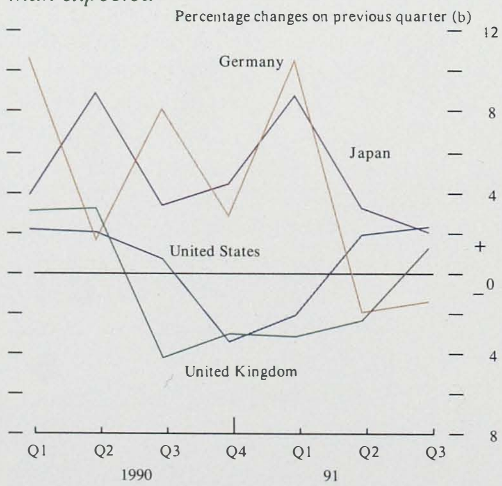
The international environment

- *Recovery in the United States has come to a near standstill. High levels of indebtedness appear to have delayed the stimulus to expenditure expected from lower interest rates. The Japanese authorities are concerned about slower growth, and particularly the decline in private investment expenditure, while in Germany economic activity has slowed to a modest growth trend.*

- *The underlying trend of inflation is fairly stable in most major overseas economies, although fears remain that rising labour costs will add to inflationary pressures in Germany. Year-on-year inflation rates have been affected by fluctuations in oil prices associated with the Gulf war.*

- *The Federal Reserve moved away from its gradualist approach and cut the discount rate by a full percentage point to 3.5%, its lowest level for almost 30 years. All ERM countries, except for the United Kingdom, raised interest rates following the tightening by the Bundesbank on 19 December. As a result of the divergence in monetary policy, the differential between short-term interest rates in Germany and the United States widened further in December. The Bank of Japan lowered the official discount rate in response to a slowdown in growth.*

World **economic activity** *has been weaker than expected*[(a)]



(a) United States, United Kingdom: real GDP. Japan, Germany: real GNP.
(b) At a seasonally adjusted annual rate.

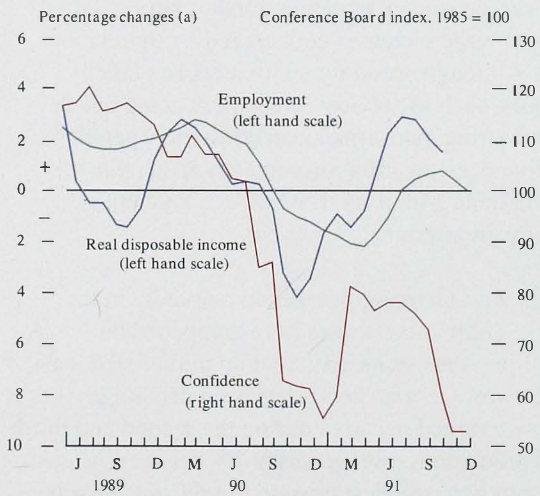
The US recovery has halted, *but a moderate pick-up about the middle of the year now seems likely.* **In Japan and Germany**, *evidence of a* **weakening in activity** *has increased*

World economic activity over the past three months has been weaker than expected. The recovery in the United States, which began last spring, has faltered; and although third quarter GNP growth in Japan was better than had generally been expected, recent evidence indicates that the slowdown in the fourth quarter has been slightly faster than earlier envisaged. In Germany, buoyant activity early in the year has weakened as the direct effects of unification have started to diminish.

The recovery in the United States, which got under way slowly in the spring of last year, has come to a near standstill in recent months. After two quarters of negative growth, gross domestic product grew in the second and third quarters of 1991 at annual rates of 1.4% and 1.8% respectively. Since then, however, signs of a weakening in activity have grown and can now be found across practically all sectors of the economy. Growth in manufacturing industry, which had been the initial driving force behind the recovery, has faltered: at the end of last year, the National Association of Purchasing Managers' Index fell below 50% (usually regarded as indicating a contraction in manufacturing output) for the first time since May 1991. Since July, manufacturing capacity utilisation has been falling gradually, and the auto industry is cutting production in line with weak sales. Industrial production has grown only marginally since August, having risen by nearly 3% from its trough in March by the end of the summer. Growth in service sector output has been flat since the summer, and activity in the non-residential construction industry remains depressed. Though bad weather conditions had an adverse effect on housing activity in November, a modest recovery continues in this sector.

