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**United Nations**  
**Department of Economic and Social Affairs**

# **Project LINK Meeting**

**United Nations Headquarters, New York**  
**17-20 April 2000**

## **GLOBAL ECONOMIC OUTLOOK**

This report was prepared by the Economic Assessment and Outlook Branch of the United Nations Department for Economic and Social Affairs and is intended as background information for participants attending the 2000 spring session of Project Link in New York City.

## INTRODUCTION

The spring 2000 Project LINK meeting is taking place at the United Nations Headquarters, New York, 17-20 April 2000. The agenda of the meeting includes various presentations of the short- and medium-term outlook for the world economy and discussions of current international economic policy issues.

With inputs from the national LINK centres and information from other sources, as of 7 April 2000, the staff of the Economic Assessment and Outlook Branch (EAOB), Department of Economic and Social Affairs (DESA) of the United Nations Secretariat, prepared a pre-meeting world economic forecast, using the LINK econometric modeling system. This report summarizes the main global features of that exercise. The outlook projected here will be updated by taking into account the discussions during the LINK meeting. *THE LINK REGIONAL OUTLOOK*,<sup>1</sup> which highlights the main regional features, and the *LINK COUNTRY REPORTS*, which contain detailed forecasts and policy analyses submitted by the national LINK centres, are available, together with many tables, on the websites at both the United Nations and the University of Toronto.<sup>2</sup>

## THE BASELINE FORECAST

Since the second half of 1999, world economic expansion, after the two-year setback engendered by the international financial crises, has been widening and deepening. This momentum continues into 2000. To some extent, the expansion in 2000 and perhaps beyond is likely to be even more dynamic than the pace observed over the last quarters of 1999. Growth of gross world product (GWP) is expected to accelerate from the 2.7 per cent in 1999 to 3.5 per cent for 2000, which is the highest pace since 1996 (see table 1). The LINK medium-term forecast actually projects this high rate of growth to be sustained for the next few years.

The current strength of the global economy has various origins. Some are highly cyclical in nature, and will inevitably fade in the near-term. Others are believed to be further reaching inasmuch as they are changing the foundations for economic development in the world economy. Their impact will therefore be much more durable.

A major cyclical factor has been the rapid pace of economic recovery in many developing countries and economies in transition most adversely affected by the 1997-1998 financial crises. Their recession bottomed out or stagnation was halted, leading to strengthening economic performances, which in a number of cases were quite surprising for most observers of these countries.

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<sup>1</sup> As this year's regional summary, EAOB is making available on DESA's website an early draft of monitoring regional trends for other outputs by the United Nations Secretariat. Comments by LINK participants would be most welcome. Note that the country, regional and total data used in that draft are not necessarily identical to LINK's because of differing weights and forecasts outside the LINK system. LINK country data are separately available on the websites as well.

<sup>2</sup> DESA's website is: <http://www.un.org/esa/analysis/link>. Toronto's is: <http://www.chass.utoronto.ca/link>.

**Table 1. Gross domestic product and world trade**  
(Annual percentage change)

	April 2000 forecasts <sup>a</sup>			November 1999 forecasts		
	1999	2000	2001	1999	2000	2001
<b>Gross world product</b>	<b>2.7</b>	<b>3.5</b>	<b>3.5</b>	<b>2.6</b>	<b>2.8</b>	<b>3.1</b>
<b>Developed market economies</b>	<b>2.6</b>	<b>3.0</b>	<b>3.0</b>	<b>2.5</b>	<b>2.2</b>	<b>2.5</b>
Canada	4.2	3.5	3.6	3.6	2.9	3.3
France	2.7	3.6	3.1	2.4	2.9	3.0
Germany	1.5	2.5	2.9	1.7	2.4	2.1
Italy	1.4	2.6	2.7	1.1	2.0	2.6
Japan	0.3	0.9	1.9	0.9	1.0	1.7
United Kingdom	2.0	3.3	2.6	1.4	2.6	3.4
United States	4.2	4.2	3.7	3.9	2.4	2.8
<b>Developing countries</b>	<b>3.4</b>	<b>5.2</b>	<b>5.5</b>	<b>3.3</b>	<b>5.1</b>	<b>5.3</b>
Latin America and the Caribbean	0.1	3.7	4.2	-0.4	3.5	4.5
Argentina	-3.0	2.8	3.5	-3.6	2.9	4.4
Brazil	0.8	3.6	4.7	-0.2	3.3	5.1
Mexico	3.7	4.8	4.4	3.5	4.9	4.4
Africa	3.0	4.4	4.5	3.0	4.4	4.5
North Africa	3.1	5.5	5.2	3.4	5.6	5.1
Sub-Saharan Africa (excl. South Africa)	3.1	4.4	4.6	3.2	4.4	4.6
Nigeria	3.7	3.4	3.2	3.7	3.3	3.3
South Africa	2.1	3.2	3.0	1.7	2.4	2.9
South and East Asia	5.8	6.2	6.2	5.1	5.6	5.6
India	6.1	6.5	6.8	6.2	6.3	6.4
Indonesia	0.1	4.3	4.6	1.3	4.1	4.6
Korea, Republic of	10.7	8.2	7.3	9.0	6.7	6.2
Malaysia	5.1	7.2	6.9	4.3	7.0	7.2
Philippines	3.2	4.1	4.2	3.4	4.9	4.2
Thailand	4.2	4.8	5.4	3.8	5.1	6.2
China	7.1	7.5	7.6	7.4	7.5	7.2
Western Asia	2.5	3.9	4.7	3.8	4.3	4.0
Oil-exporting countries	2.9	4.2	4.9	4.8	4.8	4.2
Oil-importing countries	0.3	2.0	2.6	0.2	1.7	2.1
<b>Economies in transition</b>	<b>2.9</b>	<b>3.0</b>	<b>3.4</b>	<b>1.6</b>	<b>2.2</b>	<b>3.0</b>
Russia	3.2	2.5	2.5	1.1	0.8	1.4
<b>World export volume</b>	<b>3.5</b>	<b>7.6</b>	<b>7.7</b>	<b>3.4</b>	<b>5.7</b>	<b>5.9</b>
<b>Export prices (all goods)</b>	<b>-0.6</b>	<b>1.7</b>	<b>2.2</b>	<b>-0.5</b>	<b>3.6</b>	<b>2.5</b>
Agricultural commodities	-4.9	1.3	2.7	-4.6	2.5	2.1
Raw materials and ores	-1.9	6.1	5.3	1.8	4.7	4.3
Oil	40.0	40.0	-20.0	35.2	9.0	0.0
Manufactures	-2.4	-0.9	3.9	-2.1	3.2	2.7

\* Pre-meeting forecasts.

