1.2	1.2

Source: International Monetary Fund, *World Economic Outlook* (May 1996).

substantial productivity gains, but also because of a decline in GDP, the current account deficit in Argentina also narrowed in 1995, to around 1 percent of GDP. Chile's current account moved into small surplus in part as a result of higher copper prices. Brazil's current account, by contrast, registered a deficit of 2½ per-

cent of GDP after being close to balance in the preceding two years.

In Africa, current account deficits widened in a number of countries owing to increases in imports and declines in commodity prices during the second half of the year. In Uganda, the doubling of coffee prices in late 1994 and early 1995 boosted export earnings, but this was insufficient to prevent a rise in the current account deficit. South Africa's current account deficit also widened, despite the expansion of exports, as domestic demand for manufactured goods and food imports increased.

Among the countries in transition, Hungary's current account deficit fell in 1995 owing to corrective policy actions. In the Czech Republic, in contrast, the current account deficit widened as a result of strong economic growth and, in particular, the rapid increase in import demand.

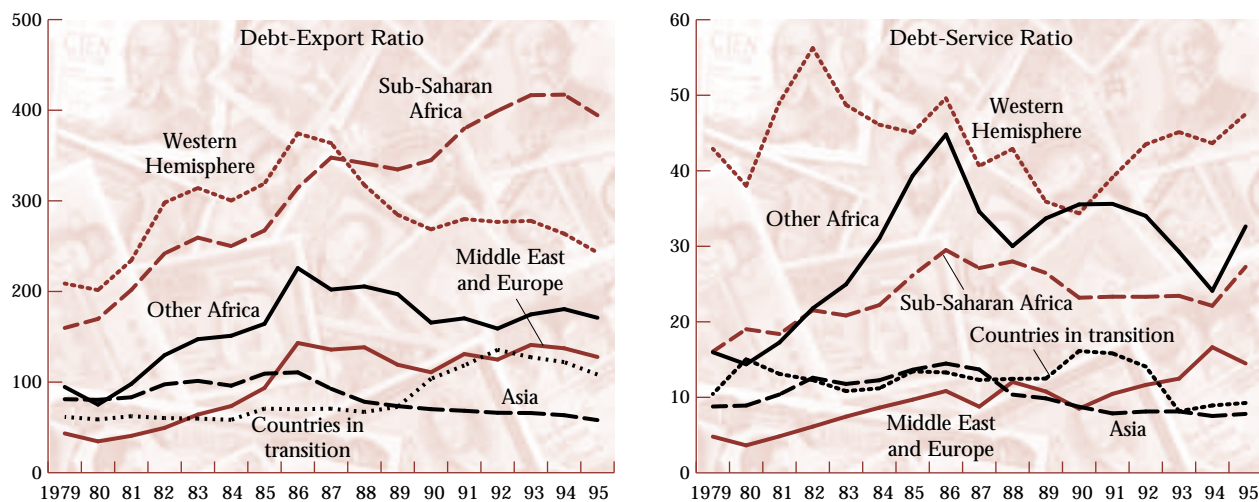
Net *capital flows to emerging market countries* recovered in the second half of 1995 following a sharp decline in the wake of the Mexican financial crisis. Net capital flows to developing countries were actually higher in 1995 than in any previous year. Nevertheless, flows to some countries did not fully recover after the fallout from the Mexican crisis—especially to those countries where weaknesses in domestic financial markets were exposed by the crisis. Interest rate declines in the industrial countries helped capital flows to emerging markets to recover, as did the favorable reaction of financial markets to policy tightening in many emerging market countries. In Latin America, with the exceptions of Mexico and Argentina, private inflows exceeded the levels attained in 1994. Increases were particularly sharp in the case of

Brazil. The developing countries of Asia continued to attract large inflows, and capital flows to South Africa, Turkey, and central Europe surged. The rapid recovery in capital flows to developing countries indicates the importance of the progress with policies that has been made in recent years.

Chart 6

DEVELOPING COUNTRIES AND COUNTRIES IN TRANSITION: EXTERNAL DEBT AND DEBT SERVICE¹

(In percent of exports of goods and services)



¹ Debt service refers to actual payments of interest on total debt plus actual amortization payments on long-term debt.

Official financial flows to developing and transition countries were unusually high during 1995. In particular, use of Fund resources surged to \$26.8 billion in 1995—more than triple its 1994 level—reflecting in part loans of about \$13 billion to Mexico and \$5 billion to Russia to support those countries' comprehensive adjustment programs.

The aggregate external debt of developing and transition countries, as a percentage of exports of goods and services, declined further in 1995 (Chart 6). Despite some improvements in the countries of sub-Saharan Africa, their debt burden is still high compared with that of other regions. The debt-service ratio for all developing and transition countries was stable in 1995, although it increased in the countries of Africa and the Western Hemisphere.

There was additional progress during 1995 and early 1996 in restructuring the commercial bank debts of the heavily indebted developing countries. As of February 1996, completed agreements for restructured bank debt for 25 countries totaled \$173 billion. In October 1995, Panama completed a debt- and debt-service-reduction agreement with commercial banks, and Algeria concluded an agreement to reschedule \$3.2 billion of its total \$4.2 billion of outstanding commercial bank debt. Peru announced an agreement in principle, and Vietnam and Côte d'Ivoire continued discussions with their commercial bank creditors. Albania, Ethiopia, Nicaragua, and Sierra Leone completed

buybacks of commercial bank debt at steep discounts, with support from the World Bank's IDA Debt Reduction Facility. In November 1995, discussions between Russia and the London Club and creditor institutions resulted in an agreement in principle to reschedule commercial bank debt and interest arrears inherited from the former Soviet Union. Slovenia and commercial bank creditors reached an agreement on Slovenia's share of the debt of the former Socialist Federal Republic of Yugoslavia.

Paris Club creditors continued progress with debt rescheduling under the Naples terms introduced in December 1994, which provide for a reduction in eligible debt of up to 67 percent in net present value terms for most low-income countries (flow reschedulings). In addition, for countries where a good track record under rescheduling agreements and Fund programs has been established and where there is sufficient confidence in the debtor's ability to respect the agreement, the entire stock of eligible debt can be rescheduled concessionally (a stock-of-debt operation). By the end of April 1996, 16 reschedulings were agreed under Naples terms—14 flow reschedulings and 2 stock-of-debt operations (for Guyana and Uganda). Paris Club creditors also agreed on reschedulings with five low- and middle-income countries on nonconcessional terms during financial year 1996, including agreements with Russia in June 1995 and April 1996.

