THE GLOBAL ECONOMY

CHAPTER 1

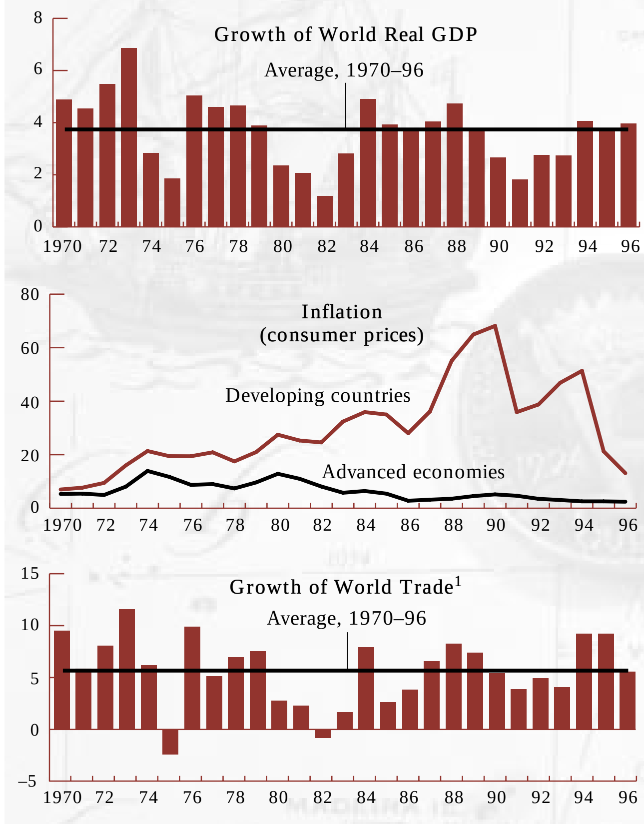
Main Developments in the World Economy

World economic growth continued at about 4 percent in 1996 for the third successive year (Figure 1). Activity picked up in a number of industrial countries, while growth resumed in those developing countries in the Western Hemisphere that had been adversely affected by the financial crisis in Mexico in 1995. Growth rates also strengthened in the Middle East and, more markedly, in Africa. In the transition countries as a group, output stabilized after six years of deep decline. There was a desirable moderation of growth in many of the newly industrialized and developing economies of Asia.

Developments in 1996 and early 1997 showed few signs of the tensions that normally foreshadow downturns in the business cycle (Table 1). Inflation remained subdued in the advanced economies (for the classification of advanced economies, see Box 1) and declined further in the developing and transition countries. Developments in financial markets reflected growing confidence in the outlook for continued low global inflation, with longer-term interest rates continuing on a downward trend in many countries. Rates declined particularly sharply in the higher-yielding bond markets in Europe as investors took note of those countries' improved fiscal and inflation performance. Exchange rates among the major currencies in 1996 were reasonably consistent with fundamentals and policy objectives. In early 1997, the continued appreciation of the U.S. dollar, especially against the yen, gave rise to some concerns, which were subsequently eased when the yen strengthened. Private capital flows to emerging market countries remained buoyant.

The expansion of world trade slowed markedly in 1996 following the exceptionally rapid growth of the two preceding years. Even though the growth of world output increased, sluggish demand for imports in some of the advanced economies—arising in some cases from efforts to reduce excessive inventories—and moderating growth in a number of Asian countries contributed to the disproportionate slowing of trade. Notwithstanding the slowdown, the growth of world trade in 1996 was close to its long-term average.

Figure 1
World Indicators
(Annual percent change)



[1] Goods and services, volume.

Despite the favorable developments in the world economy in 1996 and early 1997, there were a number of areas of concern. Many countries continued to suffer

Table 1
Overview of the World Economy
(Annual percent change unless otherwise noted)

	1993	1994	1995	1996
World output	**2.7**	**4.1**	**3.7**	**4.0**
Advanced economies	1.2	3.1	2.5	2.5
United States	2.3	3.5	2.0	2.4
Japan	0.1	0.6	1.4	3.6
Germany	–1.1	2.9	1.9	1.4
France	–1.3	2.8	2.2	1.3
Italy	–1.2	2.1	3.0	0.7
United Kingdom	2.1	3.8	2.5	2.1
Canada	2.2	4.1	2.3	1.5
Seven countries above	1.0	2.8	2.0	2.2
Other advanced economies	2.0	4.5	4.2	3.7
Memorandum				
European Union	–0.5	2.9	2.5	1.6
Developing countries	6.5	6.8	6.0	6.5
Africa	0.9	2.9	2.9	5.1
Asia	9.3	9.6	8.9	8.2
Middle East and Europe	4.3	0.3	3.8	4.5
Western Hemisphere	3.7	5.0	1.3	3.5
Countries in transition	–6.3	–6.7	–0.8	0.1
Central and eastern Europe	–4.0	–1.8	1.6	1.6
Excluding Belarus and Ukraine	0.5	3.7	5.0	3.4
Russia, Transcaucasus, and central Asia	–8.8	–12.8	–4.0	–1.9
World trade volume (goods and services)	**4.1**	**9.2**	**9.2**	**5.6**
Imports				
Advanced economies	1.8	9.7	8.7	5.3
Developing countries	8.8	7.1	11.6	8.4
Countries in transition	22.6	4.6	16.1	7.8
Exports				
Advanced economies	3.4	8.9	8.4	5.0
Developing countries	7.1	12.4	11.2	6.8
Countries in transition	20.6	8.4	13.4	4.7
Commodity prices in U.S. dollars				
Oil[1]	–11.6	–5.5	8.0	18.9
Nonfuel[2]	1.8	13.6	8.2	–1.3
Consumer prices				
Advanced economies	3.1	2.6	2.6	2.4
Developing countries	46.9	51.3	21.3	13.1
Countries in transition	486.1	246.0	117.7	42.7
Six-month LIBOR (in percent)[3]				
On U.S. dollar deposits	3.4	5.1	6.1	5.6
On Japanese yen deposits	3.0	2.4	1.3	0.7
On deutsche mark deposits	6.9	5.3	4.6	3.3

