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Global Outlook

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PROJECT LINK WORLD ECONOMIC OUTLOOK
PRE-MEETING FORECAST, 14 SEPTEMBER, 1998

INTRODUCTION

The agenda of the September 1998 Project LINK meeting, held in Rio de Janeiro, Brazil, 14-18 September 1998, included (1) discussion of the short- and medium-term outlook for the world economy, based on a review of new international and national developments since the 1998 March LINK meeting; (2) discussion of current international economic policy issues; and (3) presentation of modelling techniques and their application in forecasting and policy analysis. With inputs from the national LINK centers and information from other sources, as of 31 August 1998, the LINK team at the United Nations[1] prepared a pre-meeting world economic forecast, using the LINK econometric modeling system. This report summarizes the main features of the pre-meeting forecast. The outlook projected here is an interim exercise and will be updated with a post-meeting forecast in several weeks. Most of the *LINK COUNTRY REPORTS*, which contain detailed forecasts and policy analyses submitted by the national LINK centers may be found on the website of University of Toronto.

GLOBAL OUTLOOK

The Project LINK outlook for the global economy is moderately pessimistic, at least in the short run, as the growth rate of world GDP is expected to decelerate substantially from 3.1 per cent last year to 1.9 per cent in 1998, the lowest rate in 5 years. Growth for the next two years is forecast to be at around the mediocre rate of 2.5 per cent (table 1). Even more worrisome than such slow growth in the world as a whole is the sharp divergence across nations. While most of the developed economies in North America and Europe are still expected to perform well, a number of economies, accounting for about one-quarter of total world GDP, are falling into their worst recession since 1945, and other economies are showing a significant downshift. It is most discouraging that policies world-wide have not been sufficiently strong and coordinated to limit the contagion that has set off the series of currency, financial and banking crises which have spread from one continent to another and now are posing a serious threat to world economic prosperity and the globalization process. In the midst of the current round of world financial turbulence, there is a risk that the world economy may perform far worse than this LINK forecast. Thus far, the probability of a world-wide recession is not high, because there is plenty of room for policy makers to maneuver, especially in some large economies, in order to prevent such a recession. But the needed firm policy commitments, world-wide, have not yet been made.

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Main features of the forecast

There is a considerable downgrading of the world economic outlook in the current LINK forecasts, compared with those made in March. The expected rate of growth in world GDP has been reduced by 0.7 and 0.5 of a percentage point for 1998 and 1999, respectively. The three major factors leading to this more pessimistic outlook are the new round of turmoil in world financial markets, the large declines in commodity prices, and the worsening recession in Asia.

As of July 1998, most financial markets in emerging economies were stabilizing after the Asian crisis of 1997, and some markets were beginning to recover. However, the rouble devaluation and the announced restructuring of Russian domestic debt in August triggered a sharp sell-off in financial markets world-wide, causing a big deterioration in investors' confidence. Stock prices plunged the most in emerging markets in Latin America, Eastern Europe and Africa, and most stock markets in developed countries also suffered serious declines. As a result, many stock markets in emerging economies have dropped significantly in 1998, through the end of August (table 2). Meanwhile, the yield spreads of the sovereign debt of the emerging-market countries, compared with US treasury debt (which were decreasing earlier in 1998, after the 1997 surge caused by the Asian crisis), have been pushed up sharply (table 3). At the same time, devaluation pressure on a number of currencies has increased tremendously. In the face of world-wide financial turmoil, trouble in one market has caused indiscriminate sell-offs and raised risk premiums in many other emerging markets, as international investors appear to treat most of the emerging markets the same way in their portfolio.

Most commodity prices (in US dollars) have been on a downward trend for the past couple of years, after a few years of rebound in the early 1990s from their long-run downward trend in the 1980s. Since the Asian crisis, moreover, prices of almost all commodities— from grains to industrial raw materials and oil—have plummeted, pushing some prices to their lowest levels in decades. The oil price is now at its lowest level in 10 years, and the Bridge Commodities Bureau Research index (17 unweighted commodities) fell to its lowest level in 21 years at the end of August. The large deflation of commodity prices is one of the fundamental factors behind the collapse of stock markets and the devaluation pressure in commodity-exporting economies, including not only many developing economies and economies in transition, but also some developed economies, such as Canada, Norway, Australia and New Zealand. Weaker demand, especially from Asia, has been generally blamed for this drop in commodity prices. However, while there has been a decrease in demand, the drop in trade volume of some commodities has not been enough to account for much of the price declines. Other factors that are causing the declines in commodity prices include dumping by some countries in international markets to meet their liquidity needs; more international competition; and the appreciation of the US dollar against most other currencies.

Several Asian economies, especially Japan, are falling into a recession that is much deeper than was expected last spring. The March LINK forecast correctly predicted a quite drawn out period for the Asian countries already in crisis to recover, in contrast to the short, rapid recovery of Mexico after its 1994 crisis, and it predicted that a few of the countries in crisis would fall into recessions. But for reasons that will be discussed in the regional outlooks below, the recessions have become much deeper than LINK expected last March.

The impact of the financial market turmoil and the deflation of commodity prices on world economic growth will be significant. The impact on individual economies will not be equal, however, with a more severely adverse impact on many developing economies. For some developed economies, the benefits may temporarily overweigh the losses. For example, the effects of a "flight to quality" amid world financial turmoil have pushed long-term interest rates in the US to very low levels, benefiting US domestic consumption and investment. Moreover, much cheaper prices of imports have created substantial welfare gains and contributed to lower domestic inflation. These benefits may be larger than the losses from weaker foreign demand for US exports, plus the losses of banks and other companies on their investments in emerging markets. However, if the situation persists much longer, the negative effects may eventually exceed the benefits.

For most developing economies, the impact of financial turmoil and commodity price deflation will lead to significant losses; some damage has already been done in a number of economies. Aside from direct income losses and the negative wealth effect of the collapse of financial and real asset prices, the rise in yield spreads has caused a significant increase in the cost of external finance; for economies with high dependence on foreign capital, this increase will force a downshift in their growth path. For countries which are defending their currencies from increased devaluation pressure, a large rise in their domestic interest rates will restrain domestic demand and curb investment. A drastic loss of export revenue and government revenue in commodity-exporting countries is obvious, as a result of commodity price deflation, and there will be additional welfare losses from the sharp deterioration in their terms of trade.

By taking account of these impacts, along with the policy assumptions discussed below, Project LINK forecasts low global growth and a significant divergence across nations, as shown in table 1.

For the developed countries as a whole, GDP growth is likely to slow down moderately, from 2.6 per cent last year to 2.0 per cent in 1998, but is expected to stay above 2 per cent for the next two years. Within this group, Japan is expected to have a contraction of 1.6 per cent in 1998 and then to recover at a very slow pace of just above 1 per cent. Most other developed economies are expected to perform well this year, with a growth rate around 3 per cent, followed by growth rates of about 2 per cent for each of the next two years.

In sharp contrast, a significant drop in GDP growth is expected for the developing countries as a whole, from 5.3 per cent last year to 2.1 per cent for 1998, and their growth is not forecast to return to 5 per cent in the next two years. Within this group, at least seven countries are expected to be in a recession this year, with most of them hit by the Asian crisis; adjustment in these economies has turned out to be very painful, and their recovery is not expected to be fast. Meanwhile, a slowdown in Latin America is also significant, as the region's economies are suffering the impact of both financial turmoil and commodity deflation. Africa, on the other hand, seems to be affected less by the world-wide financial crisis; a moderate growth rate of about 3.6 per cent is forecast for this year and for the next two years. The outlook for China is for growth rate half a percentage point lower than the growth target of 8 per cent for 1998, and the LINK forecast of its growth path for the next few years has been lowered from 8 per cent to 7 per cent. The West Asian oil-exporting economies are expected to suffer a recession because of the plunge in oil prices, with a fall of 0.4 per cent in their total GDP in 1998.

The impact of the latest Russian crisis is expected to vary widely. While Russia and some other CIS members are expected to have recessions of different degrees, the economies in Central and Eastern Europe are expected to maintain their recent growth rate of around 4 per cent, on average. The Russian crisis is also having a further contagion effect on Latin America.

Along with slower growth in world output, world trade is also expected to decelerate notably. World export volume is expected to grow by 6.4 per cent in 1998, down from as high as 10 per cent in previous years, and will grow only at 5 per cent for the next two years. Because of a decline in the average price of tradeables and a strong US dollar, total world export value in 1998 is expected to drop by 1 per cent from last year's level. While import demand in the US and most of Europe is strong, their exports are weak, especially to the rest of the world. In Japan and many other Asian economies, a considerable decline in import demand is expected as a result of devaluation and adjustments in the real sector. The expected effects of devaluation by several Asian economies have not shown up yet; none are experiencing any significant export growth, in part because of credit constraints in their export sector. Almost all developing economies are experiencing a slower pace of international trade.

