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REGIONAL DEVELOPMENTS AND OUTLOOK

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DEVELOPED COUNTRIES

GDP growth accelerated in the developed economies in 1999 supported by the strength of the North American economies and a better—albeit erratic—performance of Japan. The outlook for 2000-2001 is positive, particularly for Western Europe. It is also favourable for the United States as no sharp turnaround seems to be on the horizon, and the American economy is expected to gradually decelerate its rate of growth. Economic growth will remain modest in Japan, however, due to continued uncertainties over the restructuring of the economy (see table 1).

North America: can fast growth be sustained?

The economic performance of North America continued to be extraordinary in 1999, as output rose more than 4 per cent, inflation remained subdued and unemployment declined during the year in both Canada and the United States. While continuing with the ongoing pre-emptive tightening of monetary policy could eventually slow the current expansion in the United States, there are presently no significant signs pointing to an abrupt slowdown in these two economies. But inflationary and balance-of-payments pressures would appear to be building up slowly.

Table 1. Developed economies: rates of growth of real GDP, 1997-2001

	1997	1998	1999[a]	2000[b]	2001[b]
Developed economies	3.0	2.1	2.6	3.0	3.0
of which:					
United States	4.5	4.3	4.2	4.1	3.7
Canada	3.9	3.1	4.2	3.5	3.6
Japan	1.6	-2.5	0.3	1.0	2.0
Australia	2.8	4.8	4.4	3.1	2.1
European Union-15	2.4	2.7	2.3	3.1	3.0
of which:					
Germany	1.5	2.2	1.5	2.5	2.9
France	2.0	3.4	2.7	3.6	3.1
Italy	1.5	1.3	1.4	2.6	2.7
United Kingdom	3.5	2.2	2.1	3.3	2.6

Source: UN/DESA, based on IMF and Project LINK.

a. Estimates.
b. Forecast

In March 2000, the United States set a new record for the longest period of economic expansion in its history, with real economic activity rising for 108 consecutive months. It is not only the length but also the strength of the ongoing expansion that is notable, as the increase in GDP accelerated to an annual rate of 7.3 per cent during the last quarter of 1999 and core inflation remained tame. None the less, the rapid pace of output growth has tightened the labour market. So far, however, productivity increases and international competition have restricted the scope for significant price increases.

Productivity growth has been accelerating in recent years. In 1999, labour productivity rose over 3 per cent, with a surge of 6.4 per cent in the fourth quarter, a pace much higher than the average 1½ per cent annual gain recorded over the past two decades. While productivity growth has long been strong in the computer-hardware sector, the recent pickup has been broad-based. Higher productivity growth implies a higher non-inflationary potential for total output growth, which is now estimated to be on the order of 3½-4 per cent a year, much higher than the traditional view of 2½ per cent.

The sustained period of economic growth in the United States during the 1990s has in many respects differed significantly from previous business cycles, leading some observers to believe that the United States has entered into a "New Economy". In this view, higher productivity growth is seen as mainly attributable to the information technology revolution, as well as to other factors such as capital deepening and improvements in labour quality. These factors are not likely to fade in the short- and medium-term, leading to an optimistic assessment of the sustainable pace of productivity growth of some 2½-3 per cent per year. A caveat is that past productivity growth has tended to be pro-cyclical and to depend on a balanced expansion in demand.

In the current expansion, consumption has been increasing rapidly due to real wage gains, high consumer confidence and a strong appreciation in equity markets and real estate over several years. After an increase of 5½ per cent in 1999, strong consumer demand is expected to continue in 2000-2001. Over the medium-term, however, low and falling rates of saving are likely to moderate the rapid rise in consumption; moreover, should strong employment gains end and perhaps reverse, consumption demand could be negatively affected. Looking to the longer-term, income from capital gains must moderate and could even reverse, resulting in a slowdown in consumption demand.