The delay in the recovery does not appear to be because of any new factors, but rather reflects a return to the weakness in activity experienced by the United States before the Gulf war. The end of the war caused an upturn in confidence and triggered purchases, particularly of houses and cars. This upturn in spending, however, was short-lived. Confidence fell sharply in the autumn, and although the decline levelled out at the end of last year, consumers were reported to be more pessimistic than they were at the trough of the 1981/82 recession.

Consumer confidence in the United States *has fallen sharply since the summer, reflecting, inter alia, weak income growth and the perceived threat of job losses*



(a) Latest three months on previous three, annual rate.

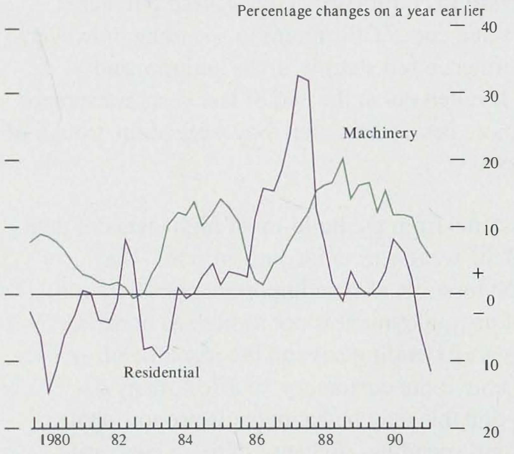
Consumers' caution stems from the build-up of high levels of debt during the 1980s and the weakness in income growth. The perceived threat of job losses is also an important consideration. Although the level of unemployment is not as high as in earlier recessions, job losses are extending beyond the manufacturing sector, where lay-offs are more customary, to affect many white-collar workers and this may be having a disproportionate impact on sentiment and spending. Because of these concerns, households are preferring to pay off their debts and await future developments rather than spend now.

Though the present state of the US economy and its short-term outlook are rather bleak, medium-term prospects are more favourable; recovery resuming about the middle of the year now seems likely. So far, the authorities have relied on a loosening of monetary policy to stimulate activity, cutting the discount rate to 3.5%, its lowest level since 1964. Doubts have been expressed, however, as to how effective monetary policy alone will be, particularly since both consumers and the corporate sector are more concerned with restructuring their balance sheet than accumulating more debt. These doubts, and concerns about the weakness of the recovery, have led the Administration to propose a package of fiscal measures to stimulate domestic demand, which would mainly be financed through cuts in defence expenditure. The deficit for the current fiscal year is, nevertheless, expected to rise to some $400 billion.

Third quarter GNP growth in Japan slowed to an annualised 1.6%, better than had generally been expected. If the level of GNP were to remain flat at its third quarter level for the next two quarters, the government's growth target of 3.8% for financial year 1991/92 would be missed by less than $^1/_2$%. The latest data, however, suggest a continuing slowdown in activity. Manufacturing industry has been hardest hit; since mid-1991 industrial production has been essentially flat, and capacity utilisation has been on a gradual downward trend from its peak in the fourth quarter of 1990, towards a more sustainable level. Private investment is growing only modestly, and new machinery orders are well below last year's levels. Concerns about the recent weakening in Japanese activity, and its implications for the trade surplus, led the Bank of Japan to cut the Official Discount Rate by 50 basis points to 4.5% in late December. This move was facilitated by the strength of the yen, and should contribute to an improvement in business confidence.

There are several factors underlying the downturn. The tight monetary stance, deemed necessary to control inflation, has had a contractionary influence on activity over the past year and helped bring about sharp falls in asset prices, after the dramatic rises in the

The slowdown in private investment *is concerning the* **Japanese** *authorities*



second half of the 1980s. The deterioration in activity and the decline in asset prices have constrained companies from raising investment funds, while land and property prices have fallen, albeit at a less marked pace than equity prices, discouraging residential investment.

Most concern at present is focused on the slowdown in private capital investment. Having grown at an annual average of 14.7% in the preceding three years, machinery investment was virtually flat during the first three quarters of 1991, leading to a distinct slowing in the annual growth rate. Several factors suggest investment may remain subdued for a while: the stock market is depressed, while bank lending is constrained by worries about non-performing loans and property-related bankruptcies. Until confidence is re-generated—perhaps by lower interest rates—this decline in investment could lead to a slowdown in annualised GNP growth rates of less than 3%, which, in Japanese terms, can be considered a 'recession'. However, consumer spending remains strong, largely because of significant wage increases encouraged by tight labour market conditions. Although spending on luxuries has fallen recently, other sectors, such as services, are experiencing quite strong demand. This strong performance in consumer spending seems unlikely to founder: low inflation should help keep real disposable income at quite a high level, while employment is unlikely to fall to any great extent.