The world-wide financial turmoil is expected to curb foreign capital flows to developing economies in the near term. As large banks and investment companies are reducing their exposure in emerging markets, a decrease in portfolio investment and commercial bank loans is not avoidable. Meanwhile, greater scrutiny and restrictive measures are expected to be imposed by some developing countries. The increased yield spreads in emerging markets will also reduce the demand for foreign capital.

Inflation is forecast to remain benign in most countries. Most developed economies are expected to keep their inflation rate below or around 2 per cent, and the recent disinflation trend in many developing economies is expected to continue. But some economies, where the currencies have been devalued recently, are expected to experience a double-digit rate of inflation. Meanwhile, the trend of deflation in commodity prices is expected to halt in the next two years.

Unemployment is expected to worsen somewhat in the world economy as a whole. High unemployment rates have been a long-standing structural problem in a number of economies, both developed and developing, and the current slowdown in world economic growth is expected to raise the unemployment rate in many countries, especially those falling into recession.

Assumptions and policy issues

Making accurate assumptions about macroeconomic policy as a basis for world economic forecasts has become more difficult, as the effects of globalization have created more dilemmas for policy makers world-wide. The increased international flows of goods, services, and capital are severely challenging the ability of existing institutional frameworks and policy instruments, both at the national and the international levels, to handle problems such as the current financial crisis.

Policy makers in a few large countries, whose economic policies have substantial influence on the world economy, may face a dilemma when there is a conflict between domestic policy objectives and an obligation to stabilize the world economy. The current case of monetary policy in the US provides such an example. With the US dollar acting as a major world currency, a case can be made that the US Federal Reserve System (Fed) should play the role of the world's central bank. But its legal mandate and its consequent policy objectives are to achieve price stability and low unemployment within the US. From the global point of view, the Fed should cut interest rates to boost the deflated world economy. But the strong domestic economy and tight labour market in the US have restrained the Fed from doing so, so far, in order to avoid inflation in the US. On the other hand, policy makers in small economies may feel powerless, as their policy actions may be totally offset by shifts in international trade and/or capital flows, as happened in the economies in financial crisis.

The architecture of the existing international economic institutions, designed decades ago, now seems inadequate to the task of supervising the mammoth foreign exchange markets and world capital markets. Moreover, international policy coordination among the major economies has been difficult to bring about, and this difficulty has hampered efforts to contain the world-wide financial crisis.

Given these circumstances, the policy assumptions embedded in the current LINK forecast are not necessarily policies which would be optimal for the world economy, but rather what seem to be most likely options that will be chosen by policy makers. Regarding monetary policies of major central banks, it is assumed that the Fed will keep interest rates unchanged. There had been an assumption of an interest rate cut by the end of 1998 in the March LINK forecast, and such a cut now would become more desirable from the global point of view. European central banks (and then the ECB, from 1999 on) are assumed to raise interest rates slightly, by a total of 50 basis points in two years, to support the euro. Lower interest rates in Japan probably would have little effect on the economy, and a further cut is limited by the already low rates.

A restraining fiscal policy is assumed for most developed countries, as they continue their long trend of fiscal consolidation. For Japan, however, more fiscal stimuli are expected.

No major exchange rate policy changes are expected, on the assumption that those economies whose currencies are under devaluation pressure, such as Hong Kong and Brazil, will be successful in defending their currencies. No devaluation is assumed for China. Exchange rates between major currencies are assumed to be as follows: the US dollar will be a little weaker against the D-mark (the euro, after January 1999), consistent with the assumption of narrowing interest rate differentials between the US and Europe. Against the Japanese yen, the US dollar is expected to remain at the current parity. A stronger yen would be more desirable for countries in Asia seeking to recover. But the assumed respective monetary policy stances and relative economic fundamentals in the US and Japan, such as their expected growth rate differentials, would not support a significant rebound of the yen against the dollar.

The forecast also assumes no significant reversal in policies on trade and foreign capital in the world economy.

More detailed policy assumptions for individual countries can be found in the regional outlooks below, and in the *Project LINK Country Reports* .

Regarding the world financial crisis and the risk of a world-wide recession, there have been two phases of policy proposals. The first, which prevailed in the early stage of the Asian financial crisis, includes a restructuring of the banking sector and the financial system, accompanied by an austere macroeconomic policy imposing high interest rates and strong fiscal restraints. The purpose of this kind of policy was to rebuild the confidence of financial investors and solve the long-run structural and systemic problems which might be at the root of the economic bubbles that caused the crisis. As time has passed, however, it became increasingly clear that confidence was not returning with many Asian economies falling into a deep recession and the financial crisis apparently spreading to more economies, a new proposal has gained momentum—calling for relaxation of macroeconomic stringency in the crisis countries and a boost to aggregate demand in the world's major economies. The former aims at rectifying the urgent short-run liquidity crunch in the crisis countries.

An increase in international liquidity, say, by cutting the US and European interest rates would help ease the threat of a world deflationary spiral, increase spending and thereby raise the growth of world trade, which is so crucial to the economy of the crisis countries. Indeed, restructuring an economy takes a long time, and the recession in some countries is so severe that, without reflation, it is not feasible to implement restructuring programmes.

Thus, a coordinated monetary stimulus is increasingly deemed a warranted policy development for global, let alone domestic reasons.

Major uncertainties for the LINK forecast include: a possible collapse of the US stock market, continued recession in Japan, a continuing deflation in commodity prices, a wait-and-see attitude of policy makers world-wide, and a lack of global leadership. All these events, or non-events, would make the world economy worse than is forecast. More discussion of country and regional forecasting risks can be found in the regional outlooks, below, and in the *Project LINK Country Reports.*

REGIONAL OUTLOOKS

North America

Despite some recent signs of weakness, the US economy is still expected to end 1998 with strong GDP growth of over 3 per cent. However, the growth rate is forecast to decelerate to 2.5 per cent and 1.8 per cent in 1999 and 2000, respectively. The probability of a recession is not great, as US policy makers now have enough maneuverability to prevent one; however, the downside risk has been increasing in the last few months.

The fall-out from both the Asian and Russian economic crises has created some divergent trends in the US economy. Through the first half of this year the US economy may have benefited from the Asian crisis, as gains from a sharp drop in the prices of US imports and lower long-term interest rates caused by a capital "flight to quality" have outweighed the losses from declining demand for US exports. However, as the contagion spread to other financial markets, including the US, and as the real economic adjustments in Asia become deeper, the negative effects are likely to outweigh the benefits.

After a surge to a 5.5 per cent growth rate of GDP in the US in the first quarter of 1998, the growth rate slowed to just 1.6 per cent in the second quarter, due largely to a widening external deficit. Exports have declined for two quarters in a row, while the appreciated dollar and low international prices have led to strong import growth. As a result, the current account deficit for the first half of 1998 alone was more than $100 billion. In contrast to the deteriorating external sector, the domestic sector is still healthy. Real consumer spending rose at an annual rate of 6 per cent in the first half of 1998, driven by a strong labour market and the significant appreciation of equity markets in the last few years. Business investment, especially in new equipment, has continued to grow at double-digit rates. The unemployment rate has remained at the historically low level of 4.5 per cent, and inflation has remained benign, at an annual rate below 2 per cent. The Federal Government budget, meanwhile, is registering a surplus for the first time in 30 years.