Business investment has also been growing rapidly, particularly spending on information-processing hardware and software. Real investment in equipment and software rose by 12 per cent in 1999; of this, spending on computing and related peripheral equipment was up about 40 per cent. Because information technology innovation continues at a rapid pace, investment in this area is expected to remain strong. In contrast, other kinds of investment outlays are seen as likely to decelerate in response to higher interest rates, excess capacity, and a sluggish rise in profits in traditional economic sectors.

Labour markets tightened further in 1999 as the unemployment rate fell to 4 per cent by the end of the year while real wages increased for the fifth year in a row. None the less, inflation remained benign in 1999, with the consumer price index (CPI) rising 2.2 per cent, which was more than the 1.6 per cent increase in 1998. A sharp rebound in the price of oil was the main factor leading to the more rapid rise in prices. However, the core CPI, which excludes food and energy prices, signals that there has not thus far been a significant pass-through of oil prices to the rest of the economy. Many factors have contributed to the benign inflation picture, including a vigilant monetary policy, disciplined government budget policies, increased global competition, and rising productivity. With these factors remaining in place, inflation is expected to remain relatively low.

Fiscal policy in the United States has in general been restrained, as government spending has been rising at a rate slower than the growth of GDP and government revenue. As a result, the surplus in government accounts is estimated at $150 billion in 1999, up from $58 billion in 1998. The federal budget released in February 2000 continued to show a modest increase in spending of 2½ per cent during fiscal 2001, lower than the projected GDP growth rate. Consequently, the federal surplus is expected to rise further, reaching over $200 billion over the course of the next few years.

Notwithstanding this notable performance, some persistent imbalances may have reached unsustainable levels. The external deficit on current account, for example, reached a record high of more than $300 billion in 1999, and widened further during the early months of 2000. Valuations in equity markets have risen much faster than the improvement in economic fundamentals, and are now at levels that are exceptionally high by any traditional benchmark. The propensity to save out of current income by households has declined to a rate below zero. Households on average now rely on large capital gains from equity markets and real estate to finance present and future spending needs. Finally, both the household and corporate sectors have been borrowing well beyond historical norms, leading to record levels of private sector debt.

The challenge before policy makers is to avoid an immediate and sharp downturn in the economy. The Federal Reserve has recently adopted a pre-emptive approach to inflation and raised interest rates five times, for a total of 125 basis points, in the period between mid-1999 to March 2000. These increases more than reversed the three interest rate reductions made in the fall of 1998 in response to the international financial crisis.

Although the economy of the United States is expected to continue its expansion during 2000 and 2001, there are several downside risks. A large and sudden decline in equity markets, for example, could depress consumer confidence and lead to much lower growth. There is also a risk of over-tightening by the Federal Reserve, which would trigger a downturn in spending and production. On the other hand, it cannot be ruled out that the United States economy will continue to grow at its current robust pace for the foreseeable future. Technological innovation and globalization may continue to support an expansion of the new economy and offset, if not eliminate, any cyclical downturn in the traditional economic sectors of the United States.

The economy of Canada also registered robust growth in 1999, with output increasing 4.2 per cent in 1999 and the unemployment rate dropping to 6.9 per cent by the end of the year—its lowest level in two decades—with inflation remaining under 2 per cent. While increases in consumption and government expenditure have been moderate, investment spending and inventory accumulation have been strong. The buoyancy of external demand, particularly from the United States, has also been an important force driving the economy, resulting in a large merchandise trade surplus. In the short- and medium-term outlook, economic growth in the Canadian economy is expected to be about 3½-4 per cent.

The central bank has raised interest rates twice since mid-1999, by 50 basis points. To date, the inflation rate has been around the mid-point of the target band of 1-3 per cent set by the policy authorities. However, at the current strong pace of growth, spare capacity is likely to be reduced substantially in 2000-2001. Furthermore, the recent rebound of international prices of many commodities produced and exported by Canada is a source of stimulus both to Canada's economic activity and to its general price level. Therefore, inflationary pressures may build up, requiring further increases in interest rates in 2000.