Economic growth in west Germany weakened markedly in the second half of 1991. High interest rates have dampened the investment boom of previous years and, after an initial burst, east German demand for west German goods has been declining. Although GNP growth turned negative during the second and third quarters, industrial production rose by nearly 2% between August and November, pointing to a modest upward trend from a low base in the summer, and recent estimates indicate that GNP growth has been flat during the fourth quarter. There are, nevertheless, continued signs of slowing activity. Capacity utilisation fell back to 87.6% in the third quarter, which, though still high, is the lowest level for three years, manufacturing orders data continued to weaken in the fourth quarter and stock levels in manufacturing are increasing.

Exports have been virtually flat since the summer. With demand from the east for western products declining, partly as a result of production being moved to the east, west German industry is diverting attention to sell outside Germany; and business confidence surveys still report optimistic export prospects. However, success in recovering export market share during a period of widespread overcapacity will depend to a large extent on whether German industry can regain competitiveness. This will hinge on the outcome of the coming wage round and its consequences for cost pressures, as well as the future course of the deutschemark exchange rate.

Consumer confidence in the west has stabilised over the last few months, though at a low level. Sentiment continues to be affected by the indirect tax increases in mid-1991 and inflation induced declines in real incomes. The impact on consumption, however, was cushioned by a fall in the savings ratio and retail sales rose by 1.5% in real terms between August and October before falling by nearly 1% in November.

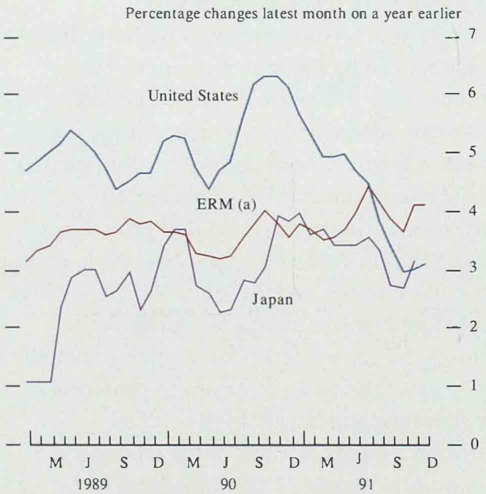
The level of activity in the eastern part of Germany appears to have bottomed out, and demand for some local products is recovering. In 1992, growth is likely to reach 10% on a year earlier, although this will depend to what extent sales to the former Soviet Republics will continue. Sales to the west remain disappointing, partly due to difficulties in breaking into western distribution networks and, in absolute terms, GNP is unlikely to reach pre-unification levels for at least five years. Unemployment is likely to be a long-lasting problem. Although registered unemployment has been stable over the last three months, at nearly 12% of the labour force, this is expected to rise sharply when current employment training schemes come to an end in January as many of those currently being trained on these schemes are unlikely to find work. Substantial fiscal transfers from the west will be needed for many years to come.

There are few signs of an imminent recovery in **France** *and* **Italy**

There are few signs that the French economy is yet recovering from the economic slowdown which started about a year ago. Throughout 1991, France's export performance was buoyant; but weak domestic demand, dampened by the high real interest rates needed to support the French franc in the ERM, prevented any recovery in activity. Following robust activity in the second quarter, strong GDP growth was maintained during the third quarter of last year at an annualised rate of around 3%. This largely reflected a build-up in inventories, however, and GDP growth is likely to have slowed during the final quarter. Industrial production has been broadly flat since the summer and the latest INSEE survey showed significantly weaker investment prospects. Confidence, too, is at low levels, although the corporate sector is more optimistic than the majority of consumers. The lack of consumer confidence largely reflects concerns about the stubbornly high level of unemployment, which currently stands at 9.8% of the labour force, amounting to a record 2.8 million people. Unemployment is expected to continue rising for some time to come and is likely to reach 3 million during the course of this year. Membership of the ERM leaves the French authorities little room to stimulate the economy through monetary policy; indeed, the Banque de France was forced to raise interest rates in both November and December of last year to support the French franc.