[1]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.
[2]Average, based on world commodity export weights.
[3]London interbank offered rate.

from large fiscal imbalances and structural rigidities. In much of the European Union unemployment rose to new postwar peaks, reflecting weak growth and impediments to labor market flexibility. In the United States and the United Kingdom, which are at relatively advanced stages of expansion, monetary authorities were concerned with the potential risk of rising inflation. This led to increases in official interest rates in the United Kingdom in October 1996 and the United States in March 1997. The strength of equity prices in many countries increased the danger of a marked correction. The sustainability of current account deficits in some emerging market countries also appeared questionable. In a number of countries fragile banking systems remained a concern.

Economic Activity and Employment

In the *advanced economies*, economic growth in 1996, at 2½ percent, was virtually the same as in 1995, but the pattern of developments was quite uneven. Year on year, growth picked up in the United States, Japan, and a number of other industrial countries (Figure 2) but weakened in much of continental Europe. Growth also moderated to a more sustainable pace in the newly industrialized economies of Asia.

Most industrial countries at relatively advanced stages of the business cycle continued to experience buoyant growth. In the United States, hesitant growth during 1995 gave way to a more solid expansion in 1996, with the economy growing at 2½ percent. This was due in part to the response to the earlier lowering of interest rates as well as strong consumer confidence, reflecting buoyant employment creation and the absence of substantive macroeconomic imbalances in the economy. The U.S. fiscal deficit continued to decline in 1996 both in nominal terms and as a share of GDP, and the economy continued to operate near full capacity. Unemployment, having stood a little above 5½ percent since late 1994, fell to about 5¼ percent in mid-1996 and subsequently remained close to that level until it fell to just below 5 percent in April 1997. Although unemployment was below most estimates of the rate at which inflation has in the past tended to accelerate, there were scant signs of price pressures. In the United Kingdom, growth rates strengthened to close to or above potential during 1996 as private consumption rebounded. By April 1997 unemployment had fallen to just below 6 percent, one of the lowest rates in Europe. Australia experienced a combination of low inflation and robust growth of around 4 percent in 1996; with growth slowing through the course of the year, there was little risk of overheating. In New Zealand, the expansion slowed to about 2½ percent, reducing the risk of overheating.

Box 1

Revised Country Classification: Advanced Economies

Beginning with the May 1997 issue of the *World Economic Outlook*, the newly industrialized economies in Asia (Hong Kong, China; Korea; Taiwan Province of China; and Singapore), as well as Israel, are considered as advanced economies together with the group of countries traditionally known as industrial countries.

The reclassification reflects the advanced stage of economic development these economies have now reached. In fact, they all now share a number of important industrial country characteristics, including relatively high per capita income levels well within the range indicated by the group of industrial countries, well-developed financial markets and high degrees of financial intermediation, and diversified economic structures with relatively large and rapidly growing service sectors.

Rather than retaining the old industrial country label, the expanded group is labeled the "advanced economies" in recognition of the declining share of employment in manufacturing common to all of these economies.

In Japan, recovery began in earnest in late 1995. During 1996 growth maintained a moderate underlying pace and became more broadly based. In late 1996 and early 1997, although activity appeared to be well sustained, concerns about the effects on demand of the planned withdrawal of fiscal stimulus adversely affected confidence and the stock market. However, the low level of domestic interest rates and the depreciation of the yen since mid-1995 provided continuing stimulus to activity. The authorities also announced deregulation plans designed to boost medium-term growth prospects.

In Canada, after 18 months of sluggish growth, activity revived in the second half of 1996, although growth for the year as a whole amounted to only 1½ percent. Increases in residential construction, and investment in machinery and equipment, fueled this pickup. The easing of monetary conditions, the return of confidence, and continued progress in reducing the fiscal deficit helped to lower long-term interest rates. Unemployment, however, remained in the 9½–10 percent range.

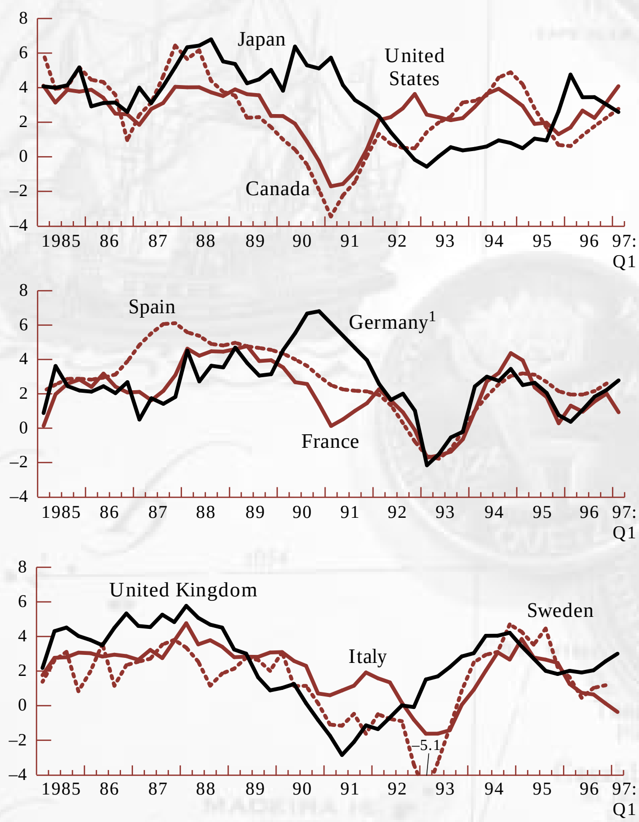
Growth in continental Europe weakened in 1996. Despite the recovery of activity in the second and third quarters in Germany, the growth of real GDP was only about 1½ percent for the year as a whole. While the export sector was buoyant, domestic demand growth was muted, with consumer and business confidence remaining low. Unemployment in Germany reached a new postwar peak of 11¼ percent (seasonally adjusted) in early 1997. In France, too, economic activity in 1996 as a whole remained sluggish, with real GDP increasing by about 1¼ percent. Investment remained flat, and destocking continued to be a drag on growth, but consumer spending and net exports both increased. In early 1997 unemployment reached a new peak of 12¾ percent. In Italy, the slowdown of activity in 1996 was particularly marked, reflecting in part the strengthening of the lira since early 1995 and the weakness of key export markets in Europe. Unemployment was relatively stable at about 12 percent.