Growth during the early phases of the business cycle was in general much stronger than had been expected. Its origin is dual: stimulus economic policies and improvement in international economic conditions, including in finance and trade. As these economies are completing the recovery phase by exhausting the slack in production capacity generated during the crises, the pace of growth is likely to moderate prospectively. Sustaining the expansion in these countries depends on domestic consumption demand and new business investment taking the relief from external demand, which should remain buoyant, however, and from macroeconomic policy stimuli, which cannot be replicated indefinitely.

An important long-term force behind the current global economic expansion has been the diffusion in depth as well as in breadth of the information technology (IT) revolution. Driven by accelerating innovations in information technology, such as the Internet and telecommunications, many economies have witnessed a marked rise in investment spending in IT-related equipment and software. To date only the United States, which has the leading edge in IT sectors, has produced macroeconomic statistics that reveal convincingly the significant impact of the IT revolution on rising productivity. Many observers believe that the strong and prolonged growth seen at a time of benign inflation and low unemployment has been supported by economy-wide improvements in productivity.

More and more optimistic economic observers have come to gravitate towards the view that other developed economies too have gradually been laying the foundations for catching up with the IT revolution, such as now stressed for the United States. They anticipate this emulation process soon to encompass a growing number of developing economies as well. In other words, the IT revolution and expanding global economic integration, principally through trade and finance, have been mutually reinforcing. This may presage the formation of a new global economic era, which should provide opportunities for sustaining strong growth throughout most of the major segments of the world economy for some time into the future.

Notwithstanding the sanguine baseline outlook and the optimistic views held on the benefits of the IT revolution, our baseline suggests several weighty caveats that need to be taken into account. First of all, the economic recovery in crisis-hit countries as well as the prolonged growth cycle in some developed countries, in combination with more sluggish growth or stagnation in other developed countries, are leaving a legacy: large fiscal and current-account imbalances have been accumulated in many economies. Examples are legion, the most critical ones being the massive trade deficit of the United States and the substantial fiscal deficits in Japan and in several emerging market economies. These imbalances cannot be sustained and need to be lowered and, in some countries, eventually reversed in the medium run. Precisely how this process will unfold and play itself out, and the ways in which policy can assist in ensuring a constructive contraction of the deficits and perhaps a build-up of surpluses, as seen from the vantage point of what is required to sustain global economic buoyancy, are crucial issues to be tackled in charting a realistic trajectory of world economic growth in the outlook.

Second, although growth rates across the world have recently exhibited some measure of convergence in trends, the strengths underlying the performances in various countries and country groups are still quite diverse. Therefore, the asynchronized phases of the business cycle across countries at a time of expanding international linkages are creating dilemmas for policy

makers worldwide. This is especially critical for the major developed economies because their policy stances exert significant impacts on the room left for policy manoeuvre in the rest of the world.

Third, the strong economic recovery in many crisis-hit economies has to some extent deflected attention from the structural problems that, at the height of the crises, were emphasized as key causes in the eruption of the various crises. Policy makers have more recently come to view that resolving these perceived structural problems as well as those that resulted from the crisis is now much less pressing. Thanks to the rapid and strong recovery, some of the problems caused by the crises—high unemployment, large budget deficits, and debt problems in private sectors—have indeed been alleviated to some extent. These cyclical gains are indisputable. However, the observed cyclical upturn cannot possibly substitute for restructuring, for example, the still fragile financial and corporate sectors in many of these economies. Much the same comment applies to the efforts launched to strengthen global economic management, including by reforming the global financial architecture. As a result, the tasks ahead remain quite formidable.

Finally, while some degree of optimism about the IT revolution is warranted on the strength of the accumulating evidence about the profound changes that have been taking place in the pace of technological progress in many economies, excessive expectations may already have built up. The high valuation of some equities in markets of developed countries, notably those of the United States, for shares of biotechnology and IT firms in particular, may be an expression of this unwarranted optimism.<sup>3</sup> A sudden correction of these excessive valuations in broader equity markets, possibly turning towards the other extreme through overshooting, would lead to a downward adjustment in the feasible pace of economic growth of major developed economies. Ripple effects on other countries through a variety of channels would be unavoidable.

### **World economic growth accelerating**

Developments in major world economic trends since the last LINK exercise in November 1999 have not been at significant variance from those then projected. Three developments moderately at variance with the last LINK baseline have been: (1) the stronger and faster monetary tightening in many developed economies; (2) the significantly higher prices of oil, with their peak in the first quarter of 2000; and (3) the Y2K problem, which turned out to be much less of a problem than anticipated in terms of affecting the inventory cycle and, of course, it was a non-event in terms of the fallout from Y2K that many observers had anticipated for early 2000. The first two should, on balance, exert a negative impact on growth trends, whereas the third should be positive because the IT investment made to prevent Y2K from happening is yielding productivity benefits; if inventory problems had been as large as anticipated in mid-1999, they would have had a negative impact on the forecast as well. So far none of the potentially negative fallout has been borne out. In fact, the current LINK baseline forecast embodies a widespread, but mild, upward revision of the near-term outlook for economic growth in 2000-2001 for many countries and regions.

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<sup>3</sup> As this report is being written, a major correction in the IT-heavy NASDAQ valuation of equities as well as in selected equities on other exchanges in the United States and several other countries appears to be under way.

Leading the current global economic upturn have been the *developed economies*. Growth in gross domestic product (GDP) for this group as whole is expected to be 3 per cent in 2000, up from 2.6 per cent in 1999. A common feature among these economies has been the acceleration of investment spending in IT sectors and on IT equipment and software in many other economic sectors. This component of demand has increasingly become the most dynamic driving force underlying the upswing recently observed in these economies.

The economic performance of the United States over the past few years has been unprecedented in recent history. By March 2000, the current upswing set a record for the longest period of continued economic expansion—108 months in a row. It is not only the length but also the strength of the current expansion in the United States with low inflation and low unemployment that has been surprising—indeed puzzling—economists and policy makers. So far, none of the conventional maturing signs of the business cycle—slowing of investment activity, contracting R&D spending, capacity constraints with their inflationary push, rising core inflation, or slowing productivity growth—are yet on the horizon of this ‘ageing’ cycle. A real surprise in this regard was the acceleration of GDP growth to an annual rate of 7.3 per cent during the fourth quarter of 1999.

An important feature of the United States’ economy has been a rise in the trend of productivity growth since the mid-1990s. In 1999, labour productivity rose over 3 per cent, compared with the average of just half that magnitude over the past two decades. The IT revolution has been accompanied with capital deepening and improved labour quality. These have recently been seen as the main causes for the higher productivity growth.

The prevailing tight labour market and the fast tightening of monetary policy in the United States, plus some accumulated external imbalances, are likely to set limits to any further acceleration. But no significant signs are pointing to an imminent and sharp downturn in the economy. As a matter of fact, the baseline forecast for GDP growth is for 4.2 per cent in 2000 and 3.7 per cent the year thereafter.