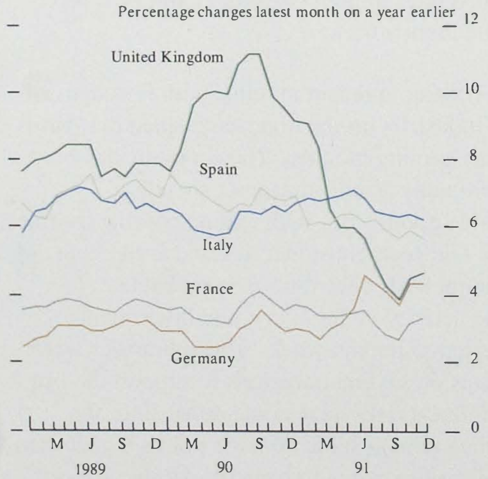
Activity in Italy has been weak in recent months, with few signs of an imminent recovery. Industrial production has levelled out, but is unlikely to improve in the coming months. The economy has been largely supported by continuing strong consumer spending, particularly on non-durable goods. But with real disposable income growth expected to slow this year, consumer demand is likely to weaken. A negative foreign trade contribution is probable, particularly with slowing activity in Germany, and investment expenditure is also expected to remain weak. The authorities were forced to raise market rates on several occasions to support the lira in the ERM. Although interest rates have come down since the beginning of the year, they remain some 50 basis points higher than in early November when the lira began to weaken. Higher interest rates will restrain activity further and will worsen the debt servicing costs of the Italian government. The high budget deficit remains a problem, especially in the context of convergence criteria for monetary union agreed at Maastricht. Parliamentary agreement on

In most major economies, **underlying inflationary pressures** *are under control . . .*



(a) Excluding United Kingdom.

. . . but fears remain that **rising labour costs** *will add to inflationary pressures* **in Germany**



the privatisation process, as part of the new fiscal package, has not been reached so far.

The recovery in Canada has been dampened in recent months by weak activity in the United States. The strong pick-up in activity earlier in the year did not continue into the third quarter, when GDP growth declined to an annualised 0.9%, and recent evidence suggests growth remained sluggish in the fourth quarter. As in the United States, the manufacturing sector's recovery has faltered since the autumn, following strong growth in the spring and summer, while, more recently, growth in housing activity and the car industry has halted. The medium-term outlook will depend heavily on developments in the US economy. In response to falling inflation and weak activity, the Bank of Canada has continued to ease interest rates over the past months.

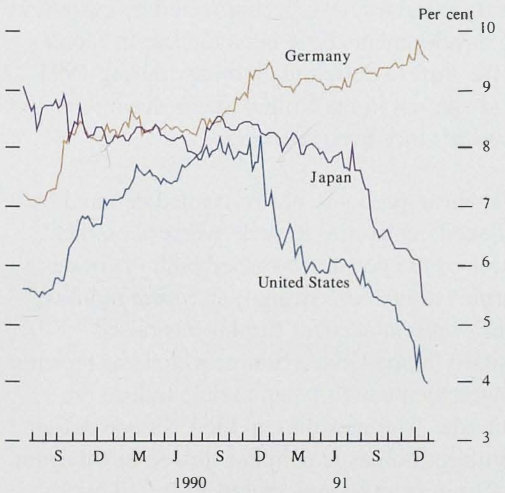
Sluggishness of world activity is keeping **inflationary pressures under control**, *though* **tight labour market conditions in Germany** *remain a concern. Year-on-year inflation rates have been affected by* **fluctuations in oil prices** *associated with the Gulf war*

Non-oil commodity prices fell marginally in the three months to January, easing pressure on consumer prices. Metals prices continued to lead the decline, with the major fall coming in copper prices as merchants released stocks which had been held at artificially high levels to support the price. The continued flood of metals from the former Soviet Republics, and the generally low level of demand, suggest that metals prices are likely to remain depressed well into 1992. The price of oil fell sharply over the quarter as fears of supply tightness this winter were replaced by concerns about a supply glut in the spring. Oil exports from the former Soviet Union were less disrupted by the political turmoil than was feared, and the winter in the northern hemisphere has so far proved relatively mild. Increased world production and the prospect of Iraqi sales have also depressed prices. Attention is now focused on OPEC which is expected to lower its production ceiling to support prices at its next meeting on 12 February.