Economic activity was more buoyant in a number of other European countries in 1996. In Sweden, the prospects for substantially lower inflation and the ongoing rapid fiscal consolidation allowed monetary policy to be eased significantly. Economic activity picked up in the middle of the year, fueled primarily by the external sector and investment spending. In Finland and Spain, a similar strengthening of exports during 1996 contributed to a resumption of growth. The strengthening of economic activity in Denmark and the Netherlands, in contrast, was primarily driven by domestic demand.

In response to the sluggishness of activity, absence of inflationary pressures, and continued efforts at fiscal consolidation, monetary authorities in Germany and its partner countries in the exchange rate mechanism (ERM) of the European Monetary System (EMS) allowed short-term interest rates to decline further in 1996. These reductions in short-term rates, combined with declines in long-term rates and depreciations of the deutsche mark and other ERM currencies vis-à-vis the dollar, constituted a substantial easing of monetary conditions, which by early 1997 had significantly boosted growth prospects for these countries.

Growth moderated in the newly industrialized economies of Asia in 1996. The slowdown represented a mild cyclical correction following the above-trend growth rates of 1994–95 and resulted partly from a tightening of financial policy intended to diminish the risk of overheating. At the same time, exports slowed owing to losses in the external competitiveness of currencies tied to the appreciating U.S. dollar, to weaker

Figure 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.

import demand from other advanced economies and from within the region, and to a pronounced weakening of the global electronics market.

In the *developing countries,* economic growth firmed to 6½ percent in 1996, marking the fifth consecutive year of expansion of 6 percent or more (Figure 3). Among the developing countries of the Western Hemisphere, growth picked up to 3½ percent in 1996 following the previous year's slowdown associated with the Mexican crisis. In Mexico, the economic recovery exceeded most expectations, and real GDP increased by 5 percent. Economic recovery also gathered strength in Argentina, with GDP increasing by about 4½ percent. Growth moderated in both Brazil and Chile, although Chile's growth rate of 7 percent was again one of the highest in the region.

With an increasing number of countries in Africa making significant progress with macroeconomic stabilization and structural reform efforts, the upturn in economic growth that began in 1994–95 broadened further in 1996. Africa's 5 percent economic growth in 1996 represented its strongest performance in two decades. The faster growth reflected strong activity in the primary products sector and, in some countries, manufacturing. CFA franc zone countries, on the one hand, saw continued recovery following the 1994 exchange rate adjustment. Ethiopia, Malawi, Morocco, and Tunisia were among other countries experiencing strong expansion. Growth in South Africa, on the other hand, continued to be constrained by the need to reduce macroeconomic imbalances and by structural rigidities.

Among the Asian developing countries, growth in 1996 remained very high at 8¼ percent, although slower than in 1995. Export growth weakened in a number of the fast-growing developing countries of the region. In some countries, such as Indonesia, Malaysia, and Thailand, the impact of the export slowdown on output coincided with the effects of tighter domestic financial policies aimed at reducing the risk of overheating. In China, output growth moderated further but was still as high as 9½ percent. Growth also slowed moderately in India to slightly below 7 percent. GDP growth strengthened further in the Philippines. And solid growth performance continued in the Asian developing countries undergoing transition from central planning to market-based systems (Cambodia, the Lao People's Democratic Republic, and Vietnam).

Real GDP growth strengthened to about 4½ percent in the developing countries of the Middle East and Europe[2] in 1996. Growth in Egypt increased to about 4 percent, reflecting the progress toward macroeconomic stabilization and deregulation of the economy in the past few years. In Saudi Arabia, improved fiscal and external positions, buoyed by higher oil export revenues, contributed to increased private sector confidence and a recovery in growth to 2½ percent. Growth in a number of other oil-producing countries also benefited from the rise in petroleum prices. Turkey's expansion weakened in 1996 in a context of rising inflation and widening imbalances.