Many other developed economies are also expected to have buoyant growth in 2000-2001 at above 3 per cent. In the euro zone, and indeed the broader European Union (EU) area, the pace of economic expansion has been gathering momentum since the second half of 1999, driven by pick-up in domestic activity and strong external demand, thanks to the broadening worldwide recovery and the competitive edge in exports enjoyed by the members of the monetary union, owing to the weakening of the euro against the U.S. dollar. Growth in other European developed economies is also robust.

In contrast, the Japanese economy remains sluggish, as the large-scale government stimulus spending in the past several years has thus far failed to put private demand, both consumption and investment, on a self-sustained path. After a very tepid recovery of 0.3 per cent in 1999 from the 2.5 per cent contraction the preceding year, GDP is expected to expand only by 0.9 per cent for 2000 and by 1.9 per cent for 2001. This subdued outlook owes a lot to the uncertainties stemming from the pace and depth of the ongoing corporate restructuring. Also the overhang of the large and increasing public debt, which is expected soon to be the highest—well over 100 per cent of GDP—for any developed country has been clouding the horizon. Belgium

and Italy used to be the largest. Both have been reducing their even higher debt-to-GDP ratios in consequence of adhering to the various requirements of monetary union and of broader economic policy coordination within the EU context.

The economic outlook for most *developing economies* has become more optimistic as well. Progress in domestic economic reforms, though varying from country to country, and the improved international environment, such as the strengthening of commodity prices and stabilized global financial markets, have been instrumental in changing the foundations of growth on which the improved outlook hinges. Recovering from two years of slowdown, GDP growth for the group is expected to be 5.2 per cent for 2000 and 5.5 per cent for 2001, back to the peak registered in the pre-crisis period.

Mainly the external sector, policy stimuli, and inventory adjustment have so far led the growth recovery in many developing economies. To continue and strengthen the pace of expansion over the longer haul, a sustained pick-up in domestic consumption and investment is required. Imparting greater and wider spread buoyancy into domestic demand depends on function of a broad-based rise in labour incomes and continued reforms of financial and corporate sectors.

Growth for South and East Asian developing economies is expected to reach 6.2 per cent in 2000-2001, as compared to 5.8 per cent in 1999. Most crisis-affected East Asian economies have been recovering at a robust pace since 1999, with the Republic of Korea leading the group at a record 10.7 per cent growth in GDP. Other economies in the region performed well too. Especially the two largest developing economies, China (which is not included in any of the subregional aggregates) and India, have been growing at 6 to 7 per cent, substantially above the average rate for the region.

Strengthening domestic demand and the foundations for sustainable export growth are expected to continue to lead the expansion in East and South Asia. Meanwhile, with still some sizeable technological gaps as compared to the leading developed economies, quite a few economies in the region are positioning themselves to benefit from the IT revolution under way, especially in the sectors of semiconductors, computer hardware, and software, not only as producers for industrial countries, but also as consumers in other segments of these economies.

A strong rebound in Latin America and the Caribbean is anticipated in 2000-2001. After a stagnation of 1999, GDP is expected to register 3.7 per cent growth in 2000 with a further acceleration to 4.2 per cent in 2001. The significant slowdown in 1999 stemmed specifically from the economic recession that several countries experienced in the first half of 1999. These recessionary experiences had varying origins, including the crisis in Brazil early in the year, the contraction of intraregional and other trade for lack of demand and weakness in non-fuel commodity prices, the tightening of financing conditions, and restrictive domestic policy responses. In fact, the region's performance, though dismal for many economies particularly those in South America, turned out better than had earlier been expected. While Brazil managed to avoid a widely expected sharp contraction, banking and financial systems in many economies did not melt down during the various international financial crises. In fact, Mexico and most of the Central American and Caribbean countries grew relatively strongly.

With improved external financing conditions for Latin America, investment is expected to lead growth. However, high levels of unemployment and tight credit in several economies may limit the feasible pace of growth in domestic demand. Fiscal retrenchment, political uncertainties, and social unrest in some economies are also likely to act as a restraint on growth.

Prospects for economies in Africa and Western Asia have improved in general, but the economic performances are highly divergent across countries. While net energy exporting economies in the group have been benefiting from the surge in oil prices, countries producing non-oil commodities have been facing less favourable conditions. Even for the oil-producing economies, the strong rebound in the prices of oil in 1999 benefited in the first instance fiscal intakes and external balances; it made much less of a direct contribution to GDP growth, in part because of reduced oil production. Despite an anticipated moderation in the prices of oil, growth for Western Asia is still likely to accelerate to 3.9 per cent in 2000, up from the 2.5 per cent recorded for 1999, and to 4.7 per cent in 2001.

After slow growth for 1998-1999, GDP for Africa is expected to rebound to about 4.5 per cent for 2000-2001. This is also the average growth forecast for sub-Saharan Africa (excluding South Africa), suggesting a welcome, if still tepid, improvement of some 1.5 per cent per year in per capita GDP.

Recent developments in the *economies in transition* in the Baltic region, Central and Eastern Europe, and the Commonwealth of Independent States (CIS) have also been positive, underpinning a somewhat moderately optimistic outlook for the group. Growth is expected to be maintained in 2000, 3 per cent as compared to 2.9 per cent for 1999, but to accelerate somewhat to 3.4 per cent in 2001.

Russia's macroeconomic performance in 1999 turned out to be much better than what had been anticipated in early 1999, thanks to increasing oil revenues and the competitive advantage domestic producers obtained from the steep rouble devaluation in August 1998. It is expected to remain positive in the near-term, although with a slight deceleration to 2.5 per cent in 2000-2001 from the 3.2 per cent for 1999, with favourable spillovers for neighbouring countries that still depend on Russia for much of their external demand. Broadening this into a recovery that would be sustainable over the longer haul remains, however, critically dependent on the country undertaking a range of incisive structural reforms.

Meanwhile, a firm recovery has been under way in the Baltic and the Central European economies, boosted by increased exports, rising investment, and more foreign capital inflows. Conditions in the South-eastern European countries remain subdued, however. For the group as a whole, GDP is expected to grow by 3.5 per cent in 2000 and 4.5 per cent in 2001.

### **International trade expanding but large imbalances remain**

Coincident with the acceleration in growth in GWP, growth in trade volume has picked up, with a strengthening momentum going into 2000-2001. World export volume is expected to grow by 7.6 per cent in 2000 and 7.7 per cent in 2001, up significantly from the 3.5 per cent registered in both 1998 and 1999. As a result, the ratio of world trade growth and world output growth, which is indicative of the speed at which global economic integration is taking place,



will return to slightly above 2, after the sharp dip in 1998-1999. This is about at the long-run average of around 2 observed for the last two decades, but still well below the high levels of around 3 attained in the early 1990s.