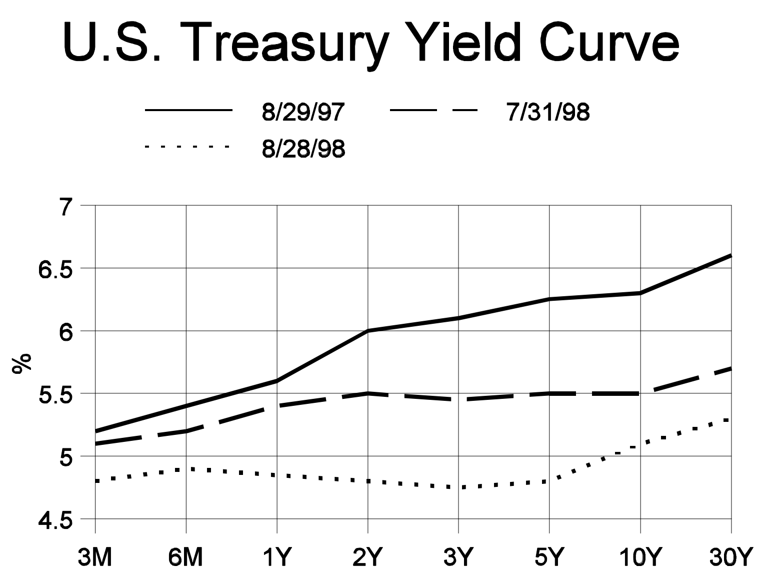
However, in addition to the weakness in the external sector, there are a few other troubling signs. Due to an acceleration in hourly compensation, unit labour costs are up by

2.4 per cent from a year ago, significantly above the inflation rate and the growth rate of productivity. It is still not clear whether this is just a catch-up of labour income, which has lagged in the current economic expansion, or whether it implies an acceleration of inflation further down the road. The growth of corporate profits is slowing—partly due to a drop in profit margins, from increasing labour costs, and partly due to effects of the Asian crisis on manufacturing and other large sectors of international business. If this trend continues, it may lead to a significant slowdown in profit-driven business investment and to a further decline in US stock market, which so far has had a correction of more than 20 per cent from its peak.

How these interacting factors will develop, and how policy makers will intervene in response, will determine the future path of the US economy. Besides a deceleration in GDP growth, the LINK forecast indicates a continuation of the weak external situation. The current account deficit is expected to reach $220 billion in 1998, with no significant improvement until the year 2000, when import demand will slow down and external demand will strengthen. Inflation is forecast to remain under control, at an annual rate of 2.5 per cent during the next two years, while the unemployment rate will rise to about 5 per cent.

Monetary policy is assumed in the forecast to stay at its current stance, with the federal funds rate remaining at 5.5 per cent over the forecasting period. The Fed has kept the federal funds rate unchanged since the last rate rise in March 1997, in the expectation that a weak external sector would bring down the economic growth rate, which has been considered by the Fed to be above potential and pro-inflationary.

Current debates on US monetary policy focus on the role of the Fed in the world economy, the divergence in economic indicators, and the new features of the US economy. An interest rate cut by the Fed would provide more international liquidity for the rest of the world, alleviating problems in many economies such as recession, commodity and asset price deflation, and currency devaluation pressures. However, a rate cut may not help greatly in solving other problems involving the economic structure and the financial and banking system in these countries. An increase in the supply of US dollars may well never reach troubled economies with the latter problems. The economic signals which guide monetary



policy are diverging, creating difficulties for policy makers: a flat yield curve (see figure) and market interest rates on all US treasury debt below the rates controlled by the Fed suggest that the economy may be heading into a recession, but the trend in the money supply growth implies an acceleration of GDP growth. Real interest rates suggest a tight monetary policy, but the data on liquidity and credit suggest an easy one; the plunge in commodity prices indicates a deflation, while the housing market suggests the opposite: the tight labour market also implies higher inflation ahead. Meanwhile, the debate on the so-called "New Economy" has continued, but it is too early to conclude whether the potential non-inflationary US growth rate has been raised substantially by technological progress and globalization.

In view of the world economic situation, the March 1998 LINK forecast assumed an interest rate cut in the US by the end of 1998. As of September 1998, such a cut seems even more desirable, although the current forecast assumes no interest rate cut.

US fiscal policy is expected to remain restrained, and a large Federal Government surplus is forecast by LINK for the next two years. This year marks the first time in 30 years that the Federal Government's budget will be in a surplus; a strong economy has increased tax receipts, while continued cuts in defense spending and moderation in other expenditure have kept Federal expenditure growth at just 0.9 per cent per year, in real terms.

Possible risks that could reduce growth below the current forecast include a sharp drop in confidence in the US stock market, which could change the current "correction" into a bear market, and further deterioration in the external economy, especially in the main trading partners of the US, such as Canada and Mexico. An over-reaction to warning signals of high domestic inflation could lead the Fed to raise interest rates. However, there is scope on both the monetary and fiscal fronts for policy makers to handle these risks.

GDP growth in Canada is expected to decelerate from 3.8 per cent in 1997 to 3.0 per cent this year, followed by about 2.2 per cent in each of the next two years. While inflation is expected to remain at its current low rate of 1 per cent, the recent improvement in the labour market, which has reduced the unemployment rate to about 8 per cent from 11 per cent two years ago, is likely to halt. The Canadian economy has been weakening since the second quarter of 1998, as GDP growth slowed to 1.8 per cent from a 3.4 per cent rate in the first quarter, with the value of the Canadian dollar sliding to a historic low against the US dollar. Major factors behind the economic deterioration include weak external demand—as a result of the faltering Asian economies and the slowdown in the US economy in the second quarter (which may be temporary)—and a sharp fall in commodity prices world-wide, which has caused a significant worsening in Canada's terms of trade.

To stem the fall in the Canadian dollar, the Bank of Canada finally raised short-term interest rates by 100 basis points in August. This action, which is likely to exacerbate the slowdown of the economy, is very controversial according to many economists, and the monetary authority has been facing a policy dilemma for quite some time. On the one hand, the devaluation pressure from the currency exchange markets has been rising, pushing the Bank to raise interest rates. On the other hand, the weakening real economy calls for an easing of monetary policy. Not only is the economy thought to be growing at a rate well below its potential growth rate, but it is slowing down, while real interests rates are rising because of declining inflation. A reversal in Canada's monetary policy is expected in the near future, after the pressure on the Canadian dollar eases.

Japan

The economic situation in Japan has deteriorated substantially since the March 1998 LINK meeting. The economy slid further into a full recession and its near-term economic outlook is bleak. A recovery was aborted by premature fiscal consolidation measures implemented in April 1997, and the economy was further impacted by the Asian crisis and the ensuing domestic financial crisis late in the year. By the first quarter of 1998, the extent of the slowdown had become alarming. Real GDP declined by 5.3 per cent (annualized) in the first quarter, after a decline of 1.5 per cent in the last quarter of 1997. The unemployment rate surged to a postwar record of 4.3 per cent in June, and the inflation rate has fallen further. Moreover, contagion effects from renewed financial turmoil in Russia have further weakened the already fragile financial system. Despite a series of announced fiscal policy measures, the Japanese economy now faces an increased danger of succumbing to a serious contractionary spiral, which would in turn impart deflationary pressures to its trading partners.

Given limits to the feasible easing of monetary policy, a series of fiscal stimuli and financial reforms have been introduced since late last year, which were designed to boost domestic demand, enhance the asset base and efficiency of the financial system, reduce credit tightness, restore confidence and put the economy on a sustainable recovery track. In June, the Diet passed the first 1998 supplementary budget, containing a stimulus package of ¥16 trillion (more than 3 per cent of GNP), in addition to a stimulus of ¥2 trillion implemented in the first quarter 1998. The package includes tax cuts and public works spending as well as structural measures, such as deregulation and schemes for resolving problems with non-performing loans. The Government is considering another stimulus of ¥10 trillion of spending on public works as part of the second 1998 supplementary budget, in order to maintain fiscal momentum through March 2000.

These policy measures, combined with the recent depreciation of the yen, are expected to play a key role in shaping the near-term prospects of the Japanese economy. Weakness in domestic demand is likely to continue into the second half of this year, given the problematic state of the financial markets, rising unemployment, the severe shrinkage of the asset base, the large volume of non-performing loans, the worsening credit situation and the deflationary effects of financial restructuring. Real GDP is expected to contract by 1.6 per cent this year, to grow modestly by 1.5 per cent in 1999, and then to return gradually to a sustainable growth path.

Built into this forecast are the assumptions that the fiscal stimulus will be implemented and that reform measures will successfully stabilize the financial system and restore confidence. A rebound in private consumption is critical, as both consumption and investment declined sharply, by about 5 to 6 per cent, in the first quarter of this year. A substantial portion of an income tax rebate is likely to be saved; thus the effect of a tax cut on personal consumption may be limited. Only a modest recovery in consumption is expected in 1999, and then only if offsetting measures are not introduced prematurely and if tax cuts manage to keep disposable income steady. Non-residential investment (particularly by small- and medium-size firms) is expected to decline by almost 7 per cent this year and to rebound just by 1 per cent in 1999. Despite a corporate tax cut, recovery in business fixed investment is likely to lag. Dwindling corporate earnings, low capacity utilization, high inventories, a worsening corporate debt situation, tighter credit, the deteriorating situation in Asian emerging economies and weak business confidence all will discourage investment. Housing investment is expected to continue to fall through 1999.