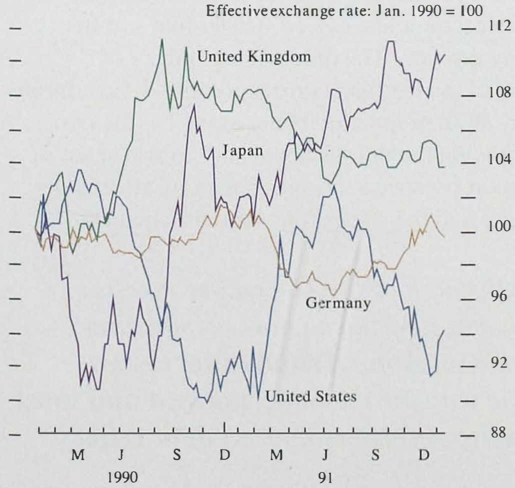
In the United States, headline consumer price inflation fell continuously throughout 1991, reaching 3.1% in December from a peak of 6.3%, and the all-items index is at its lowest level since March 1987. The fall in headline inflation partly reflects the decline in oil prices from the Gulf war highs a year earlier, as well as the impact of the economic slowdown. But 'core' inflation—excluding food and energy—has shown only a modest improvement. The strongest source of inflationary pressure continues to be the service sector, particularly shelter and medical services. Given the current weakening of the US economy, it is likely that inflation will continue to ease for a while, depending on the timing and pace of recovery. In Japan, there continues to be little change in the underlying inflationary trend. Headline consumer price inflation in 1991 averaged 3.3%, compared with an average inflation rate during the 1980s of around 2%. Inflation was lower in the second half of 1991, partly reflecting oil price effects.

Inflationary pressures remain a concern in west Germany, with underlying inflation estimated at just under 3½%. Headline inflation rose above 4% in November and December, after three

Divergence in monetary policies *has widened the differential between* **US and German short-term interest rates** . . .



and the **dollar,** *after weakening against the* **deutschemark** *in December,* **recovered in January**



consecutive months of declining year-on-year rates. Since the consumer price index was depressed by lower import prices, resulting from a stronger deutschemark, this reflects quite strong underlying domestic cost pressures. Headline inflation is expected to near 4.6% in March before falling gradually over the rest of the year. The rate of decline however, will depend crucially on the outcome of the current wage round; some unions are demanding increases worth more than 10%. Although an outcome of around 6% appears likely, this is still inconsistent with the Bundesbank's objective of price stability. Neither the Bundesbank nor the government has the power to intervene directly in the private sector's wage setting process. But with the rise in official interest rates in December, the Bundesbank reaffirmed its commitment to bring inflation under control in advance of the wage round and against the background of monetary growth accelerating above target. Consumer price inflation is expected to peak in the early part of this year, and then fall as last July's indirect tax increases drop out of the annual calculations.

Inflationary pressures in France remain subdued. Annual growth in consumer prices fell to a three-year low of 2.5% in October, before picking up again slightly to 3.0% in November and 3.1% in December, mainly as a result of oil price effects. The recent slowdown in activity, together with high interest rates, has helped contain inflationary pressures. The underlying rate of inflation is probably just above 3%, and headline inflation is expected to fall gradually below that figure over the coming period.

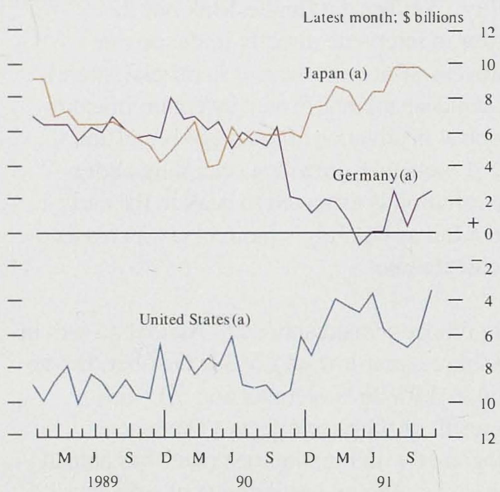
Inflation rates in most other ERM countries have fallen gradually in the last few months. In November, year-on-year inflation in the EC averaged 4.8%, with the lowest inflation rate in Denmark at 2.3% and the next lowest in Luxembourg at 2.6%. The outlook for inflation in Canada remains favourable as a result of sluggish activity. Headline inflation is expected to fall sharply in January and February as last year's introduction of the Goods and Services Tax drops out of the annual calculations.