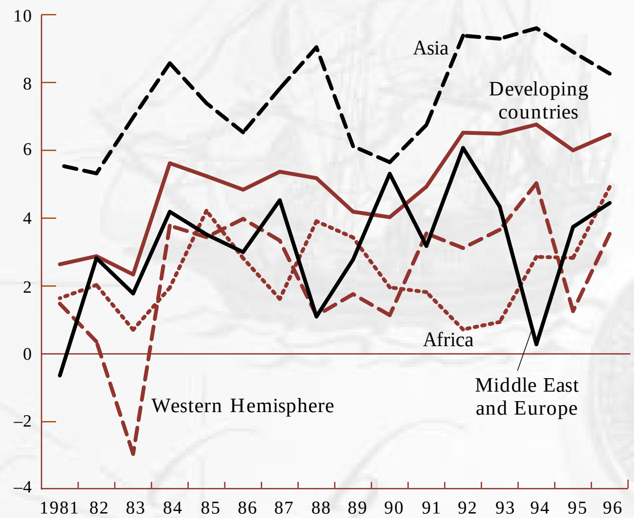
In the *countries in transition* as a group, economic activity stabilized in 1996 after having declined for six years. The countries more advanced in the transition process generally continued to record positive growth. Poland, in its fifth year of expansion, saw growth moderate somewhat, to around 5½ percent. Growth in the Czech Republic, Estonia, and Slovenia, while still exceeding 3 percent, also moderated in 1996, mainly as a result of weaker exports to the European Union. In Latvia and Lithuania, growth increased to about 3 percent and 3.5 percent, respectively. GDP growth in Hungary slowed to about 1 percent, but policy

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

action to correct financial imbalances helped to strengthen conditions for sustainable growth.

The experience of the countries less advanced in transition was more mixed. Signs of recovery emerged in 1996 in Azerbaijan, Kazakstan, and the former Yugoslav Republic of Macedonia, while Armenia and the Kyrgyz Republic recorded growth above 5 percent, and Georgia above 10 percent. Macroeconomic stabilization significantly reduced inflation in Russia and Ukraine, but both countries continued to experience stagnant or declining output, although available statistics may exaggerate the extent of the output contraction. The reported decline in output in Russia, at 3 percent, was more moderate than in each of the preceding five years, but sharper declines were seen in Bulgaria, Tajikistan, and Ukraine. In Bulgaria, the lack of structural reforms undermined banking system solvency and led to a severe banking-cum-currency crisis and deep recession. Albania was also confronted with a financial and economic crisis in early 1997 caused by the collapse of "pyramid" investment schemes.

Figure 3
Developing Countries: Real GDP Growth
(Annual percent change)



Consumer and Commodity Prices

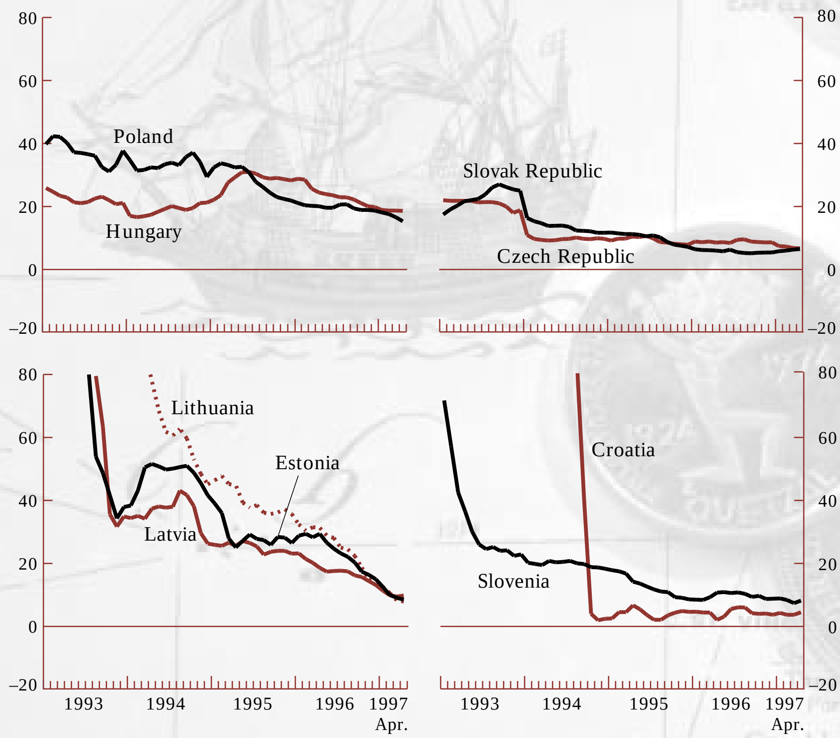
Inflation remained subdued during 1996 in the advanced economies and declined further in the developing and transition countries, despite a sharp increase in oil prices, which peaked in early 1997. It was particularly notable that inflation remained low in those advanced economies where economic expansions were quite mature, an indication of the increased resolve of monetary authorities in many countries to resist inflationary pressures.

In the *advanced economies* as a group, consumer price inflation remained at 2½ percent in 1996. Despite the high utilization of resources, core consumer price inflation in the United States remained subdued at just above 2½ percent, although there were signs of an acceleration in wages. The increasingly tight labor market in the United Kingdom was also reflected to some extent in labor earnings; consumer price inflation remained above the official 2½ percent target until it fell to that level in April 1997. In Canada, core inflation eased to 1½ percent in 1996, in the lower half of the official target range of 1 to 3 percent, owing to significant slack in the economy. In a number of continental European countries, including Germany and France, weak growth and muted demand helped to keep inflation at about 2 percent or lower in 1996 and early 1997. Inflation in Italy fell particularly sharply—to 1½ percent on a 12-month basis in April 1997 from 5 percent in early 1996—owing in part to the lira's appreciation. Both Sweden and Finland recorded inflation rates of only ½ of 1 percent in 1996. In Japan, following the protracted period of slow growth, the price level was virtually unchanged. In Korea, inflation picked up slightly to 5 percent, but in the other newly industrialized economies of Asia price increases moderated.