With a depreciation of the yen leading to improved competitiveness, however, net exports will increasingly contribute to growth. Inventory accumulation will also drive firms to seek exports. However, the total export gain this year is likely to be small, due to a continuing fall in exports to Asian countries and an expected slowdown in the United States. Depressed domestic demand and lower prices of primary commodities (particularly oil), combined with the depreciation of the yen, are expected to result in a sharp fall in the import bill, measured in US dollars. As a result, the current account surplus is expected to exceed $US 110 billion in both 1998 and 1999, compared with $94 billion in 1997.

With the growing deflationary forces, the jobless rate has increased from 3.4 to 4.3 per cent in 1998. The inflation rate is expected to fall further—almost to zero in 1999—reflecting weak demand, slack in the labour market, a tight credit situation despite near-zero interest rates, owing to the financial system crisis in Japan, and lower commodity prices, all of which will more than offset upward pressure on import prices from the depreciation of the yen.

There are considerable downside risks in this outlook, particularly as regards the effectiveness of the fiscal stimulus, the stabilization of the financial system and the movement of the yen/US dollar exchange rate. First, it is not clear whether the fiscal injection will suffice in amount, or in the adequacy of its time frame. In the past, actual fiscal stimuli have appeared to be smaller than the amounts announced by the Government. Even though the personal income tax cut has been made permanent this time, households may save a major part of this cut, as consumer confidence is low due to the precarious job market, reduced personal wealth and flat earnings. Without financial restructuring, the effectiveness of such fiscal measures will continue to be limited. Second, the credit crunch related to the fragile financial system is at the heart of the current crisis, and a rapid and full implementation of financial reform is critical. Third, if the yen continues to fall, the possible devaluation of the Chinese yuan may become a reality. The negative impact of a depreciation of the yen on the exports of competing Asian emerging economies has already manifested itself and, if the damage reaches a trigger point, a wave of competitive devaluation could occur in the region.

Australia and New Zealand

Despite a macroeconomic policy stimulus and rising exports, mainly in response to currency depreciations, the worsening situation in Asia and a sharp fall in commodity prices are likely to moderate the growth momentum of Australia and New Zealand this year. In Australia, while real GDP grew unexpectedly by 3.7 per cent (year-to-year) in the first quarter, this was attributable mainly to an inventory build-up, and growth will slow moderately in the second half. Record-low interest rates, however, are likely to maintain real GDP growth close to 3 per cent in 1998. In New Zealand, with subdued private consumption and investment, real GDP growth is expected to slow to 2.3 per cent this year from 3.1 per cent in 1997. Despite the depreciation of their currencies, inflation has remained within target in both countries this year, due to subdued domestic prices.

In Australia, despite some revival of exports and fixed investment, real GDP growth is likely to slow to 2.4 per cent in 1999, as import demand from the Asian economies and the US remains weak or slows down, respectively. In New Zealand, growth is expected to accelerate to 3.5 per cent in 1999 in response to cyclical factors, a policy stimulus, enhanced competitiveness and improving confidence.

A sharp fall in exports to Asia (offsetting increases in exports to non-Asian regions) and weak commodity prices are expected to result in widening current account deficits for both countries. Sharp declines in inbound tourist flows from Asia and in migrant transfers and, in the case of Australia, increased debt service payments have also contributed to the worsening of their current account deficits.

Europe

The outlook for the European economy is quite positive over the near and medium terms. Within the so-called EUR11 (those countries set to participate in the EMU), the growth performance over the recent past has been characterized by an asymmetry between the three major economies— France, Germany, and Italy—and most of the smaller economies.

The three major economies have seen low rates of growth. France and Germany have very been slow to emerge from the early stages of their recoveries; their growth has been particularly dependent on exports and investment, while consumption has lagged. There has been some concern that these recoveries might stall, as they did in the previous recovery. Italy has been particularly hard hit by massive fiscal retrenchment and by an appreciating currency that hurt exports. In contrast, most of the smaller economies have had significantly higher rates of growth, with domestic demand playing a major role. This asymmetry is expected to diminish, however. France and Germany are finally showing signs of sustained, increasingly broad-based growth; their GDP growth rates are expected to be 3.0 per cent and 2.6 per cent, respectively, in 1998 and 2.8 per cent for both countries in 1999. In France and Germany the number of people unemployed has come down slowly but steadily for several months, and indicators of consumer confidence have been high. Private consumption therefore is expected to pick up substantially this year and in 1999. Italy has completed much of its fiscal retrenchment (required for joining the EU) and the lira has stabilized. Its GDP growth is expected to increase, to a rate of 2.2 per cent in 1998 and 2.6 per cent in 1999. The smaller economies are expected to continue their strong performance.

The recent and expected performance of the United Kingdom is quite different, as it is well ahead of continental Europe in its phase of the business cycle. It has enjoyed a number of years of strong, above-trend growth and has reached a turning point in its cycle. Monetary policy, which has been geared to slowing the economy down, has generated a lot of strength for the pound, thus hurting the export sector, but the service sector has remained very strong. The major question is whether there will be a hard or soft landing. GDP is expected to grow by 2.2 per cent in 1998, with particularly strong growth of consumption and investment, despite weak exports, and then to decelerate dramatically in 1999 to a growth rate of only 1.3 per cent, as consumption and investment also are expected to moderate substantially.

The inflation outlook for Europe in 1998 and 1999 mirrors the expected growth pattern. Germany and France are expected to register rates of inflation, as measured by the personal consumption deflator, well below 2 per cent. Falling commodity prices and slack labour markets complement the moderate growth outlook in providing such a positive outlook on inflation. A major question is how the large drop in interest rates at the start of the EMU in some of the member countries will evolve. Italy has considerable slack in its economy, so the risk of a resurgence of inflation is low; its inflation is forecast to be 2.1 per cent in 1998 and to remain below 2.5 per cent during the forecast period. For the smaller economies the inflation picture is less benign, with potential for overheating in a number of countries even without monetary easing. A number of these countries are forecast to register inflation rates near 3 per cent for a number of years. In the United Kingdom, inflation as measured by the retail price index is expected to be 3.4 per cent this year; with the expected sharp slowdown in the economy next year, it is expected to slow to 2.5 per cent.

The most important development in Europe is that the unemployment situation has finally started to turn around. Both France and Germany have registered declines in the number of people unemployed recently, and these declines are expected to continue during the forecast period. The situation is similar in almost all of the smaller countries. In the United Kingdom, however, unemployment is expected to rise marginally over the next few years, but not much above 5 per cent. For Europe as a whole, these changes will give a continued decline in the region's average rate of unemployment through the end of the forecast period. However, the problem of high structural unemployment will remain, for most of the countries.

Fiscal policy is assumed to remain tight in the majority of European countries; low rates of growth of government consumption are assumed in the forecast. Starting in 1999, the strictures of the Maastricht criteria will be transformed into those of the Growth and Stability Pact. To satisfy the deficit criteria, which were so narrowly attained by many countries, will still require effort, particularly as the one-off measures utilized in many cases will no longer be available. In addition, debt-to-GDP ratios are still too high in many countries, according to the Maastricht criteria. In fact further fiscal tightening might be appropriate for those countries that are potentially overheating. (Denmark has followed this route.) On the positive side, falling rates of unemployment will reduce outlays, and higher rates of growth should increase tax revenue. The United Kingdom has announced a new fiscal policy rule, whereby current spending should be balanced over the course of the business cycle and new debt should be used only for capital spending. Operationally, this will mean an increase in government spending over the near term.

Monetary policy has been complicated by recent events in the world economy and by the hesitant performance of the three largest economies in the EUR11. Until recently, the consensus view of the likely path of monetary policy in the near term was dominated by two issues. The first was that at the moment of final convergence of interest rates, a large gap between the high and low interest rate countries needed to be bridged. In the second quarter of 1998, short term interest rate differentials vis-a-vis Germany were 150 basis points for Italy, 70 for Spain and Portugal, and 260 for Ireland. The second was a perception that the European Central Bank (ECB) would want to raise rates immediately in 1999 to demonstrate tough inflation-fighting credentials. These two issues were treated in the March LINK forecast, such that countries with low interest rates would start to increase their rates at the end of 1998 and the others would reduce their rates. But as the crisis in Asia worsened and evidence of more sustained, balanced growth in the three large economies was lacking, the consensus has shifted. It is now most likely that interest rates in the low-interest-rate countries will remain flat, and the others will have to bridge the entire gap. Additionally, the final convergence is now expected to happen at the last possible moment, on 1 January 1999. This is the assumption adopted in this LINK forecast. German short term rates actually declined slightly in the 3rd quarter and are assumed to be stable in the 4th quarter. Another part of the shift in consensus is that the ECB will not need to increase rates substantially in 1999 to generate credibility for the new institution. Instead it is assumed that the ECB will set rates according to economic conditions. Consequently, the LINK forecast assumes a moderate increase in EUR11 interest rates in the first quarter of 1999, on the order of 20 basis points, and again in the 4th quarter, but this would amount to a slight easing in the EUR11 average interest rate. Thereafter, moderate increases are expected during the forecast period.