The differential between **short-term interest rates in Germany and the United States** *reached 550 basis points in December, as monetary policies diverged further*

Short-term interest rates in the United States and Germany have diverged further. After the increase in official rates by the Bundesbank on 19 December and the cut by the Federal Reserve on 20 December, the differential reached 550 basis points, having risen steadily from a margin of around 240 basis points in the beginning of 1991. The Federal Reserve has responded step-by-step to signs of weak activity by reducing official interest rates, while the Bundesbank has been determined to assert its anti-inflationary stance as monetary growth remained strong and concern about wage demands persisted. A similar, though less marked, divergence between German and Japanese interest rates is now occurring, partly reflecting the concern of the Japanese authorities over weakening activity.

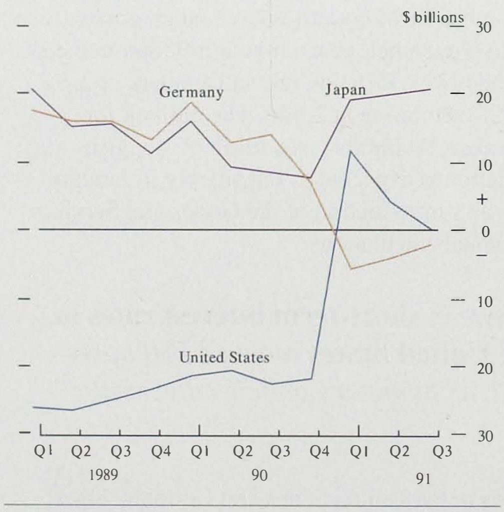
The divergence in monetary policy between the United States and Germany caused the dollar to weaken sharply against the deutschemark through December; but this was reversed in January

Japan's external surpluses *continued to rise; the widening of the* **US trade deficit** *in the third quarter has been reversed*



(a) Trade balance.

G3 current account balances



as markets judged that US rates had bottomed and German rates had peaked. The yen strengthened against all the major trading currencies during December and January, having weakened slightly in November. It had gained against the dollar ahead of the cut in the US discount rate—the strength of the yen helped the Bank of Japan to cut its discount rate on 31 December—and remained firm afterwards.

Monetary policy movements exacerbated tension within the ERM. All ERM countries, apart from the United Kingdom, followed the tightening of German policy in late December and, at the beginning of the year, the narrow band approached its maximum permitted width, with the Danish krone being the weakest currency.

Slower activity in the G3 has caused the **US trade deficit to** *narrow, while* **in Japan and Germany** *the* **trade accounts** *have moved further into surplus*

Recent developments in international trade volumes have mainly reflected movements in relative domestic demand and competitiveness, while trade values have been affected by currency movements. The main developments have been the rise in Japan's external surpluses and the shift to deficit in Germany during 1991. The widening of the trade deficit in the United States during the third quarter of last year has since been reversed.

The slowdown in the Japanese economy has restrained demand for imported goods and induced companies to seek overseas markets. This, and the appreciation of the yen, have caused both the trade and current account surplus to increase strongly in recent months. The resurgence in Japan's current account surplus has raised concern abroad, particularly in the United States, which has recently been seeking to reach agreements with Japan to help reduce the imbalances in bilateral trade. The widening in the US trade deficit since June has levelled off, as domestic demand slowed down again at the end of the year. The current account balance shifted back into deficit in the third quarter, following surpluses in the previous two quarters, which were partly a result of Gulf war contributions. Though the German trade surplus nearly disappeared in September, mainly because of reconstruction-led demand from the east, in recent months the trade account has moved further into surplus, consistent with slowing growth. The diminishing impact of unification also narrowed the German current account deficit during the course of the year. With production being moved to the east, west German trade with other countries could start to rise again in the medium term. Export prospects, however, may be affected by depressed world activity and the strength of the deutschemark.

There was a breakthrough at the December meeting of the **Paris Club** *when a new package incorporating much of the United Kingdom's* **Trinidad terms** *was agreed, opening the way for the other* **poorest and most indebted countries** *to receive enhanced* **debt relief**

In 1991, output growth in developing countries is expected to have been slightly negative in per capita terms, mainly due to the sharp drop in economic activity in Eastern Europe and the former Soviet Republics. Given the recent deterioration in prospects for growth in the industrial countries, a resumption of export growth in developing countries is likely to be delayed. However, recent improvements in the stance and implementation of policy in a number of countries mean that there is some prospect of a recovery in output this year.