In the *developing countries*, inflation declined to about 13 percent in 1996, the lowest rate in over a decade, with price increases moderating in all the major regions. Among the developing countries of the Western Hemisphere, inflation was virtually zero in Argentina in 1996, while Brazil's inflation rate declined to 11 percent, its lowest level in many years, reflecting the success of the *real* plan. Inflation in Mexico was unchanged at about 35 percent on an annual average basis, but by April 1997 it had fallen to 22 percent on a 12-month basis. Inflation also moderated widely in Africa. Following the implementation of structural adjustment programs, the countries of the CFA franc zone experienced a significant decline in inflation, to 6 percent, along with a strengthening of economic activity. Malawi, Morocco, and Ethiopia were other countries in Africa where inflation declined perceptibly. Some limited progress was made during 1996 in restoring economic stability in Nigeria, but inflation, while easing, remained high. In Asia, China achieved a soft landing after three years of double-digit inflation: by late 1996, 12-month inflation was down to 6 percent. Most other developing countries of Asia also achieved lower inflation in 1996. In the regional grouping of the Middle East and Europe, inflation in most countries remained in single digits in 1996. In the Islamic Republic of Iran and the Republic of Yemen, inflation moderated to below 30 percent, but in Turkey it remained above 80 percent.

In the *countries in transition*, inflation fell to an average rate of 43 percent in 1996, the lowest level

Figure 4
Selected Countries More Advanced in Transition: Inflation
(Twelve-month percent change in the consumer price index)



January 1997, however, petroleum prices fell by about 23 percent up to the end of April owing to stronger world oil production, including the resumption of shipments from Iraq, and improved inventory levels.

Financial and Foreign Exchange Markets

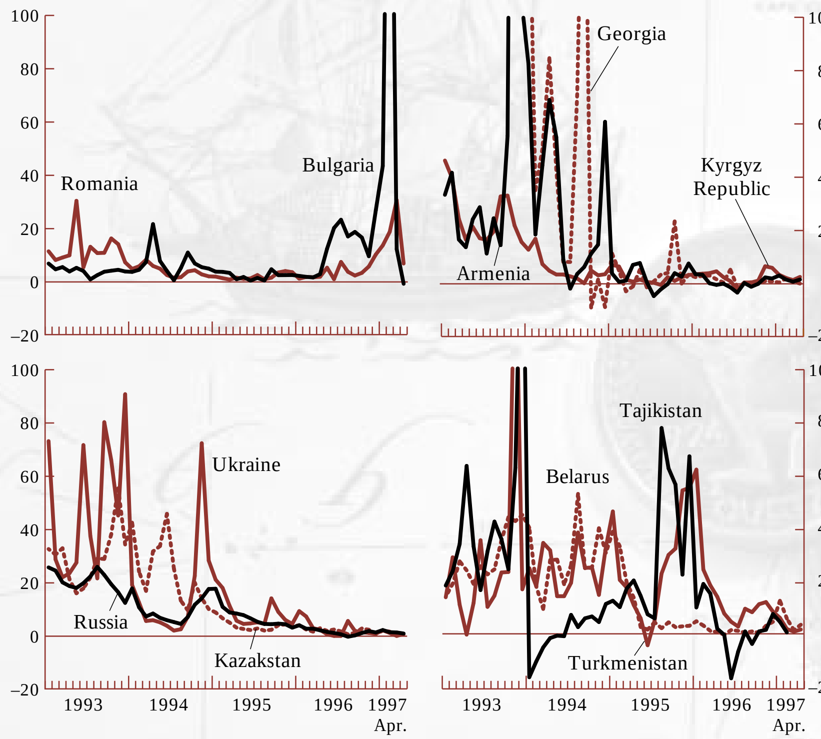
Developments in the foreign exchange and financial markets of the advanced economies in 1996 and early 1997 reflected changing perceptions of the near-term growth prospects of individual countries and growing confidence in the outlook for continued low global inflation and in prospects for fiscal consolidation and monetary union in Europe. Short-term interest rates in most cases either remained broadly unchanged or declined, the most notable exceptions being the United States and the United Kingdom, where they rose slightly. Long-term interest rates followed a variety of paths. They rose significantly on balance in the United States through 1996 and early 1997 but continued on downward trends in most other industrial countries. The higher-yielding bond markets in Europe recorded the largest overall declines. Movements in exchange rates also, for the most part, maintained the trends prevailing since around April 1995. Generally speaking, these have been helpful responses to relative demand pressures in the major economies, without moving exchange rates out of line with medium-term requirements for balance of payments sustainability. The U.S. dollar appreciated further against most other major currencies, while a marked acceleration in the appreciation of the pound sterling in late 1996 and early 1997 was a notable new development. The ERM was generally free of significant tensions. The Finnish markka joined the ERM in October, and the lira reentered in November. The environment of low inflation, stable or falling interest rates, healthy corporate profits, and buoyant or improving growth prospects in most countries laid the basis for further large gains in industrial country equity markets during 1996, with the notable exception of Japan.

In the United States, with indicators showing the economy continuing to operate near capacity but with little evidence of rising inflation, the Federal Reserve Board held *short-term interest rates* unchanged between February 1996 and late March 1997. Then, with

since the transition began. By the end of 1996, inflation had declined to 20 percent or less in the countries more advanced in the transition process, and to below 10 percent in Croatia, the Czech Republic, the Slovak Republic, and Slovenia (Figure 4). In a number of countries less advanced in transition, efforts at macroeconomic stabilization were rewarded in 1996 with sharp declines in inflation (Figure 5). Inflation fell markedly in Armenia, Azerbaijan, Georgia, Kazakstan, Russia, and Ukraine and remained broadly stable in the Kyrgyz Republic and Moldova owing in part to the increased stability of nominal exchange rates. In other countries less advanced in transition, including Albania, Bulgaria, and Romania, macroeconomic stabilization slipped, and inflation increased.