The value of the US dollar versus other currencies has been relatively high for more than a year; it has been supported by favourable interest rate differentials, stronger growth in the US than Europe, and the perceived risk in the EMU process. But this situation is turning around; in the forecast, interest rate differentials narrow and then move in favour of Europe—growth in the US is slowing while it is picking up in the EU, and the upside potential for the US is limited while it is considerably more for the EU. Finally, the perceived riskiness of the EMU seems to have diminished. The LINK forecast assumes that the value of the US dollar will decline moderately in the 4th quarter of 1998 and will continue this pattern in 1999. Based on normally considered fundamentals, the dollar could fall more rapidly; but there is still some risk in the early stages of the EMU process, and it is assumed that this will hold down the value of the euro. However, after the year 2000, it is assumed that the dollar will drift down more substantially vis-a-vis the euro.

Economies in transition

The March 1998 LINK meeting provided a forecast of a GDP increase of 3 per cent in 1998 in the transition economies as a whole. At that time it was not clear what effect the Asian financial crisis would have on the region. The economic situation in Russia deteriorated substantially after its near default on Government debt (GKO) and the devaluation of the rouble in mid-August. The authorities could not collect nearly enough tax revenue, and the economy could no longer attract foreign capital. The problems created by the need to repay domestic debt and by the intention to monetize it are not yet solved. In addition, low oil prices hit the Russian economy seriously 1998. The March forecast of a 1.4 per cent increase in GDP in 1998 in the Russian Federation has been revised to an expected decline of more than 3 per cent. A decline in GDP is predicted for the next two years, together with a more serious decline in investment.

Russia's GDP already had started to decline in May 1998, and poor agricultural output accelerated the decline. Increasing unemployment and a growing Federal budget deficit, as well as deteriorating current account balance, were already in place in the first half of the year. Insufficient efforts were made to initiate tax reforms and to improve tax collection.

The Russian economic authorities kept the rouble exchange rate in a narrow band until 17 August, when it froze payments on its internal debt, devalued the rouble, and declared a moratorium of 90 days on part of the private foreign debt owed by private Russian banks. The authorities introduced drastic changes in the exchange rate policy by setting a "new currency corridor" (6 to 9.5 roubles per US dollar), which amounted to a devaluation of the currency, in addition to the near default on short-term government debt. Other temporary financial restrictions were introduced (a 90-day moratorium on repayment of financial credits, on insurance payments and on forward exchange contracts) but these measures did not restore the market's confidence and led to an abrupt fall of the rouble. After the devaluation, consumer prices rose rapidly in the face of a surge in demand. The exchange rate deteriorated significantly below the announced lower bound of 9.5 roubles per US dollar. On 11 September, Russia delayed some interest payments on its debt to the Government of Germany, raising the risk that Moscow could be considering a widespread default on repayment of its foreign sovereign debt.

Possible measures that the Russian authorities might take include short-term budget adjustments and increasing foreign exchange reserves, partly by import compression, to enable payment of sovereign debt. New long-term measures to reduce the Federal budget deficit, such as tax reforms, rigorous tax collection, and banking reforms, are also necessary.

The Russian crisis is affecting other countries; some are exposed through their trade with Russia and some because of financial investments there; others are suffering through indirect routes. The main trading partners of Russia—Belarus, Kazakhstan and Ukraine—are the most vulnerable. Latvia's and Lithuania's trade with Russia exceeds 20 per cent of their total trade as well. At the same time, the Ukrainian currency has fallen after the rouble devaluation, and their biggest threat is the debt default.

The countries that have done the most to restructure their economies–the Czech Republic, Hungary, Poland and Slovenia–have managed to reduce their dependence on Russia and, as a consequence, are suffering less from direct effects.

The countries most in need of foreign capital —including Ukraine and potentially vulnerable Croatia, Romania and Slovakia—are having the most difficulty attracting it. The crisis is likely to cut economic growth next year by less than one per cent in Central Europe and in the Balkans, but probably more seriously in the Baltic states.

The majority of the countries in Central and Eastern Europe are expected to grow in 1998 and 1999, but growth in the Czech Republic stalled in 1998 and the level of GDP of Romania, Russia and Ukraine is forecast to decline in 1999, in contrast to the earlier expectations. The March forecast suggested that the Romanian economy began growing in 1998, but that forecast is now revised—not only because of the Russian crisis, but also because of weak domestic demand, as well as delays in the privatization of large state-owned private companies and banks.

Governments are expected to continue their restrictive macroeconomic programmes and increases in both private and public consumption are forecast to be lower than GDP growth. Public consumption in the Czech Republic and in Romania is forecast to decrease in 1998 and 1999.

Investment is expected to increase in 1998 and 1999 in most of the economies in Central and Eastern Europe. In the majority of them, the investment growth rate is expected to be higher than the GDP growth rate—except in the Czech Republic and Romania, where investment growth is expected to decelerate in 1998 and 1999.

Foreign trade has played, and is playing an important role in these countries, and quite high export growth rates are expected in 1998 and 1999. The current account deficit is forecast to increase in 1998 and 1999 in all CEE countries, except the Czech Republic.

Latin America and the Caribbean

According to current LINK forecasts, GDP growth in Latin America and the Caribbean as a whole will decelerate from 5 per cent in 1997 to 2.9 per cent in 1998, and a growth rate of about 3 per cent is predicted for the following two years. Compared with the March 1998 LINK forecast, the near-term economic outlook for the region is noticeably worse, due to two major factors—the new round of turmoil in financial markets world-wide, which was triggered in August by the Russian rouble and debt crisis, and the continuing deflation of commodity prices, which has been even faster than was expected in March. Meanwhile, many countries in the region will have important elections; related political uncertainties thus have also contributed to the slowdown.

Up to July 1998, most economies in the region had been quite successful in managing the contagion effects of the Asian crisis. The region's stock markets, which had experienced a large downward correction by the end of 1997, were stabilizing and some were tending towards recovery. The costs of external debt financing also were stabilizing or even falling, although the yield spreads were still much higher than before the Asian crisis. The pegged currencies, which had been under severe speculative pressure, remained intact, and those in floating regimes had been devalued only moderately. Meanwhile, the composition of the foreign capital inflows to the region had improved, with more FDI and longer term debt.

Since August 1998, however, the financial systems and economic growth in the region have again been under severe pressures. The Russian crisis in August reversed the revival of confidence which was stabilizing emerging markets world-wide, setting off a seemingly indiscriminate sharp fall in the Latin American financial markets, thus pushing the already high costs of external capital even higher, triggering capital flight from the region and putting tremendous devaluation pressure on the region's currencies .

The region's stock market values, measured in US dollars, have collapsed 45 per cent on average as of end August 1998 from their level at the beginning of the year, with most of the decline occurring in August. Venezuela's market was hardest hit; it has declined by more than 70 per cent in 1998 so far as of end August 1998. Meanwhile, the risk premium on the region's sovereign debts has increased substantially. Historically, in light of the region's high dependence on external financing, the yield spreads for Latin American debt over US Treasury paper had been higher than for other developing countries. For several years before the Asian crisis, however, the region's spreads were tending to decrease. The Asian crisis raised these spreads from about 3 percentage points to a range of 5 to 7 percentage points and the Russian crisis has driven them to 10 to 20 percentage points. This sharp rise in the risk premium has enormously increased the cost of external financing. The implied risk perceived by foreign investors will make it almost impossible for the region to attract enough foreign capital to maintain future economic growth on the current path.

Devaluation pressure on the region's currencies is mounting. Colombia recently announced a devaluation of 9 per cent and Brazil's real and Venezuela's bolivar are under tremendous pressure. So far, Brazilian economic authorities have managed to smooth the crisis effectively and have held to the policy of supporting the real. But the risk of devaluation remains high as long as the problems of Brazil's large fiscal deficit, overvalued pegged rate and sizeable debt service are not resolved or alleviated. There already has been some noticeable currency devaluation in Venezuela, Mexico, Chile, and other countries in the region. In order to defend their currencies and to prevent capital flight, domestic interest rates in the region have been held very high, thus depressing economic growth.