International trade was severely depressed during 1997-1998 as a result of the fallout of the international financial crises. Many emerging market economies were forced to cut their import demand substantially because of the sudden deterioration in external financing conditions and deep currency devaluations in a number of countries. Through external trade and other international linkages, the impact of the financial crises on the real economy was transmitted from country to country. As domestic demand started to contract and called for even further cuts in import demand, a vicious circle was under way. The more interdependent the world economy becomes, the larger these multiplier effects will be. As a result, the growth of world trade in cyclical terms declined more and for longer than the growth of world output during the crises. When world output started to recover in 1999, international trade did not respond immediately. It lagged until the second half of 1999. For many crisis-affected economies, export was one important driving factor in their economic recovery; but their import demand did not pick up immediately for various reasons such as large slack in domestic capacity, devalued currencies, and rebuilding of depleted foreign reserves. Now that recovery in world output is solidifying, the same multiplier effects work in a beneficial reinforcing mode.

The rebound in trade growth has been fairly even across countries and regions. Unlike during the past two years when the United States was the only major economy maintaining high import growth because of brisk domestic demand, growth of import demand ranging from 5 to 10 per cent is expected for almost all major developed and developing country groups. In the developed economies, while the growth of import demand in the United States is expected to remain strong, at about 10 per cent in nominal terms, both exports and imports in Europe are likely to grow at an appreciably higher rate than in 1999, partly because of the weak euro. For the developing economies, a sharp turnaround in imports in Latin American economies is expected, from a decline of 1999 to near double-digits growth in 2000, as these economies recover from the region's 1999 stagnation. Meanwhile, trade in Asia, which had started to recover in 1999, continues to accelerate, and both imports and exports in many of the East Asian economies are expected to grow by 20 to 30 per cent in 2000. A marked pick-up in trade for African economies is also expected. At the same time, import demand in the economies in transition has been strengthening.

The spreading of the IT revolution, including last year on account of Y2K, would seem also to have substantially bolstered trade, for many developed economies as well as for many East Asian economies, where IT-related electronics account for a high proportion of their total exports. In fact, a large proportion of trade of IT equipment and software involves intra-industry trade, as the parts produced in many different countries are shipped to one place for assembly and then redistributed across the globe. The degree of specialization in IT sectors is now surpassing that in automobile production, well above broader measures of intra-industry trade.

Despite a worldwide increase in trade growth, large trade imbalances across countries continue to pose policy problems that need to be addressed. The most significant imbalance is the large trade deficit in the United States, which reached about \$350 billion in 1999 or about 4

per cent of GDP, in contrast to the large surpluses of Japan and Western Europe. Large imbalances were accumulated over the past several years mainly as a result of the widening differentials in growth rates across countries, owing notably to the extremely strong growth of the United States. They were also coincident with a strong U.S. dollar and outperforming equity markets in the United States, the latter attracting massive capital inflows to finance the country's large trade and current-account deficits.

As economic expansion in the rest of the world continues to pick up, these imbalances are expected to shrink. One of the core policy issues on the table at this time is how the adjustment process will prospectively play itself out. Given the size of the imbalances to be worked off, a gradual process spread out over time and all sectors of economic activity is the more desirable; otherwise, the adjustment process itself would administer a major negative shock to the world economy.

Along with the global economic recovery, trade liberalization is expected to continue, notwithstanding the impasse sustained at the Seattle meeting of the World Trade Organization (WTO) in November 1999 about convening a new round of multilateral trade negotiations, including several service areas. That failure did, however, underline the depth and breadth of the disagreements among nations and various interest groups on how to liberalize further broader areas of economic activity, given the complexity of international economic interdependence as the globalization process proceeds.

A recent positive development in the multilateral trading system has been the success of China's negotiations with a number of members on the terms of its eventual accession to the WTO. Critical in this regard has been the agreement signed with the United States, though this has yet to be approved by the United States' Congress, which has ultimate authority over the country's foreign treaties. If all procedures run their course now seems likely, China is expected to join WTO as a full member sometime in 2000. Once this materializes, China will in consequence liberalize in the next few years several sectors that have been protected administratively as well as through fairly high tariffs and other more non-parametric trade barriers. This is likely to boost world trade, with especially large benefits expected to accrue for trade with China's neighbouring countries.

### **External financing for emerging markets recovering**

External financing conditions for emerging market economies have been on a modest mend since mid-1999. After a sharp drop during the 1997-1998 international financial crises, net private capital flows to emerging markets stagnated in 1999, with virtually no increase from the low levels of 1998, when flows contracted to less than one half of their pre-crisis peak.<sup>4</sup> As international investor sentiment towards emerging markets continues to improve, net private flows to these countries are projected to increase by 30 per cent in 2000. In contrast, net official flows are expected to decline, as most crisis-affected economies are repaying the emergency assistance they secured during the crises.

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<sup>4</sup> According to the definition of the Institute of International Finance (IIF), net private capital flows to emerging markets peaked at about \$330 billion in 1996, while the flows registered at less than \$150 billion in both 1998 and 1999. All capital flow data in this section follow the IIF's definitions.

Despite the anticipated upturn in capital flows, external financing for most emerging market economies will remain as a major factor restraining the sustainability of strong economic growth in the medium to long run in these economies. Meanwhile, any unexpected developments in financial markets of developed economies, such as large corrections in stock markets and significant increases in interest rates, can considerably affect the volume, composition and direction of capital flows to emerging market economies.

Foreign direct investment (FDI) continues to be the most stable and the largest component of total capital flows to emerging markets, accounting for 90 per cent of net private flows in 1999 and reaching a record high of \$140 billion. Most conspicuously, FDI to Latin America registered a sharp rise of more than 30 per cent in 1999, due largely to an increase in privatization activity in Argentina and Brazil. FDI flows to emerging markets in Asia and Europe remained stable, however. China, the largest emerging-market recipient, by contrast experienced a 10 per cent decline in 1999. FDI is expected to moderate slightly in 2000, as privatization receipts are likely to slow down in quite a few countries.

Portfolio equity flows to emerging markets strengthened markedly in 1999, following the significant drop during the 1997-1998 crises. The recovery of foreign portfolio investment coincided with a sharp rise of equity prices in these economies. As measured by the Morgan Stanley emerging market index, equity markets in these economies appreciated by about 60 per cent in 1999. In the first quarter of 2000, equity markets in emerging market economies were adversely affected by increased volatility in equity markets of developed countries. None the less, portfolio equity flows to emerging markets are expected to rise for 2000, buoyed partly by increasing share issues of these economies in equity markets of major developed countries.