The Fund's index of *commodity prices* rose by about 5 percent in dollar terms in 1996; an increase of about 37 percent in the price of crude petroleum was partly offset by a 5 percent decline in the prices of nonfuel commodities (Figure 6). The low levels of stocks in the aftermath of the unusually harsh 1995–96 winter in the Northern Hemisphere exacerbated the impact on petroleum prices of increased demand for heating oil, particularly in the second half of 1996. After peaking in middemand pressures apparently increasing, it raised the target federal funds rate to 5½ from 5¼ percent. Short-term rates meanwhile remained unchanged in Japan at the historically low levels set in August 1995. In Germany, key short-term rates were lowered by 50–75 basis points between end-1995 and August 1996 and then were kept unchanged. The Bank of France lowered short-term rates by about 1¼ percentage points between end-1995 and early 1997, while the Bank of Italy's discount rate was lowered by 2¼ percentage points in the same period. Apart from the United States, the most notable exception to the downward trend in short-term rates was the United Kingdom, where official rates were increased by 25 basis points in October 1996 to contain the inflation risks associated with a consumer-led upswing in activity. Elsewhere in Europe, fiscal consolidation and favorable inflation developments provided scope for official rate cuts in Portugal, Spain, and Sweden. The Australian and New Zealand central banks also permitted short-term rates to fall during 1996.

Figure 5
Selected Countries Less Advanced in Transition: Inflation
(Monthly percent change in consumer price index)

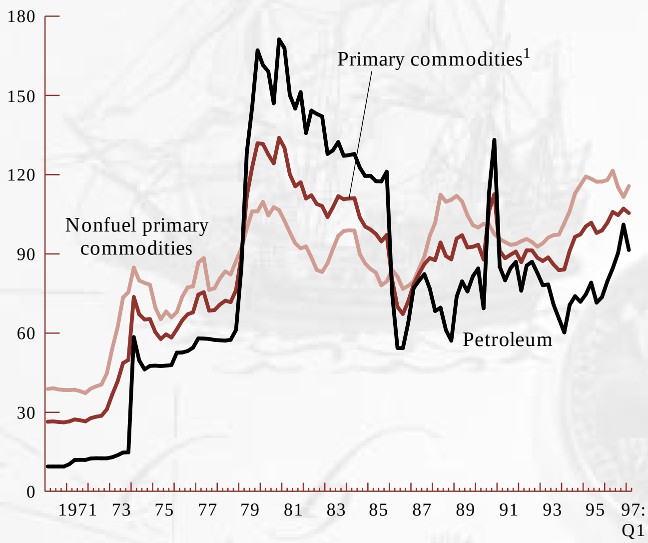


Long-term interest rates rose in most industrial countries in early 1996 but then followed a variety of paths. In the United States, they leveled off in midyear and declined through most of the remainder of 1996 as the moderation of growth in the third quarter became clearer in the data. Subsequently, however, yields rose again on signs of stronger growth and fears of tightening by the Federal Reserve. By late April 1997, they were 1¼ percentage points higher than at the end of 1995, but below mid-1996 highs. In most other countries, long-term rates peaked earlier in 1996 and subsequently fell below end-1995 levels. Bond yield spreads narrowed significantly in Europe, in response to further convergence in inflation performance and progress with fiscal consolidation, which contributed to more positive market assessments for Economic and Monetary Union (EMU). The largest declines in bond yields—of around 3 percentage points—were recorded in Italy, Portugal, and Spain. Contributing to yield declines in the latter half of 1996 were cuts in official interest rates in several countries. In Japan, expectations that the highly accommodative monetary stance would be maintained for longer than perceived earlier, given the hesitant progress of the recovery, caused long-term rates to fall to historically low levels below 2.2 percent in April 1997, about 75 basis points lower than at the end of 1995.

In *foreign exchange markets,* the U.S. dollar continued to appreciate against most other major currencies through 1996 and early 1997. Compared with its trough of April 1995, the dollar by the end of April 1997 had appreciated by 56 percent against the yen, by 27 percent against the deutsche mark, and by 20 percent in nominal effective terms. During the fourth quarter of 1996 the pound sterling rose against all other major currencies. By late April 1997 it was 19 percent higher in effective terms than at the end of 1995, and 27 percent higher against the deutsche mark. Following the currency movements of 1996 and early 1997, the value of the dollar, in real effective terms, had risen back to levels last seen in the late 1980s, while the value of the yen had fallen back to levels last seen in early 1993.

The exchange rate movements during 1996 and early 1997 were in part attributable to the continued disparities in relative cyclical positions among the major economies. The appreciation of the dollar was supported by the continued relatively strong position of the U.S. economy and by associated interest rate

Figure 6
Commodity Prices
(In U.S. dollars; 1990 = 100)



[1] The weights are 57.7 percent for the index of nonfuel primary commodities and 42.3 percent for the index of petroleum prices.

differentials in favor of dollar-denominated assets. Interest rate differentials favoring sterling-denominated assets, and expectations that higher interest rates would be needed in the United Kingdom to contain inflation also contributed to the rise of the pound. In contrast, the yen continued to weaken as concerns over the robustness of the Japanese economic recovery contributed to expectations that domestic interest rates would remain low. Similarly, low interest rates in Switzerland and weak domestic growth prospects contributed to a marked depreciation of the Swiss franc.