Another adverse factor threatening the region's growth has been the sharp deflation of commodity prices in international markets, including oil, grains and metals. Since many economies in this region are heavily concentrated in the production of such commodities, exports and government revenues are falling substantially, contributing to a deterioration in both the external and internal balances. The region's oil-producing economies–including Colombia, Ecuador, Mexico and Venezuela–are suffering the lowest price of oil in ten years. The export revenues of Chile and Peru have suffered from a sharp drop in copper prices, and Argentina and Brazil have been hurt by the depressed prices of grains and soybeans. The commodity price deflation has caused a severe deterioration of the terms of trade for many commodity-exporting economies in the region. The welfare effects of this deterioration will go beyond the direct effects of revenue losses.

Despite the foregoing serious adverse factors, the LINK foresees no recession in the region. A noticeable slowdown is inevitable, however, even assuming no further deterioration in these factors. The improvements made in the region's banking system and in many economic fundamentals, through persistent long-run economic restructuring in the 1990s, should help the region survive the current financial turmoil. In light of a downward modification in the region's growth, GDP in some economies, such as Argentina, Chile and Mexico is forecast to grow moderately, at rates around 4 per cent. Brazil is expected to register only one per cent growth, both this year and next. Venezuela is expected not to grow at all this year and to contract in 1999.

According to the forecast, inflation in most of the region will remain under control. Inflation in Venezuela is still high, however, and the devaluations that some economies have undertaken recently will raise their inflation rates.

Unemployment rates are still persistently high in a number of countries, although some slight improvement was made in the last few years. With a deceleration in economic growth, the employment situation in some countries is expected to worsen.

The weakness in the external sector, as a result of commodity price deflation and slowing demand world-wide, is not expected to improve in the near future. Intra-regional trade, which had been booming until recently, is expected to slow somewhat, in tandem with the slowdown in the region's output growth. The deterioration in current account balances, which commenced early this year, is not expected to improve in the near future.

One significant downside risk to the forecast for the region is that, if the current trend of commodity price deflation is not reversed, a further slowdown in the economic growth of the region will be inevitable. This concern partly explains the recent upheaval in the financial markets in the region. Another is that the high dependence of many Latin American economies on foreign capital due to their generally low domestic saving, has made the region's financial markets highly vulnerable to external shocks. The concentration on commodity production in many economies also makes the real sector highly vulnerable to external shocks.

South and East Asia

Financial markets in the developing countries in South and East Asia had begun to stabilize early this year, but they have been hit by contagion from the recent Russian financial crisis and the volatile movement of the yen. These events increased the vulnerability of the three economies most in crisis (Indonesia, Korea and Thailand) and also most other emerging economies in the region. The latter had survived the earlier contagion effects of the 1997 Asian financial crisis, but had begun to weaken in the past several months as the negative impacts of the financial turmoil on the real sector unfolded. The situation in the region has continued to deteriorate since the March 1998 LINK meeting. The March forecast of aggregate GDP growth in the region in 1998 has been marked down by 4.5 percentage points, to a decline of 1.1 per cent. Growth in virtually every economy in the region has slowed, with some of them facing the worst recession in decades.

The LINK forecast assumes that the three hardest-hit countries will remain committed to the stabilization policies and reform programs agreed on with the IMF. The stringency of their monetary and fiscal policies recently has been eased somewhat; interest rates are assumed to fall gradually and government spending is assumed to be more expansionary than in the past year. Their overall stance will remain cautious, as they are now embarking on full-scale structural adjustment, including the closing down of non-viable banks and firms, after the initial phase of stabilizing their currency markets. The forecast assumes that structural reforms of the financial and corporate sectors will be implemented successfully. Malaysia is assumed to cut interest rates and to increase fiscal spending to stimulate the economy and accommodate adjustment costs . Most other countries in the region are expected to maintain their prudent policy stances, which aim at sustaining growth while keeping inflation low.

The three hardest-hit economies may face even greater difficulties as they enter the second phase of full-scale structural adjustment in the coming months. With a sharp contraction in domestic demand more than offsetting the gain in net exports, real GDP in these countries is likely to decline by 6 to 16 per cent in 1998. Private investment and consumption are expected to contract dramatically—by 40 to 60 and 10 to 15 per cent, respectively. Heavy downward pressures on domestic demand come from a credit crunch, reduced net inflows of foreign capital, plummeting asset prices, a high debt burden, high interest rates and rising unemployment. In addition, in Indonesia and the Republic of Korea, bad weather has caused a significant loss in agricultural production. So far, gains in net exports in these countries have been achieved mainly through severe compression of imports, but such gains could not offset the slump in domestic demand. Despite sharp depreciation of their currencies, their exports are not strong enough to lead their economies out of recession this year. A gradual upturn of domestic demand may be possible late in 1999 if structural reforms are implemented quickly, without further hesitation, and confidence returns.

Most other economies in the region also have proved not to be totally immune to spillover effects from the 1997 financial crisis; many of them had a sharp deceleration of growth in the second quarter of this year, as indirect effects of the financial crisis hit the real sector through trade and investment linkages. They have suffered from collapsed intraregional trade, reduced net capital inflows and higher interest rates. Business and consumer sentiment are deteriorating rapidly. Malaysia, the Philippines and Singapore–despite their more resilient financial systems– have fallen into recession or are on the verge of doing so. Most of them appear to have fallen into a downward spiral of falling property prices, credit tightening, weakened domestic demand and a rising volume of non-performing loans. The health of their banking and corporate sectors is deteriorating. The Philippines also suffered substantial damage to its agricultural production, from the El Niño weather pattern. Malaysia, together with Indonesia, suffered a significant terms-of-trade deterioration. India has been more or less immune to direct impact from the crisis, and is expected to have only a mild slowdown in 1998.

With increasing layoffs as a result of surging bankruptcies and a drastic cutback in production, unemployment in financially troubled countries has been rising rapidly since the beginning of the crisis. Unemployment in the Republic of Korea surged from 65,000 at the end of 1997 to 1.65 million by July 1998. In Indonesia, it rose to 13.2 million in May 1998, from 4.4 million at the end of 1997. Thailand also has rapidly rising unemployment, which is expected to reach 3 million by the end of 1998. In most other emerging economies in the region, the unemployment rate also has been rising significantly, albeit much less severely. If the adjustment is protracted, high unemployment may well persist for a long time. Rising unemployment tends to heighten social tension, posing an additional fiscal challenge to the three countries most in crisis.

The inflation rate also surged rapidly in the troubled emerging economies— as a result of sharp depreciation of their currencies, easing of price controls and elimination of subsidies. In Indonesia and the Philippines, poor agricultural production also was a factor. In Indonesia, the inflation rate may reach 70 per cent in 1998; in Thailand and the Republic of Korea, inflation in 1998 is expected to be nearly double the 1997 rates. Given stabilizing exchange rates, depressed domestic demand and large amounts of idle productive capacity in these economies, as well as low oil prices, inflation is expected to moderate from now on and is expected to decline rapidly in 1999.

In response to the collapse in domestic demand and higher import prices, combined with difficulties in import financing, imports in the three hardest-hit countries are expected to contract drastically, by 30 to 40 per cent this year, contributing to a shift of their combined current account balance from a deficit of $15.8 billion in 1997 to a surplus of $57 billion in 1998 and $49 billion in 1999. The improvement of the current account of the Republic of Korea is particularly large—from a deficit of $8.2 billion in 1997 to a surplus of over $35 billion in 1998. So far, the improvement on current account is almost entirely due to import compression. But the pace of this compression cannot continue if the contraction in domestic demand moderates.

Exports from countries that have experienced sharp depreciation of their currencies have not been as strong as expected, except from the Philippines. On the contrary, their exports in current US dollars are likely to decline or at best to remain stagnant this year (compared with the 30 per cent export growth rate Mexico achieved in 1995 after its currency crisis), due to financing difficulties (partly reflecting ongoing restructuring), a sharp decline in intraregional trade, falling export prices and the depreciation of the yen. The potential export gains from such depreciation was offset by comparable depreciation by their competitors. In the case of commodity exporters, such as Indonesia and Malaysia, a sharp fall in the international price of oil and other commodities is adversely affecting their export earnings in 1998.