On the fiscal side, the budget was in surplus for the fourth consecutive year at an estimated Canadian $8 billion for fiscal 1999. The two-year budget for 2000-2001, released in February 2000, marks a transition in fiscal strategy from the stabilization programme of the mid-1990s to one that addresses structural problems in the tax system by focusing almost exclusively on tax reduction. At the same time, the ratio of government debt to GDP is expected to decline to 55 per cent in fiscal 2001, well below its high of 71 per cent in 1995.

Asia and the Pacific: Japan still struggles

Following a steep recession in 1998, when real output dropped by 2.5 percent, the economy of Japan grew very slowly in 1999, recording only a 0.2 per cent increase in GDP, as weak domestic demand continued to constrain any rise in economic activity. While economic growth is expected to resume in 2000-2001, with GDP forecast to rise 1 and 2 per cent, respectively, the economic situation and prospects for Japan continue to be beset by considerable fragility.

The economy began in 1999 with an unexpected spurt in economic activity, attributed mainly to substantial increases in public spending that had formed part of a stimulus package implemented in 1998. However, the package failed to elicit a sustained increase in demand from the private sector, and the upturn in economic activity sputtered before the economy contracted and slipped back into recession during the second half of the year. One consequence of the spending package is that the budget deficit of the central government has risen markedly, along with levels of government debt.

Weak private consumption has been a major depressing factor. Its origin lies in the continued deterioration in employment and incomes. The unemployment rate reached almost 5 per cent of the work force in mid-1999, the highest level since postwar stabilization, and the ratio of job offers to job applicants declined to its lowest level in decades. But both indicators began to improve marginally at the beginning of 2000. Wages and compensation of employees have been on a declining trend since 1998. While part of the severe unemployment conditions might be cyclical, structural problems also exist as high-skilled workers are in short supply. The outlook for a recovery in private consumption remains gloomy: although consumer sentiment, which stayed flat for most of 1999, has recently shown some improvement, employment and income conditions are not expected to improve soon. Moreover, the ongoing full-scale corporate restructuring aimed at cutting redundant employees, reducing debt and eliminating idle capacity, is expected to continue to exert pressure on employment and income in the short run.

Business investment, which had been on a sharp downward trend since 1997, has finally started to rebound since mid-1999, led by investment in information technology (IT) and telecommunications. In fact, these two sectors are booming with robust growth of production, increased new job offerings, and rising stock prices. In comparison with other developed economies, investment spending on IT is low in Japan, leading to optimism that a rapidly growing IT sector could drive the rest of the economy on to a path of sustained recovery. Although many traditional sectors still have excess capacity, business investment in those sectors is also expected to increase as a result of a continued improvement in financing conditions and in the profitability of firms, along with further progress in corporate restructuring. Correspondingly, industrial production has also been on an upward trend and is expected to remain firm. Investment in housing, on the other hand, is forecast to remain stagnant.

In general, the external sector has been favourable to economic growth since mid-1999, when international trade started to recover from the 1997-1998 financial crisis. With the recovery of many crisis-hit Asian countries and strong economic growth in the United States, exports from Japan have been increasing. At the same time, imports have been trending upward, especially capital goods and IT related-goods. The appreciation of the yen during the second half of 1999 generated some concerns about possible downward pressures on exports, but since the beginning of 2000 the yen has depreciated to levels where export competitiveness continues to be good.

Japan has experienced a period of mild price deflation for the past two years, with a decline in the consumer price index of 0.2 –0.3 per cent a year. While weak domestic demand has contributed to this trend, efficiency improvements on the supply side stemming from the IT revolution have also been important. Given the degree of slack in the economy, inflation is expected to remain tame.

Various policy measures have played an active role in recent attempts to revive the economy. The Bank of Japan, now formally independent, has held the overnight interest rate to near zero since early 1999, while the Government has extended credit lines, especially to small and medium-sized firms, in order to further relax credit conditions. Private financial institutions still remain cautious, but credit conditions have in general eased as major banks are gradually becoming more active lenders. However, credit demand of private firms remains stagnant, as many firms continue to restructure their balance sheet by reducing debt. An accommodative monetary policy is expected to continue in 2000.