Emerging market economies registered another large net outflow of commercial bank lending in 1999, as net repayments to banks totaled \$40 billion, following \$50 billion in 1998. Further net repayments to banks are expected to be concentrated in Asia, where economic recovery, an improved balance-of-payments position, and financial restructuring are reducing inter-bank liabilities. Net inflows of bank lending to Latin America are expected to resume in 2000 as economic growth picks up in the region. Although the retreat of bank lending triggered by the 1997-1998 financial crises has almost been halted, a revival in the volume of bank loans to emerging markets is not very likely in the short and medium run.

On the other hand, after a sharp decline in the past two years, net non-bank lending to emerging markets is expected to rebound moderately in 2000, though remaining far below their pre-crisis levels. Bond issuance by major emerging market borrowers declined in the second half of 1999, after a brief surge in the first half. Most emerging bond issues were concentrated in Latin America and dominated by public sector borrowers, the latter accounting for more than 80 per cent of the total issuance. Meanwhile, the proportion of the U.S. dollar-denominated bond issuance decreased in 1999 while the euro-dominated share increased. Even so, the former still accounted for 65 per cent of total bond issues.

Along with the stabilization of most emerging financial markets and improved investor sentiment, risk premiums for these economies have been reduced since mid-1999, as indicated by the shifts of the interest-rate spreads between emerging market sovereign bonds and United

States treasuries. Measured by the data recorded in J.P. Morgan's Emerging Market Bond Index (specifically, the EMBI+), for most emerging market economies the spreads in secondary markets have now returned to the levels observed prior to Russia's default in August 1998, ranging from about 400 to 750 basis points for Asia and Latin America, respectively; the spread for other emerging markets, notably Russia, continues to be much higher, however, just under a punitive 2000 basis points. Differentiation according to country-specific risks has also risen, as the spreads for Asian emerging markets are much lower than those for Latin America; but those for Russia remain the highest.

While there is more room for further narrowing the spreads in 2000, any large fluctuation in the financial markets of developed countries could adversely affect investor sentiment towards emerging markets, thus once again widening the spreads.

### **Commodity prices stabilizing**

After reaching long-term lows in 1998, prices of many commodities, as measured in U.S. dollars, stabilized in 1999. But sharp divergences among the trends for the various kinds of commodities need to be noted. While the prices of oil tripled from their recorded trough and prices of several metals and minerals rebounded by appreciable amounts, prices of most agricultural commodities stayed at their lows and some declined even further until late in 1999.

In line with the anticipated strong growth in world output, most non-fuel commodity prices are expected to firm up in the near-term. Nevertheless, high volatility of commodity prices will continue, owing to the low price elasticity of demand and supply as well as speculation in commodity markets. While there may temporarily be an uptick in many commodity prices, due to demand growth overtaking the pace of growth of supply in the short run, the observed long-term downward trend is expected to remain largely unaffected.

Leading the recent cyclical movement of commodity prices has been the drastic rebound of oil prices. This has been brought about by a combination of factors, including an organized reduction in supply by many oil-producing countries, a recovery of global demand, and speculation in futures markets. Measured by the price of Brent oil, the price surged from below \$10 per barrel as the lowest in over a decade in the beginning of 1999 to about \$32 per barrel at its peak in March 2000.<sup>5</sup> This sharp swing can be contrasted to a mere 2 per cent decline in total world oil supply between 1998 and 1999; but 4.5 per cent for members of the Organization of Petroleum Exporting Countries or OPEC. Aggregate global demand for oil rose by 1.7 per cent. Yet such comparatively small changes in demand and supply can produce such huge short-run price swings.

Facing pressures from large oil-consuming countries, OPEC members agreed in March 2000 to raise production quotas. Other oil-producing countries are committed to follow suit. An estimated 1.5 million barrels per day (mbd), or about 2 per cent, is being added to world supply, beginning with the second quarter of 2000. Following the agreement, oil prices softened very quickly to about \$25 per barrel.

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<sup>5</sup> Peaks and troughs at least in nominal terms. In real terms, however, even at their recent peak oil prices did not quite match prices of, say, the early 1980s.

In the baseline forecast, given strong world economic growth, the price of oil is expected to fluctuate around the current price of \$25 per barrel for the rest of 2000 and move slightly lower in 2001. A range between \$20-\$25 per barrel is considered reasonable. Such a range would not be so high as to choke off world economic growth and not too low to substantially hurt revenues of oil-producing countries. The downtrend in prices from their peak will, of course, exert a negative impact in particular on oil-exporting countries with little to no spare capacity to raise output levels in the foreseeable future, if at all.

Prices of base metals, such as aluminium, copper, nickel, tin and zinc, have all experienced a significant rebound over the course of 1999, from the deflated low levels in 1997-1998. With strong growth in global industrial production and generally lean inventories for most metals (but not copper, whose inventories have risen to high level), a continued gain in these prices is expected in 2000-2001.

Lagging in this broadening recovery are prices for most agricultural commodities. Prices of grains dropped another 10 to 20 per cent in 1999, on top of the large declines in 1997-1998. Increasing supply and large inventories were the main reasons for the further weakening of prices. In the near-term outlook, only a moderate recovery is expected for the prices of grains. Prices of agricultural raw materials, such as cotton and rubber, and of beverages, which are very volatile, are likely to decline further. As a result, the trade-weighted price index for industrial agricultural and foodstuff products is expected to grow by only 1 to 3 per cent in 2000-2001 (see table 1).

### **Inflation remaining under control**

In spite of the acceleration in the pace of output growth and the sharply risen oil prices, inflation worldwide remained under control in 1999 and the short-run inflation outlook continues to be benign. Inflation trends across countries are far from uniform, however.

The disinflation trend observed for developed economies in the last decade seems to be over, most countries in this group having reached the near-zero inflation zone in the last couple of years. While the headline inflation indices in some of these economies started to rise notably at the beginning of 2000, mainly because of the surge in energy prices, the core inflation indices, which exclude the volatile prices of food and energy, remained subdued. This suggests that so far there has not been a pass-through of the high energy prices into prices of other goods and services. Now that oil prices have softened somewhat, pressures to catch up with oil prices, notably in negotiating wages, have been weakening. However, there does remain a major potential problem if in subsequent wage negotiations and price adjustments economic agents were to seek a redress for the fall in their real incomes and profits on account of the risen energy prices.

Many factors that worked together in the past to keep inflation at bay in many developed economies are expected to remain operative in the outlook. These factors include disciplined fiscal policy, increased international competition, and vigilant monetary policy, many central banks having already raised interest rates substantially in pre-emptive approaches in recent months. While tight labour markets in some economies, especially in the United Kingdom and North America, seem to have gradually elicited somewhat higher inflation pressures if account is

taken only of nominal wages in some sectors, improved productivity resulting from further technological progress is likely to continue reducing unit labour costs, thus keeping the lid on inflation. As a result, inflation rates in most developed economies are expected at best to move up slightly, from below 2 per cent in 1999 to above 2 per cent in 2000-2001. The forecast rates of inflation for developed countries do not exceed 3 per cent. Though the precise reaction function of monetary authorities in major countries is not really spelled out in the disclosed rules, these inflation rates would seem to be within a reasonable confidence interval below the trigger for monetary tightening. Policy makers should therefore not be unduly alarmed by the slight uptick in inflation.