Stock market prices rose strongly in most industrial countries in 1996, reaching peaks in early March 1997 before undergoing moderate corrections as bond yields rose and the Federal Reserve tightened monetary conditions. U.S. share prices were buoyed by strong growth, low inflation, reduced fiscal imbalances, and high corporate profits. But the rise in the U.S. stock market to new peaks—over 30 percent higher in late April 1997 than at the end of 1995—prompted official expressions of concern. Equity markets in Canada and Europe had mostly lagged behind the U.S. market prior to 1996. In late 1996 they rose more rapidly, apparently reflecting improved growth prospects in many countries combined with lower bond yields. The main exception to the upward trend was Japan, where equity prices fell by about 4 percent in the period between the end of 1995 and April 1997 on concerns about the outlook for growth and corporate profitability, and uncertainty about the pace, extent, and implications of financial deregulation.

In contrast to the performance of industrial country markets, overall equity price gains in emerging market countries were modest, with the International Finance Corporation composite index (in U.S. dollar terms) rising by 7½ percent during 1996.

External Balances, Financing, and Debt

The expansion of *world trade* slowed markedly in 1996 following the exceptionally rapid growth of the two preceding years. The overall slowdown was widely spread. Japan, Germany, and France experienced declines in their shares of world exports, while other major industrial countries and the emerging market economies maintained or increased their shares.

The *external current accounts* of the advanced economies, taken together, were close to balance in 1996 after three years of moderate surpluses. Current account deficits and surpluses in the seven major industrial countries in most cases remained moderate (Table 2), and generally smaller than those seen in a number of these countries in the mid-1980s. This pattern of imbalances reflected the improved alignment of exchange rates among the major currencies that had emerged in recent years, although relative cyclical developments also had important effects. In Japan, the appreciation of the yen in the period up to early 1995, in combination with structural changes, helped to reduce the current account surplus to 1½ percent of GDP in 1996. In the United States, the current account deficit widened somewhat as the domestic economy grew relatively strongly. Current accounts were close to balance in both Canada and the United Kingdom. A pickup in exports in 1996 increased France's surplus modestly. Italy's surplus increased more significantly, owing mainly to a decline in imports. Among other advanced economies, Australia's current account deficit narrowed from the levels reached in 1995. In Korea, a sharp drop in export prices and the appreciation of the won against the yen led to a widening of the current account deficit to almost 5 percent of GDP.

The overall current account deficit of the developing countries increased somewhat in 1996. Higher deficits in a number of Asian and Latin American countries were only partly offset by an overall improvement in the external current position in Africa. External balances of oil-producing countries improved significantly. Among the developing countries of Asia, changes in current account positions in 1996 reflected a variety of factors. In Malaysia, the current account deficit declined to 6 percent of GDP as a tightening of monetary policy reduced import demand, more than offsetting a slowdown in exports. Current account deficits remained roughly unchanged both in Indonesia, where a slowdown in non-oil export receipts was offset by stronger oil exports and low growth in imports, and in Thailand, where a decline in imports was offset by higher foreign interest payments on short-term bank liabilities. In China, the current account remained in approximate balance in 1996, reflecting a narrowing of the trade surplus.

As recovery took hold in a number of Latin American countries, current account deficits expanded in 1996 owing to faster growth of imports, particularly of capital goods. Argentina and Brazil experienced modest increases in current account deficits. Mostly because of significant declines in the prices of copper and other commodities, Chile's current account shifted from near balance in 1995 to a deficit of 4 percent of GDP in 1996. Mexico's current account deficit was virtually unchanged at around ½ of 1 percent of GDP. In Venezuela, higher oil prices boosted exports, resulting in an increased current account surplus, despite higher imports.

Declines in certain commodity prices resulted in a widening of current account deficits in some African countries in 1996, although higher oil prices helped to eliminate current account deficits in Nigeria and Algeria. Also aided by higher oil prices, Saudi Arabia's current account returned to approximate balance after several years of deficits. Jordan's current account deficit fell by about 1 percent of GDP to 3 percent in 1996, as a rise in workers' remittances more than offset higher imports of food and transport equipment.

Current account deficits widened in 1996 in many countries in transition. In the Czech Republic and the Slovak Republic, deficits widened to 8½ percent and 10¼ percent of GDP, respectively, as imports surged and capital inflows contributed to real exchange rate appreciations. In contrast, Russia's current account surplus widened to more than 1½ percent of GDP. Tight financial policies in Hungary helped to keep the current account deficit in check.