The Republic of Korea and Thailand have been able to stabilize their currency markets to a certain extent, so far. They have remained committed to structural reforms and have even been able to lower interest rates gradually. In the second half of 1998, however, the recession in these countries seems likely to deepen, as they tackle full-scale restructuring. There are likely to be more bankruptcies, falling property prices, increasing volumes of bad loans, and additional unemployment. However, without structural reforms of the financial and corporate sectors, the restoration of confidence will be delayed further, and a recovery will be slower. To gain the confidence of investors and to secure a sustainable recovery, it is essential to overhaul the structural weaknesses of these sectors—particularly to strengthen their capital base and free them from the overhang of bad debts.

Such an overhaul will be very costly and complex; it is expected to encounter many difficulties that affect the process of recovery. A substantial recovery will require the mobilization of enormous resources, particularly to deal with non-performing loans and massive unemployment. In the process of restructuring, however, banks may fall into a vicious cycle of a credit crunch and falling property prices, which would put further deflationary pressures on the economy and could last for several years. A second important factor is the viability of the balance of payments constraint. With limited access to additional international financial resources, a large current account surplus is essential in order to service existing debt, to rebuild reserves (which must be larger than traditional levels, in the face of highly globalized and volatile financial markets) to maintain at least the minimum import level required for the short-term survival of the economy and to begin a recovery. Since import compression is not a sustainable long-term solution, exports will have to increase more than they have so far, for the reasons mentioned above. Other complicating variables–such as the Russian financial crisis and the dramatic depreciation of the yen–also have created havoc with the incipient recovery process.

Growth prospects in India have deteriorated a little since the March LINK meeting, partly due to the indirect effects of the Asian crisis, high interest rates and economic sanctions. Domestic demand is sluggish, exports are slowing down, and business sentiment has turned more pessimistic. Moderate inflationary pressures are building up as a result of devaluation and a large fiscal deficit. Despite a series of recently announced export promotion measures, exports are unlikely to respond strongly, due to increased competition from other Asian countries and inadequate infrastructure. Imports are expected to continue to expand, however; thus the current account deficit is expected to widen. This, together with falling foreign investment, will reduce international reserves, putting further pressure on the currency.

In Pakistan, real GDP is expected to grow about 5 per cent this year, compared with 3 per cent in 1997, thanks partly to bumper crops. Domestic demand remains weak, however, and Pakistan faces a very tight balance of payments constraint. Its current account deficit is expected to narrow this year, due mainly to a contraction of imports and lower oil import prices and also to high foreign remittances. With its weak export structure and a worsening external environment, exports are not expected to be strong; high inflation also has eroded the country's competitiveness. The slowdown of capital inflows in 1998 also has contributed to lower international reserves, and the rupee is likely to devalue further. The balance-of-payments constraint, combined with political uncertainty and sanctions will put downward pressure on growth in 1999. The persistently large and increasing fiscal deficit (6.5 per cent of GDP in the last fiscal year) and the rupee depreciation are expected to raise inflation to 12 per cent in 1999.

China and Hong Kong

China's targeted GDP growth rate of 8 per cent for 1998 is still believed to be attainable, although its economy is challenged by many difficulties—the impacts of a drastic devaluation and a deep recession in many neighbouring countries, falling domestic demand due to long-standing problems in state-owned enterprises (SOEs), and one of the most severe floods in decades. LINK has lowered its forecast for China's GDP growth path over the next two years slightly, to about 7 per cent on average, on the assumption that economic policies will shift to focus on the efficiency of the economy rather than on an economic growth target.

In the first half of 1998, China's GDP grew at an annual rate of 7 per cent, a very strong performance in comparison with most of its neighbours. As expected, China's external sector has weakened notably, due to the impact of the Asian crisis; exports rose by

7 per cent in the first seven months of 1998, compared with 20 per cent growth in the previous year. Most of the slowdown was attributable to a dramatic drop in exports to Japan and other Asian economies (with decreases ranging from 10 to 30 per cent), as a result of both income and price effects related to the recessions and currency devaluations in these economies. So far, however, the so-called competitiveness effect–an expected loss of China's export share in other markets, relative to that of the rest of South and East Asia–has not been significant. In fact, China's exports to the U.S., Europe and Latin America have been growing faster than before. At the same time, due to weak domestic demand, China's imports rose only 0.7 per cent, raising its trade surplus to about US $26.7 billion in the first seven months of 1998. Foreign investment in China also has slowed down; the substantial decline in the inflow of capital from other Asian countries was not offset by increased investment from the U.S. and Europe. Nevertheless, foreign direct investment (FDI) still amounted to about US $20 billion in the first half of 1998.

An increasing number of layoffs, as long-unprofitable SOEs are reformed, plus some lagged effects of the macroeconomic tightening measures adopted in earlier years, have led to a deceleration of growth in domestic demand since the end of 1997; continuing weakness, especially in private consumption demand, has put deflationary pressure on the economy. The retail price index has dropped by more than 2 per cent, with a much larger drop in the prices of consumption goods in large cities.

The disastrous flooding in the summer of 1998 is estimated to have caused a direct economic loss equivalent to about 2 per cent of China's annual GDP, but the post-disaster reconstruction will offset some of the slowdown in domestic demand.

Several stimulus measures have been adopted so far, and more are expected. Among them are increased public spending on some large projects financed by government bond issues, and an easing of monetary policy (by cutting interest rates and lowering reserve requirements). After a lag, these policy measures are gradually stimulating the economy, as shown by a moderate acceleration in investment and a recent rebound in industrial production. The LINK forecast assumes a continuation of expansionary fiscal policy and an accommodative monetary policy in the near future. It is also assumed that long-run economic reforms will continue, though some, such as reforms of the housing sector and the SOEs, may be implemented only gradually, in order to mitigate certain side-effects in the short run.

The LINK forecast keeps the exchange rate assumption made for the March forecast—that the existing exchange rate between the Chinese yuan and the US dollar will remain unchanged. It is not feasible for any country with its own monetary policy to peg its currency to a foreign currency for a long period, because the differences among countries in economic fundamentals can change substantially over time. Above all, since an exchange rate is just a relative price between two currencies, it should be used as a signal, rather than as an instrument of control. Given the current situation, however, it may not be optimal for China to devalue its currency at this time. First, devaluation is not yet economically urgent, as its foreign reserves are about $140 billion, the current account is running a fairly large surplus, and its capital account is non-convertible. Second, while a devaluation might alleviate the mounting pressure on the export sector, it also might bring some destabilizing effects to the economy—such as a loss of policy credibility, a shock to the financial system, and a possible ignition of spiraling inflation. Third, a devaluation would most likely disturb other, already weak Asian economies and financial markets, including the Hong Kong Special Administrative Region. After China survives the shocks of the current Asian financial crises, it may adopt a more flexible exchange rate policy in the future, as well as establish sounder financial and banking systems.

The LINK forecast is for stable, low inflation, but unemployment will remain a serious policy issue. The Government's fiscal deficit, which was improving recently, is expected to widen.

Downside risks and uncertainties in the forecast include a continuation of weak external demand, further devaluation in neighbouring countries, and some serious pitfalls in domestic reforms.

In comparison with the mainland, the Hong Kong Special Administrative Region (HKSAR) of China has been suffering much more seriously from the Asian and global financial turmoil. The Hong Kong economic authorities so far have been quite successful in defending its currency board system from intense speculative attacks and in keeping the HK dollar firmly pegged to the US dollar. But the losses in the real economic sector have been significant—a decline of more than 3 per cent in GDP (annual rate) in the first half of 1998. Real consumption spending and investment have been declining, due to higher interest rates and sharply deflated stock and property markets, which have fallen more than 50 per cent and 40 per cent, respectively, from their pre-crisis peak values. The external sector has been affected by weak regional demand, and exports declined by 5 per cent in the first half of 1998.

The LINK forecast indicates that it will take at least two more years for the real economy of HKSAR to recover from the recession. Real GDP is expected to decline by 4 per cent in 1998, compared with growth of 5.3 per cent in 1997. No growth is forecast in 1999, and only a moderate recovery of 3 per cent is predicted in the year 2000. Despite a 5 per cent increase in government spending in 1998, total domestic demand is expected to decline by over 5 per cent— private consumption by over 4 per cent and investment by 7 per cent. The short-term outlook for HK's external sector is also weak; the strong HK dollar and continued weak regional demand will continue to constrain exports, which are expected to decrease by 3.4 per cent in 1998. Inflation as measured by the CPI is expected to continue to ease, decelerating to an annual rate of 4 per cent in 1998 from 5.7 per cent in 1997. The labour market is forecast to deteriorate along with the shrinking economy; the unemployment rate is expected to rise to 4.5 per cent for 1998, from 2.2 per cent in 1997.