On the other hand, inflation can be expected to be further reduced in many emerging market economies in 2000. Especially economies with double-digit inflation rates in 1999, such as Russia, Turkey and a few Latin American countries, are expected to compress inflation. Many emerging market economies succeeded with disinflation in 1999. This was especially pronounced in Asia, where inflation fell significantly in many economies, on account of excess capacity, international competition, and, in some cases, appreciation of the currencies that had been sharply devalued during the crises. Many Asian economies registered near-zero inflation in 1999, with China and Hong Kong Special Administrative Region (SAR) experiencing mild deflation. In Latin America, inflation reached an annual average of 7.5 per cent, the lowest in decades in spite of currency devaluation in a number of countries. As the recovery stage in many emerging market economies is coming to an end with slack capacities being exhausted, further economic expansion is likely to increase inflation pressures in some of these economies. But inflation is not expected to be a major problem in emerging market economies in the near-term.

Meanwhile, deflation in a few economies, mainly China, Hong Kong SAR and Japan, caused by weakening effective demand, has shown some sign of easing since the beginning of 2000. Reflationary policies and the pick-up in the pace of economic activity are the major driving forces here.

### **Improving employment prognosis**

Global labour markets have improved recently as demand for labour rises, albeit usually with a lag, once the economy turns up and expansion takes hold. The sharp contrasts in labour markets in various countries, and indeed among regional groups, deserves to be emphasized. The outlook reckons with continued improvement. Note, however, that the situation varies considerably among countries.

For the developed economies, labour markets in a few countries, such as the United States, have recently become extremely tight, unemployment rates having reached record lows since the late 1960s. In Western Europe, although the gains on the labour front have been much less spectacular, some steady improvement has recently been booked and further slight gains are in the offing. In fact, by the end of 1999 unemployment in the euro area dropped below the psychologically important marker of 10 per cent for the first time since 1993.

Forecasts are for the EU to create 4 million new jobs during the forecast period, which would reduce unemployment from 16.3 million at the end for 1999 to 14.4 million at the end of

2001. While these gains would be very welcome, unemployment in Western Europe will remain above 9 per cent for the foreseeable future. The comparatively small dent suggested by these numbers underlines the widely recognized view that this cyclical improvement cannot possibly solve the structural problems characterizing European labour markets. Incisive labour market reforms should therefore continue to rank very high on the policy agenda.

In contrast to the progress with unemployment in North American and Western Europe, in Japan, given its nearly stagnant economy, unemployment has continued to deteriorate. The near-term outlook is for more layoffs as inevitable if the needed financial-sector and corporate restructuring is to be continued.

For most developing countries and economies in transition, the crisis-induced rise in unemployment has finally peaked in some economies and started to improve in others. In Asian developing economies, the current strong expansion is expected to reduce unemployment further in 2000-2001. However, unemployment rates in the crisis-hit economies remain still well above their pre-crisis levels. The continuing corporate restructuring will dampen somewhat the ongoing improvement in employment in the near-term. Meanwhile, in China layoffs from state-owned enterprises rose in 1999. Further restructuring of that sector, including by shedding labour, remains an item ranking high among core policy concerns in modernizing the Chinese economy, including through further integration into the global economy. Accession to the WTO will only strengthen this need for further restructuring of the public sector.

In Latin America, unemployment in some countries is still rising. On average, however, the level of unemployment should decline over the near-term as growth accelerates. The situation in individual countries differs markedly, however. Thus, while unemployment is very low in Mexico, a number of other large economies in the region, such as Argentina, Brazil and Venezuela, are still struggling with high and rising unemployment. Joblessness in the region is expected to subside somewhat during 2000-2001, but the projected moderate growth will be insufficient to make a substantial dent in unemployment in many Latin American economies in the near future.

Levels of unemployment in the formal sector in Africa continue to be quite depressing, including in large countries, such as South Africa, and those recently beset by natural calamities, such as Zimbabwe. Also in Western Asia, despite the improved outlook for growth in 2000, the situation in labour markets is far from encouraging.

Although most of the economies in transition more advanced with their transformation succeeded in halting the rapid run-up in unemployment that accompanied the introduction of transformation policies, the situation throughout the region remains precarious. Unemployment soared again in Central and Eastern Europe in 1999 as economic growth receded (as in Poland), enterprise restructuring received a major impetus (as in the Czech Republic), or economic conditions remained mired by lacklustre commitment to structural and other reforms (as in many South-eastern European countries). The picture for the CIS improved for some countries (such as Russia) but further deteriorated for a number of other CIS members in pronounced recession or experiencing reduced growth. The downturn in the Baltic States also had adverse effects on employment opportunities.

With intensifying international competition in IT sectors in particular, a shortage of skilled labour has become a common structural problem for both developed and developing economies. Several developed countries have recently introduced (as in the United States) or are about to introduce (as in Germany and the United Kingdom) special temporary immigration quotas for IT specialists in particular. Brain drain from the developing countries will further reduce the already scarce skilled labour in these economies and slow down the pace at which these countries can narrow their technological gap relative to developed economies.

## **POLICY ISSUES**

Among other policy measures, various macroeconomic policy stances have been crucial in stimulating the emergence from the recent international financial crises, in encouraging recovery in countries, and indeed in bolstering the pace of world economic growth. As many economies are now entering a more stable expansion phase, prudent macroeconomic policy will remain equally important in order to maintain an appropriate pace of output growth, while keeping inflation within a safe range.

In effect, policymakers worldwide are facing many new challenges in an era of increased global economic integration, rapid technological innovation, and post-financial-crisis restructuring.

In many developed economies, the combination of strong output growth with low inflation and unemployment has suggested a decoupling of the links traditionally assumed among those variables, leading to a “new economic paradigm.” The new theory contains three main strands. First, the recently observed acceleration in the IT revolution has bolstered productivity growth, lifting it possibly onto a new, higher path. Whether this shows up in macroeconomic statistics as yet has been a hotly debated topic among economists, if only because of serious methodological defects in the traditional methods used to measure the contribution of new economic activities. Second, increased international competition resulting from greater global integration in trade, finance and production has placed limits on the pricing power of many firms. Third, the traditional “wage-price spiral” has been weakened, if not irrevocably broken, by more transparent macroeconomic policies and, in a growing number of countries, more flexible labour markets. Greater transparency and flexibility reduce uncertainty, leading economic agents to lower their inflation expectations below what they would otherwise have been. As a result, the non-inflationary potential growth of many economies may have been raised. In other words, a seemingly excess demand can be accommodated faster than under the conditions that prevailed earlier, thus not necessarily building up as much pressure on inflation as in the past. Therefore, monetary authorities may not have to tighten monetary policy as much as they would earlier have had to enact, thus avoiding unnecessary sacrifices of output growth and employment. The key challenge is to identify the underlying potential growth.