Fiscal policy has been crucial in stimulating the economy, especially the massive injection in the first quarter of 1999. Since then, however, spending slowed markedly. In order to generate a strong and sustained recovery, the government unveiled a new and long awaited stimulus package in November 1999, totaling 18 trillion yen ($170 billion). The package includes spending on infrastructure projects, such as a highway network and an information-telecommunications network. It also contained an allocation for loans to small and medium-sized enterprises, and measures for job creation, employment stability, and housing finance. In terms of expected impact, direct government spending on infrastructure, at about 6.8 trillion yen ($65 billion), is forecast to boost GDP growth by 1½ per cent in 2000.

Nevertheless, fiscal expansion in Japan appears to have reached its limit, as the government deficit is now estimated to be about 10 per cent of GDP. The additional bond issue of around 6 trillion yen required to finance the recent package is likely to push the ratio of public debt to GDP to the highest level among developed economies. This rise in public debt is expected to complicate debt management by government, which has already generated some concern in international financial markets. Other downside risks include high uncertainty about the short-term effects of the ongoing corporate restructuring on production capacity and employment, and therefore on aggregate demand. Similarly, the problem of bad loans, though improving, still remains as obstacle to any sustained business recovery.

Elsewhere in the region, Australia and New Zealand recorded more positive, though distinct, performances. While Australia sustained another year of above-trend growth in 1999, New Zealand just managed to recover from a mild recession. This divergence in growth trajectories is expected to narrow substantially in 2000-2001, with GDP likely to increase on the order of 3½-4 per cent in both countries. Both economies have widening current account deficits, which do not appear to be sustainable at their current levels.

1999 marked the eighth year of continuous GDP growth in Australia. Household demand has been surprisingly vigorous, fueled by income gains from rapid employment growth, wealth effects from asset appreciation, and easy credit. These conditions facilitated a strong expansion of consumption and spending on housing. Gross household debt has been rising, but from a rather low base, and so household balance sheets remain in good shape. Business sentiment continued to improve during 1999, following declines during the Asian financial crisis of 1997-1998. Corporate profits rose by 11 per cent, as sales and production registered solid increases in both manufacturing and services. However, the growth of total business investment decelerated, largely because of a decline in investment in the mining and quarrying sector, and a slowdown in construction. On the other hand, investment in equipment and software, especially in the form of information technology, grew strongly. Recent surveys of consumer and business sentiment point to continued strong domestic demand, and so the outlook for 2000-2001 remains optimistic.

Economic activity in New Zealand, on the other hand, exhibited considerable volatility during the past two years. A modest recovery started in mid-1998 but was interrupted by a dip of 0.3 per cent in its GDP in the second quarter of 1999. But the economy bounced back strongly in the second half of 1999, supported by rising exports, a turnaround in consumption expenditure, and a strong pick-up in agricultural production.

Part of the reason for the differences in overall growth performance in the two countries were varying domestic economic conditions. Reflecting its stronger and more stable growth, the labour market in Australia was tighter in 1999 than that in New Zealand. Inflation remained at about 1½ per cent during 1999 in both economies, but actual price increases and inflation expectations edged up modestly in the second half of the year. Although forecasts for inflation point to some increase in 2000, rates are expected to remain below the 3 per cent inflation target set by the central banks of these countries. Government budgets are in surplus for both countries.

Australia and New Zealand both recorded a current-account deficit of about 6 per cent of GDP in 1999. While strong import demand was the main reason for the large deficit in Australia, in the case of New Zealand the deterioration in its terms of trade was a contributing factor. Additionally, both countries also experienced a sluggish increase in export volume in the early months of 1999.

With regard to economic policy, low interest rates maintained by the Reserve Bank of Australia since the Asian crisis have contributed to offsetting global deflationary forces. The monetary policy of the Reserve Bank of New Zealand was also accommodative during most of 1999. However, since mid-November 1999, both central banks have raised official interest rates. By April 2000, the Reserve Bank of Australia had increased interest rates three times, totaling 100 basis points, while the Reserve Bank of New Zealand had moved three times, for a total of 125 basis points.