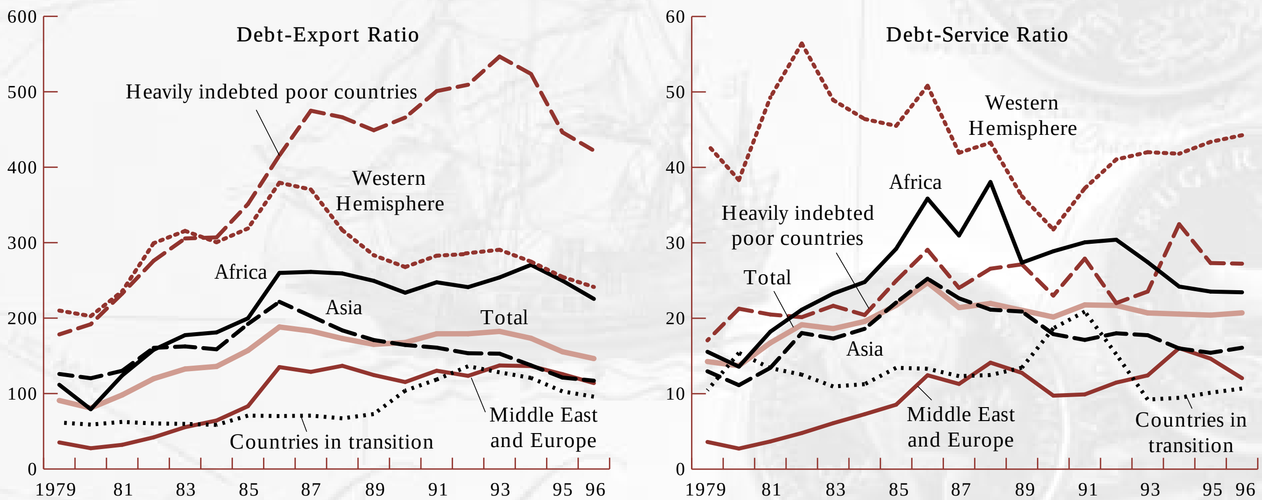
Net private capital flows to developing countries reached a record high of almost $200 billion in 1996, with flows to China alone reaching about $40 billion. The increase in net capital inflows to both the develop-

Table 2
Selected Economies: Current Account Positions
(In percent of GDP)

	1994	1995	1996
United States	–2.1	–2.0	–2.2
Japan	2.8	2.2	1.4
Germany	–1.0	–0.9	–0.7
France	0.5	1.1	1.3
Italy	1.5	2.5	3.5
United Kingdom	–0.4	–0.5	–0.0
Canada	–3.0	–1.4	–0.2
Australia	–5.0	–5.3	–3.7
Austria	–0.9	–2.0	–1.8
Finland	1.3	4.3	3.4
Greece	0.2	–1.5	–1.3
Hong Kong, China	2.0	–2.0	1.3
Ireland	2.7	2.4	1.1
Israel	–3.1	–4.5	–5.2
Korea	–1.2	–2.0	–4.9
New Zealand	–3.0	–4.3	–5.5
Norway	2.4	3.1	7.2
Singapore	15.9	17.7	15.7
Spain	–1.4	0.2	0.5
Sweden	0.4	2.1	2.5
Switzerland	6.9	6.9	6.6
Taiwan Province of China	2.6	1.9	2.7
Algeria	–4.4	–5.3	2.9
Argentina	–3.6	–1.4	–2.1
Brazil	–0.3	–2.5	–3.3
Cameroon	–4.2	–0.4	–2.4
Chile	–1.2	0.2	–4.1
China	0.6	0.2	–0.1
Côte d'Ivoire	–1.0	–5.0	–4.7
Egypt	0.4	1.2	–0.6
India	–0.8	–1.5	–1.7
Indonesia	–1.7	–3.4	–3.5
Malaysia	–6.3	–8.3	–5.2
Mexico	–7.0	–0.5	–0.6
Nigeria	–3.2	–1.7	5.0
Pakistan	–3.7	–3.7	–6.9
Philippines	–4.6	–4.4	–4.3
Saudi Arabia	–8.9	–5.6	–0.2
South Africa	–0.3	–2.1	–2.3
Thailand	–5.6	–8.1	–8.0
Turkey	2.0	–1.4	–3.8
Uganda	–2.5	–2.0	–1.1
Czech Republic	–0.1	–3.0	–8.6
Hungary	–9.5	–5.6	–3.8
Poland[1]	2.3	3.3	–1.0
Russia	3.8	1.2	1.7

[1]Based on data for the current balance, including a surplus on unrecorded trade transactions, as estimated by Fund staff.

Figure 7
Developing Countries and Countries in Transition: External Debt and Debt Service[1]
(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.

ing and transition countries may be attributed partly to relatively low interest rates in industrial countries, sluggish investment growth in Europe and Japan, and the continued development of capital markets, particularly bond and equity markets, as well as progress with privatization in many emerging market countries.

Within private capital flows, the trend away from bank loans toward foreign direct investment and portfolio investment continued, particularly in Latin America and Asia. Bond issues also increased, including those by some transition countries. In Russia, for example, the issuance of Eurobonds amounting to $1 billion represented one of the largest-ever debt issues by a sovereign government. The cost of capital to emerging market countries also declined in 1996. Many of these countries responded to this improved environment by lengthening the maturity of their new sovereign issues. Spreads on bonds in many Latin American countries narrowed considerably in the aftermath of the Mexico crisis, as a result of restored confidence in adjustment programs. Elsewhere, spreads narrowed by less, but they still dropped below 100 basis points for Poland and the Philippines. While the narrowing of spreads in many countries resulted from improvements in economic conditions and policies, in some cases there were indications that expected returns might be overestimated and risks underestimated.

Net official financial flows to developing and transition countries declined sharply in 1996 after the surge in lending to Russia and Mexico in 1995. In particular, net lending by the Fund declined in financial year 1996/97, in part reflecting early repayment of part of the credit extended to Mexico (see Chapter 9).

The solid and steady economic expansion in the developing countries as a group and the gains in stabilization and reform in the countries in transition resulted in a further easing of the overall burden *of external debt* in 1996, for the fifth consecutive year (Figure 7). Many poor countries, particularly in sub-Saharan Africa, continued to suffer heavy external debt burdens. For some of these countries, traditional debt relief mechanisms are unlikely to make debt burdens sustainable in the medium term even with continued policies of adjustment and reform. To ensure that all heavily indebted poor countries (HIPCs) that pursue appropriate policies can attain debt sustainability, the World Bank and the Fund are implementing the HIPC Initiative involving also official, other multilateral, and commercial creditors (see Chapter 7).