In many emerging market economies, the international financial crises of the late 1990s not only damaged their economies in terms of welfare losses. They also caused changes in the institutional framework for economic policy. Examples are the switch in exchange-rate regimes, the mutation in the rules and instruments for monetary policy, and reforms of banking and



financial systems. Together these and related mutations have enhanced crucial channels through which macroeconomic policies can affect the real economic sectors.

Many emerging market economies have recently moved, or have been forced to do so under impact of the financial crises, from fixed exchange-rate systems to floating regimes. But a few countries still cling to extreme forms of a fixed exchange rate, such as a currency board. Countries that adopted more flexible exchange-rate arrangements have gained more freedom in conducting their monetary policy. As a counterpart, these countries have lost the nominal anchor for monetary policy in maintaining low inflation and a stable exchange rate. As a result, “direct inflation targeting” has been proposed for emerging market economies with a floating exchange-rate regime, and some have already adopted this monetary framework.

Inflation targeting as a practical framework has been adopted in several developed economies since the early 1990s. In this approach to monetary policy, a specific inflation rate or a band is announced as the target of monetary policy, and the monetary authorities through certain institutional commitments are accountable for keeping inflation within the target range or, in principle, at the point target by adjusting monetary policy.<sup>6</sup> The experiences of the developed economies that have embraced this policy framework, usually after notable failures in targeting either money supply or the exchange rate, have in general been successful, as inflation has remained fairly stable in the last decade. However, there continues to be an intense debate around several controversial issues of inflation-targeting such as credibility of the policy, time consistency, effectiveness under different economic shocks and institutional provisions (especially for countries, such as many economies in transition, undergoing rapid and deep structural and institutional changes), and welfare costs or benefits resulting from adhering to such a framework.

A more pragmatic debate has recently been focusing on the requirements for the adoption of an inflation target in emerging market economies as a constructive and credible monetary policy. First, initial conditions are important for obtaining the minimal required credibility; success with adopting the framework is more likely when inflation is already low. Second, it requires that fiscal deficits not be monetized. Third, the inflation process has to be clearly understood and a target needs to be selected that is transparent to economic agents. Fourth, in countries undergoing major structural change, in part by adjusting relative prices, it will be difficult to establish a realistic target and meeting it. Without such ‘success,’ credibility for the monetary authorities will be rapidly eroded and not easily regained. Finally, it requires a sound, robust, fairly deep, and predictable financial system.

### **Major monetary policy assumptions**

There has been a significant shift in monetary policy of central banks in many developed economies since mid-1999. Led by the United States Federal Reserve, most central banks in

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<sup>6</sup> In theory, a point target should work symmetrically: if exceeding the target, monetary policy should be tightened; if falling short of the target, monetary policy should be loosened. However, this is theory. In practice, there is asymmetry for many countries and institutions that subscribe to a point target, leaving a margin of discretion to monetary authorities. It is precisely this uncertainty about what monetary authorities will do that tends to weaken, however marginally, the credibility of inflation-targeting.

developed economies started to reverse the easing stance implemented at the height of the financial crisis. As expected in the last LINK exercise, the tightening has since continued, albeit at a stronger pace than had been anticipated. By April 2000, the United States Federal Reserve has raised interest rates five times for a total of 125 basis points. The central banks of other developed economies also raised rates, ranging from 75 to 125 basis points. There are, however, some exceptions such as Greece, where interest rates had been kept high for stabilizing the economy, but have recently been declining because of the political and monetary authorities' determination for Greece to join monetary union in Europe in 2001.

Although most tightening so far has been pre-emptive, as core inflation rates in these economies have edged up only slightly at best, further rises in interest rates are likely as per the latest policy statements of many central banks of developed countries. In the LINK baseline, another rise in interest rates by 50 basis points is assumed for the United States, 75 basis points for the euro area, and 50 to 75 basis points for other developed economies other than Japan.

Japan is an exception among developed economies, for the central bank of Japan has maintained near-zero interest rates since early 1999. No tightening is likely for the rest of 2000 as the Japanese economy's recovery for now continues to be highly tentative. However, monetary policy announcement in mid-April suggested that the near-zero interest-rate policy may be abandoned before the end of 2000.<sup>7</sup>

In contrast to the trend of monetary tightening in most developed economies, interest rates in many emerging market economies have to date remained virtually unchanged. In fact, quite a few of these economies have managed to lower their policy interest rates from the high levels embraced during the crisis.

This suggests a kind of decoupling of interest rates in developed and developing countries, in the sense that the latter have not apparently been following actions taken by the policy authorities in the former. This phenomenon stems from a variety of reasons. Perhaps most important are the lagged growth cycle in many emerging market economies; the relatively high interest rates in some of the countries, especially in real terms; and the greater degree of independence, though still limited, gained for monetary policy in those countries have embraced floating exchange-rate regimes. These are the principal factors that have permitted monetary authorities in these countries not to follow nominal targets of developed countries, thereby reducing somewhat their real interest rates.

In the outlook for 2000-2001, no substantial rises in interest rates are expected for most emerging market economies. While a few Asian economies, which are completing their recovery at a strong pace, such as Hong Kong SAR (also because of its adherence to a rather rigid currency board), Korea and Singapore, are expected to enact a small increase in interest rates, some Latin American economies are likely to cut their interest rates, from rather high levels, to underpin the gathering momentum of the recovery.

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<sup>7</sup> *Financial Times*, 13 April 2000, p. 4.

## Major fiscal policy assumptions

As a result of the strengthening pace of economic growth since mid-1999 in particular, there have been some notable, but cyclical, improvements in fiscal balances in many developed economies as well as in several emerging market economies.

Most developed economies, except Japan, have recently maintained sound fiscal conditions. The large government surplus in the United States continued to balloon, reaching over \$150 billion in 1999. Also several other developed economies have switched their fiscal balances from deficit into surplus or they have compressed their fiscal deficits. In fact, the budget deficit in almost every EU member is now below the critical Stability Pact thresholds.

For many of these countries, the acute need of monetary authorities to borrow is shrinking, entailing in some cases major changes in the structure of bond markets. If the United States federal authorities were to reduce substantially the accumulated public debt, at the very least the long bond (30-year bond) would no longer function as a bell-wether of expectations in financial markets. Something along those lines appears to be disturbing the structure of fixed-income securities in several major developed market economies, the United States in the first instance.