These two economies share some uncertainties and downside risks. First, low saving ratios and widening current-account deficits, if adjusted abruptly, present major risks to the current outlook. Second, the strength of recovery in Asian economies and the continued buoyancy of the United States economy will be crucial in determining the prospects for both economies, especially New Zealand's.

Western Europe: faster growth and lower unemployment

The current expansion in Western Europe, which started in the second half of 1999, is accelerating and is expected to yield a strong growth performance of about 3 per cent in 2000 after registering 2.2 per cent in 1999. Thus, the region will complete a full recovery from the weak growth experienced in the first half of 1999. The continuing effects from the East Asian and subsequent Russian crises had depressed export growth, leading to a sharp decline in the manufacturing sector; strong consumption growth provided a cushion, however. With the pick-up in world activity in the second half of 1999 exports recovered sharply and manufacturing rebounded. Earlier concerns over the fragility of the recovery in Germany and Italy have been mostly allayed as recent indicators point to sustained, though moderate, growth. Strong performances are expected in France, Spain and the United Kingdom, while some of the smaller economies in the region will continue to grow briskly.

Of particular note, employment growth was steady throughout 1999[1], which led to a significant contraction in the rate of unemployment. The strengthening growth profile over the period 2000-2001 should lead to a continuation of this trend. On a less positive note, inflation has picked up due in part to the surge in oil prices. Monetary policy has already been tightened, but some additional policy response is expected. Strong growth has led to substantial improvements in budgetary positions, despite some easing of fiscal policy in the wake of the slowdown, but sustained improvement in structural deficits is more problematic.

One of the most positive factors in 1999 and in the near-term outlook has been the performance of consumption expenditure. This had been a major drag on growth during the 1990s. Strong employment growth coupled with moderate wage gains, very low rates of inflation, and tax relief in some countries boosted disposable income. In the course of 1999, consumer confidence subsided from the record highs registered at the beginning of the year, but then moved up sharply at the end of the year and in early 2000 hit new highs. This together with the favourable growth profile should lead to continuing strong consumption growth in 2000.

Growth of investment remained weak at the beginning of 1999, but recovered in the second quarter, showing moderate strength for the rest of the year; some pause in the fourth quarter probably reflected concerns over Y2K. The outlook for 2000 is fairly positive. Accelerating growth, notably of exports coupled with increasing rates of capacity utilization should be highly supportive. In addition, despite the recent rise in short-term interest rates and the gradual rise envisaged in the future, real short-term rates are still fairly low and should provide further stimulus. Precautionary stock-building during the fourth quarter should reverse itself in the first quarter of 2000.

Exports picked up strongly in the second half of 1999 and are expected to further strengthen in 2000 and 2001. Foreign demand is buoyant, North America in particular, but also Asia, and the broad recovery across Europe is generating increased intra-European trade. In addition, the continuing weakness of the euro has boosted export competitiveness. Continued strong performance is expected in 2000, with some moderation in 2001 due to a strengthening euro and less robust foreign demand. Imports were also affected by the slowdown at the beginning of 1999, but were supported by the strong consumption growth. They have since strengthened in line with the recovery. As a result, net trade represented a negative contribution to growth at the beginning of 1999 but turned around in the second quarter as export growth accelerated. Trade is expected to be a positive impetus to growth in 2000 and 2001.

[1] Initial estimates by the European Central Bank suggest that employment grew by 1.4 per cent in 1999.

Industrial production, particularly manufacturing, was hit hard by the crisis but accelerated in the second half of the year in line with the recovery in exports. Industrial confidence, which had weakened substantially at the beginning of 1999, turned around in the second quarter of the year and has since improved in parallel with strong consumer confidence. Recent production data yield a mixed picture, though they may be revised upwards as initial estimates tend to miss a large proportion of smaller firms. Other indicators of industrial activity, such as order books in the manufacturing sector and capacity utilization, continue to indicate considerable strength in the first quarter of 2000.