According to recent estimates by the World Bank, external indebtedness of developing countries as a group was static last year, although the weakness of export earnings led to a rise in debt and debt service ratios in most regions. In particular, a further rise in the debt service burden of the poorest African countries from already unsustainable levels underlined the need for exceptional relief. There was a breakthrough at the December meeting of the Paris Club when Nicaragua and Benin became the first countries to receive enhanced debt relief, similar to the Trinidad terms proposed by John Major in September 1990. All creditors, apart from the United States and Australia, granted relief equivalent to 50% in net present value terms on those debt service payments covered by the Agreed Minutes. Creditors also agreed to consider granting further debt relief in three years' time, affecting the whole stock of debt, provided the debtor countries adhered to their IMF programmes. Following this breakthrough, the way is now open for the other poorest and most indebted countries to receive enhanced debt relief on similar terms.

Heavily indebted middle-income countries such as Mexico and Chile have made considerable progress in gaining renewed access to private capital markets. A combination of good domestic policies and the catalyst of debt reduction agreements with commercial bank creditors have given a considerable boost to external confidence and encouraged substantial inflows of flight capital. New bond issues by Latin American countries reached $13 billion last year, double the amount raised in 1990. The prospect of free trade agreements both between Mexico and North America (North American Free Trade Agreement), and among the other Latin American countries (Mercosul) has also contributed to the recovery of confidence in the region. Nevertheless, concerns remain over Brazil's policies and its relations with creditors.

In Eastern Europe, Hungary and Czechoslovakia have made good progress with their structural reforms and expanded their trading links with western industrial countries. Both successfully tapped international capital markets last year. In contrast, Poland's IMF programme has gone off-track. This, and the failure to reach agreement with the banks on a package comparable to the relief granted by the Paris Club, puts the second stage of Poland's debt reduction agreement with the Club at risk. Bulgaria is suffering the worst recession among the East European economies, and in Romania the political and economic situation remains unstable. The civil war in Yugoslavia has caused a substantial loss in service income, which implies a significant financing gap on the balance of payments.

There remains uncertainty about the future course of the newly formed **Commonwealth of Independent States**

The formation of a Commonwealth of Independent States (CIS) by eleven republics on 21 December has only partially resolved the uncertainty surrounding the future economic and political structures of the former Soviet Republics. In spite of the consensus reached on the need for a Commonwealth, the actual form it will take

Currency convertibility in Eastern Europe

Economic reform in Eastern Europe has brought the question of 'currency convertibility' to the fore. At its simplest, the term refers to the ability to exchange one currency for another; and the degree to which a currency is convertible depends on the extent of exchange controls. The most important distinction is between *current account* and *capital account* convertibility, but within these categories there are also important differences between resident and non-resident convertibility. Resident *current account* convertibility permits domestic individuals and enterprises to purchase foreign exchange with domestic currency in order to import goods and services, as well as to service foreign debts. A further relaxation of exchange controls to include the *capital account* would allow residents also to purchase and hold foreign assets. *Non-resident* convertibility on the current account enables foreign-owned enterprises and foreign individuals to purchase domestic goods and services with domestic currency, as well as to remit domestic currency profits abroad; and, if extended to the capital account, allows non-residents to purchase assets and to dispose of holdings of domestic currency in other ways.

Progress with convertibility in Eastern Europe has been varied. In January 1990, Poland introduced current account convertibility for residents, with some controls remaining on non-residents. Czechoslovakia followed with broadly similar reforms twelve months later, although resident individuals' access to foreign exchange remains slightly more restricted than in Poland. Hungary, which initiated a gradual liberalisation of currency restrictions in 1989, maintains a marginally stricter regime than either Poland or Czechoslovakia. For all three, full current account convertibility, for both residents and non-residents, is a medium-term objective.

Poland has been assisted in introducing a convertible currency by a $1 billion Currency Stabilisation Fund provided by the Group of Twenty Four leading industrial nations in December 1989. The Fund (which has not been utilised to date) has bolstered domestic policy credibility in this area. In general, all three economies have had little problem in sustaining the degree of convertibility introduced thus far. This has reflected the relative success of these countries in implementing macroeconomic stabilisation and reform programmes.