By contrast, the recession of 1998 and a nearly stagnant economy in conjunction with sizeable government stimulus spending over two years have led to huge budget deficits in Japan, nearing 10 per cent of GDP in 1999 and a public debt-to-GDP ratio of 120 per cent.

In the outlook, fiscal policy in most developed economies is expected to remain restrained. Various tax cuts have been proposed or already approved in the 2000-2001 budgets for a number of developed economies. Fiscal positions of governments in most developed economies are expected to improve further, either raising the surplus or reducing the deficit as economic expansion strengthens. In Japan, taking into account the total effect of the fiscal package approved by the end of 1999 for implementation mainly in early 2000, the stance of fiscal policy is likely to be slightly stimulating in 2000-2001.

Fiscal positions in many emerging market economies have also improved to a varying degree and on the strength of a number of different sources. The surge in oil prices has brought some windfalls to government revenues of many oil-producing emerging market economies. The strong growth recovery in the crisis-affected countries particularly in Asia has compressed the large budget deficits that had been a concomitant of the stimulus fiscal policies pursued during the crises in an effort to emerge from the calamity as early as possible. Lower interest rates in several emerging market economies with high levels of public debt have also contributed to reducing interest payments, thus lowering current deficits.

In contrast to the generally sound fiscal positions of developed economies, fiscal balances in the majority of emerging market economies remain in deficit. A number of these countries have fiscal deficits above 5 per cent of GDP, which is generally considered quite high and unsustainable. A general fiscal consolidation, aiming at reducing fiscal deficits, is expected for most of these economies in 2000-2001.

## **Exchange rate outlook**

The exchange rates of most currencies were relative stable over the course of 1999 and early 2000. Although the near-term baseline outlook assumes no sharp fluctuations in foreign exchange markets, the risk of a larger than expected weakening of the U.S. dollar against other major currencies, given the massive external deficit and a possible larger than expected correction of equity markets in the United States, remains.

Among the major currencies of developed economies, the 20 per cent depreciation of the euro against the U.S. dollar since its debut in 1999 may have been partly due to overshooting. Some depreciation occurred undoubtedly in response to the sizeable differentials in GDP growth rates and interest rates between the United States and the euro area, as well as on account of the remarkable appreciation of equity markets in the United States relative to those elsewhere. Now that the pace of economic expansion in the euro area is picking up, a mild recovery of the euro over the course of 2000-2001 is to be expected and has been factored into the baseline.

The exchange rate between the Japanese yen and the U.S. dollar has, to some extent, also been driven by the even larger growth differentials between the two countries: the yen strengthened against the U.S. dollar for a period during 1999, when the expectation of a recovery in Japan was high, but it retreated towards the end of 1999 as the Japanese economy recorded two quarters of negative growth, thus reversing growth expectations. In the outlook, the yen is expected to remain relatively weak against the dollar, consistent with the mediocre growth projected for Japan and the rising interest rate differentials in favour of the U.S. dollar.

After the large currency devaluations in many emerging market economies during the 1997-1998 international financial crises, since the Brazilian currency crisis of early 1999 many of these currencies have stabilized. While a few currencies in Asia and Latin America appreciated from their extreme lows, which was most spectacularly the case for the Korean won, most others stayed at the devalued levels.

In contrast to these developments, the Russian rouble, the Kazakh tenge, the Ukrainian hryvnya, and several other currencies of the economies in transition have continued to drift downward. Exceptions are for countries that have adopted a rigid exchange-rate regime, such as a currency board or, as in Latvia, emulation of the rules of the currency board. Several of these arrangements came under pressure, however, under the fallout of the Russian crisis. However, all countries adhered to their currency board-type arrangements, if perhaps at the cost of larger domestic adjustments than might otherwise have been required.

In the baseline outlook, assumptions for most exchange rates, other than those among the major currencies in the developed economies, are made according to the following rules: (1) currencies with a fixed exchange-rate regime remain at the currently pegged value and (2) those with a floating regime follow shifts in purchasing power parity as measured, in the first instance, by differential price movements. These principles are in some cases slightly modified if individual country conditions warrant doing so.

## UNCERTAINTIES AND RISKS OF THE FORECAST

The optimistic LINK baseline outlook presented earlier is predicated on the assumption that the existing large imbalances, both fiscal and external, in the world economy will be adjusted gradually in a fairly smooth manner. However, the adjustment process may turn out to be much more abrupt, leading to an interruption of the current economic expansion.

One of major downside risks is centred primarily on the large and increasing imbalances of the United States. The extremely tight labour markets, the large trade and current-account deficits, the record low personal saving rates, and the apparent bubble in the highly appreciated equity markets, in spite of the recent down-trending in some, are all ingredients for a potentially large and rather quick correction.

A stylized downside scenario simulated by the LINK modeling system, whose details were first reported in the LINK Report of May 1999 and reiterated in the LINK Report of November 1999, was a collapse in equity markets in the United States and other major developed markets by about 40 per cent. The wealth effects of such a downturn on real economic sectors in these economies, the depressed investment, the international contagion, and the cumulative repercussion effects would send the global economy to a much lower growth pace.

However, given the ongoing large correction in the equity values of technology sectors (a near 30 per cent decline of the NASDAQ markets in the United States in the first two weeks of April 2000), a large correction in the broader equity markets is not likely. The 'old economy' equity values, although still high by historical valuation standards, appear to be supported by the downturn in the 'new economy' technology stocks.

Other triggering factors for a possible hard-landing scenario in the United States, with subsequent rippling effects throughout the world economy, include over-tightening monetary policy in conjunction with supply-side shocks to slow productivity growth. Currently, inflation is still subdued. But, if the risen pace of productivity growth were to turn around, say, by a substantial faltering of the earlier hyped technology shocks in e-commerce and the Internet companies more generally, an impetus to inflation may be imparted. This in turn would force the monetary authorities to tighten further and perhaps more rapidly than the actions seen over the past quarters. The resulting credit crunch would then lead to a sudden drop in output growth, possibly even a recession.

Uncertainties are also hovering over the Japanese economy, where large government deficits are piling up while the recovery in private sectors, both in consumption and investment, continues to be quite fragile.

Some supply-side shocks cannot be ruled out. While oil prices have just dropped to a much lower levels since the recent OPEC agreement, and the easing of winter conditions in many developed countries, if the observed high prices of well over \$30 per barrel had persisted for much longer than they did, they could have posed a real threat to sustaining the forecast pace of economic growth throughout the world.

On the other hand, there could be an upside to the baseline proposed here. For example, if the wave of benefits from IT technology were to spread itself wider in more developed and emerging market economies, the benefits that the United States economy has recently reported would cumulate and help to sustain a faster pace of economic expansion in the short to medium run than the baseline suggests. This possibility cannot be ruled out in particular for economies that have recently raised their pace of investment in IT technology by a substantial margin.