The HK dollar is assumed in the forecast to remain linked to the US dollar at the current rate, while a set of new measures to regulate the financial markets will enhance Hong Kong's currency system. Some economists have proposed reconsideration of the linking of the HK dollar to the US dollar. As HKSAR's economic ties with the mainland will become more important in the long run than those with the United States, this currency linkage may need to be modified.

West Asia

No other group of countries is as dependent on one area of economic activity as the oil-exporting countries of West Asia. Even the economies in the region which have no oil reserves have not been immune to developments in the international oil market, because of their strong economic linkages (such as grants, workers' remittances and trade flows) with their oil-exporting neighbours.

Low oil prices have adversely affected economic performance of all the West Asian economies; economic growth is expected to decline only to 0.4 per cent in 1998 in the West Asia as a whole. All the major oil-exporters of the region (Iran, Saudi Arabia and the United Arab Emirates) face economic contraction and fiscal and current account deficits. For example, GDP in Iran is expected to contract by about 2.5 percentage points in 1998. One challenge for Iran is to make its external debt payments, despite reduced oil revenues and diminishing reserves. Saudi Arabia is also likely to face economic contraction by about 2.0 per cent in 1998, with a weak recovery of about 1.0 per cent in 1999. A large fiscal deficit is expected this year, together with an increased current account deficit. Economic recession is also expected in the United Arab Emirates for 1998. Only Kuwait among the oil exporters is likely to record positive growth in 1998, though at a much lower rate than in 1997.

In response to plummeting oil revenue, fiscal policy in most countries in the region will tighten during 1998-99 via a reduction in public expenditure (mostly investment) , a broadening of the tax base and increasing some fees. Saudi Arabia, for example, has announced increases in air fares and new airport taxes; a rise in gasoline prices is expected before the end of the year. Most countries are resorting to quantitative restrictions on imports, to reduce their current account deficits. Some countries are likely to finance their fiscal deficits partly by issuing treasury bills and to finance their current account deficits by using foreign exchange earnings from foreign portfolio investments.

Africa

The total GDP of Africa as a whole is expected to grow about 3.6 per cent in 1998. The recent collapse of oil prices, however, will reduce the export earnings of African oil-exporters and lead then to an economic recession or, at best, a growth deceleration. Growth in Nigeria is expected to decelerate to 2.6 per cent in 1998, and in South Africa, the largest economy in the region, it is expected to be a meager 1.4 per cent. On the other hand, 25 countries in Africa are expected to grow by 5 per cent or more in 1998. Morocco, which plunged into economic recession in 1997 due to a devastating drought, has recovered sharply this year, with GDP growth of around 6.0 per cent, due to a very good harvest. Improved weather in part accounts for the good economic performance in these 25 countries, and continued implementation of sound economic policy reforms also has played a key role.

The Asian crisis reduced Africa's earnings from exports of raw materials, such as ores, and generated more competition for African products such as rubber and copper. As a result, the export receipts of many countries are falling. Meanwhile, import demand is strong, responding to tariff cuts on intermediate and capital goods, and also to emergency needs. Financing the current-account deficit remains the major challenge faced by African countries. Foreign direct investment might relieve the pressure on the balance of payments, but such investment goes to only a few countries, mostly oil producers. Also, some Asian developing countries, such as Malaysia, which have become significant investors in Africa, almost certainly will have to halt any new investments in Africa during the next few years.

Many African countries have had a very large debt-service overhang for some time, and it is expected to persist in 1999. The total debt of many countries is well above 400 per cent of their GDP. Several African countries probably will qualify for the Highly Indebted Poor Countries (HIPC) initiative. So far, only Burkina Faso, Côte d'Ivoire, Mozambique and Uganda have won commitments of assistance. Uganda was the first country to complete its programme, having reached the "decision point" in April 1998. The total amount of debt relief expected for these four countries from the international community is almost $4.5 billion. Preliminary discussions are being held for Guinea-Bissau and Mali.

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

	1997	1998	1999	2000
World GDP	3.1	1.9	2.5	2.6
Developed market economies	2.6	2.0	2.3	2.1
Canada	3.5	3.0	2.3	2.1
France	2.6	3.0	2.8	3.1
Germany	2.3	2.6	2.8	2.4
Italy	1.5	2.2	2.6	2.9
Japan	0.8	-1.6	1.5	1.7
United Kingdom	3.4	2.2	1.3	2.2
United States	3.9	3.4	2.5	1.8
Developing countries	5.3	2.0	3.8	4.6
Latin America	5.0	2.9	2.8	3.9
Argentina	8.4	5.0	4.6	4.6
Brazil	3.0	1.1	1.2	3.4
Mexico	7.0	4.5	4.0	4.0
Africa	3.1	3.6	3.6	4.0
North Africa	3.0	4.6	4.4	5.0
Sub-Saharan Africa	3.8	4.1	3.5	3.8
Nigeria	3.0	2.8	3.4	3.3
South Africa	1.7	1.5	2.8	3.4
South and East Asia (excluding China)	5.0	-1.1	3.1	4.6
India	5.3	5.4	5.8	6.3
Indonesia	4.5	-16.8	-2.7	0.4
Korea, Republic of	4.9	-6.2	1.4	3.8
Malaysia	7.8	-2.3	2.1	3.5
Philippines	5.2	1.3	4.0	4.5
Singapore	7.6	1.2	0.7	2.4
Taiwan Province	6.8	4.8	5.6	6.0
Thailand	-0.4	-7.8	-0.7	3.5
China	8.8	7.4	7.5	7.2
West Asia	3.9	-0.4	2.0	3.3
Economies in transition	1.7	-0.2	0.8	1.3
World exports, volume	10.6	6.3	5.1	4.5
Export prices				
All goods	-5.7	-6.8	1.3	3.1
Agricultural commodities	1.4	-11.4	-2.0	2.1
Raw materials and ores	-7.3	-9.5	1.7	3.2
Oil	-7.9	-28.9	4.0	8.0

* Regional and global aggregates are weighted average of countries for which LINK forecasts are prepared; Weights are 1988 GDP in U.S. dollars.

Table 2: Prices of Equity Share in Emerging Market Stock Exchanges
(in U.S. Dollars *)

Index	August 27	1998 Range
Argentina	1054.7	1784.1 - 1045.7
Brazil	552.9	1075.5 - 552.9
Chile	467.6	777.0 - 467.6
China	21.7	56.2 - 21.7
Colombia	80.9	162.0 - 80.9
Czech Rep.	66.9	91.6 - 66.9
Egypt	139.4	204.3 - 139.4
Greece	429.1	555.0 - 293.8
Hungary	217.8	374.7 - 217.8
India	79.4	120.7 - 75.1
Indonesia	69.1	163.0 - 56.2
Israel	102.5	123.8 - 97.3
Jordan	71.0	83.7 - 70.0
Korea, Republic of	41.7	62.4 - 33.0
Mexico	664.6	1304.1 - 664.6
Morocco	271.9	275.5 - 206.8
Pakistan	37.8	91.6 - 30.2
Peru	156.4	254.1 - 156.4
Philippines	137.4	269.5 - 136.7
Poland	382.7	598.0 - 382.7
Russia	57.6	399.5 - 57.6
South Africa	104.4	236.5 - 104.4
Sri Lanka	58.3	114.7 - 55.1
Taiwan, Province of China	208.5	341.8 - 208.5
Thailand	46.7	129.3 - 46.7
Turkey	145.3	304.2 - 145.3
Venezuela	64.3	219.2 - 64.3

Source: Morgan Stanley Capital International Perspective.

* Adjusted for foreign exchange fluctuations relative to the US dollar.

Table 3: Yields on Emerging Market Bonds

Region	Bid yield as of Sept.8	Month's change	Spread vs.US Treasury bonds
Europe			
Croatia	9.42	+1.41	+4.65
Poland	8.32	+1.87	+3.47
Russia	45.88	+22.35	+40.93
Latin America			
Argentina	13.95	+2.77	+8.66
Brazil	17.67	+4.51	+12.38
Mexico	12.81	+2.06	+7.53
Asia			
China	9.39	+1.83	+4.47
Philippines	13.52	+3.68	+8.40
Thailand	14.44	+4.44	+9.49
Africa/Middle East			
Lebanon	9.46	+1.21	+4.66
South Africa	11.20	+1.99	+6.28
Turkey	12.69	+2.22	+7.74
Brady Bonds			
Argentina	10.27	+1.39	+5.04
Brazil	14.41	+2.28	+9.33
Mexico	9.31	+0.92	+4.14
Venezuela	12.19	+1.66	+7.01

Source: **Financial Times**, 9 September, p.26.