In Bulgaria and Romania, the move towards convertibility has been slower. During 1991, Bulgaria relaxed exchange controls in stages, so that by the end of the year resident enterprises had access to foreign currency for external trade purposes. This specific measure was also introduced in Romania in November 1991. In both countries, individuals' access to foreign exchange has also been increased somewhat. Some former Soviet republics have indicated an intention to introduce independent currencies, each with a degree of convertibility; but there have as yet been no firm proposals.

In drawing up a convertibility programme, these republics should be aware that the benefits of this reform can be realised only if accompanied by other important policy measures. Price and trade liberalisation is required if domestic agents are to behave according to market stimuli; and, to the same end, the enterprise sector must be exposed to hard budget constraints (ie, enterprises' expenditure decisions must be constrained by their income and by their ability to service any debt which they incur). An adequate stock of foreign currency reserves is also required (assuming the adoption of a fixed rate of exchange, or that there is a point below which the government does not want the exchange rate to depreciate). But, most importantly, convertibility must be supported by macroeconomic policies which will help to stabilise both the domestic and external sectors of the economy.

The introduction of a convertible currency is one of the most important steps in opening up the region (where the economies have been distorted by decades of central planning) to foreign competition. Over time, this should lead to efficiency gains and improve the quality of investment as the economy responds to more rational cost and price structures imported from abroad. Opening markets will also encourage the import of modern technology and managerial skills— scarce commodities throughout Eastern Europe. Successful introduction of even limited convertibility, which implies increased confidence in the domestic currency as a store of value, will also tend to integrate black markets into the formal economy. This should lead to a decline in transactions costs, a further improvement in resource allocation and some widening of the tax base.

Convertibility does, however, result in some transitional costs. In association with other measures, such as the removal of subsidies and price reform, the relaxation of exchange controls (and hence increased foreign competition) will tend to imply a decline in output as previously protected enterprises struggle, at least initially, to compete with foreign suppliers. To counter the impact of these competitive pressures on domestic industry, Eastern European governments have considered a number of options; of these, an initial, substantial devaluation of the exchange rate has been most widely used.

A possible drawback in extending convertibility to the *capital account* in Eastern Europe at the present time is the risk that destabilising capital flows, either inward or outward, may develop. If the exchange rate is fixed, such flows could lead to fluctuations in foreign currency reserves and interest rates; or, if a floating regime is adopted, in the value of the currency itself, with a consequent distortion of price signals. The adverse effects that restricting convertibility for capital account or non-resident current account transactions may have on inward foreign investment can be reduced by special legislation. To this end, for instance, legislation covering profit repatriation by non-residents has been passed throughout the region, within Laws on Foreign Investment.

There are a number of other related issues. In addition to determining an appropriate initial rate of exchange, governments must also consider whether a fixed or floating exchange rate regime, or a compromise between these two extremes, will best serve domestic economic policy objectives in the context of a convertible currency. If some form of fixed exchange rate is preferred, then governments must determine the most appropriate currency or 'basket' of currencies to which to peg. Of possible candidates, given prospective patterns of trade and foreign investment, the Ecu would seem particularly attractive for the countries of Eastern Europe.

remains a subject of intense debate. This is notable in the economic sphere where differences exist between the republics over, *inter alia,* the implementation of reform measures, the introduction of national currencies and the co-ordination of banking policy.

Besides the need to create new republican political and economic structures, the continued fall in output and rise in inflation throughout the former Soviet Republics make it imperative that Russia and the other republics implement effective macro-stabilisation policies to reduce the budget deficit and to curb the growth of the money supply. The Russian Federation is eager to pursue reform at a fast pace and has adopted a bold reform programme. One of the first measures to be implemented was a liberalisation of all prices (with the exception of energy products and certain staple foods) on 2 January. Other republics have also announced their intention to undertake reform, but lag behind the Russian Federation in implementation.

The CIS' acute shortage of external liquidity was partially alleviated in January when a debt deferral was negotiated with different creditors on principal payments of medium and long-term official external debt contracted before 1 January 1991 and falling due between 5 December 1991 and end-1992. A similar deferral was also agreed with commercial banks, but only for 90 days. The basis for the deferrals was the November agreement between the G7 countries and representatives from the Union and eight republics which confirmed the earlier memorandum of understanding, whereby the latter would accept 'joint and several liability' for former Soviet debt. In spite of the deferrals, however, the debt servicing climate remains difficult.