The inflation situation has turned around sharply. At the beginning of 1999 there were legitimate concerns about deflation. In addition to the slowdown in activity, the significant drop in oil prices over the course of 1998 and general weakness in non-oil commodity prices were major causes. Moderate wage behaviour was a contributing factor as well. For the euro area, the Harmonized Index of Consumer Prices (HICP) was at or below 1 per cent in the first two quarters of 1999, a period when industrial producer prices fell. All this, despite the potential inflationary impulse stemming from the substantial depreciation of the euro against the U.S. dollar. However the situation shifted with the tremendous rebound in oil prices and moderate increase in non-oil commodity prices, which in combination with the growing weakness of the euro and the strengthening of economic activity have raised inflation concerns. Producer prices turned around in August of 1999 and have been strongly positive in the last few months, reflecting their sensitivity to the oil price rise, while the HICP rose to 2 per cent in February 2000, the ECB's stated maximum bound for inflation. However core inflation, excluding energy, is estimated to be closer to 1 per cent and as the effects of the oil price shock feed through the system, HICP inflation is expected to gradually decline to about 1.5 per cent. In addition, the expected recovery in the euro towards the end of 2000 and into 2001 will put downward pressure on import prices.

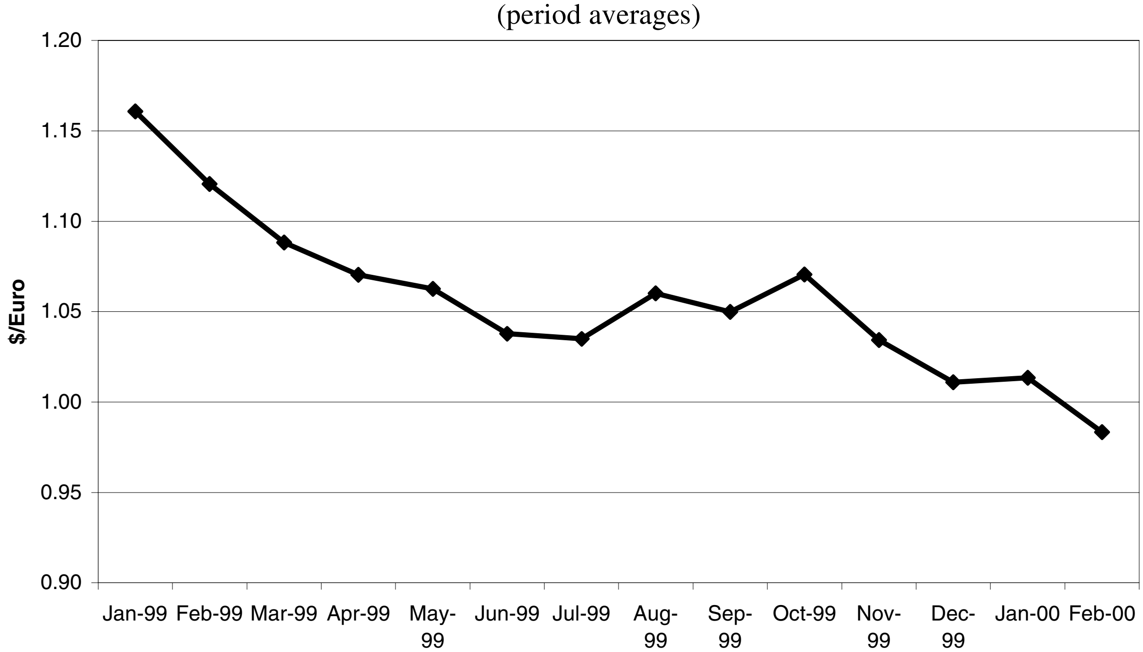
Worries over the current round of wage negotiations have receded with the news that, in Germany, moderate wage claims were accepted by the IG-Metall Workers. A number of structural factors also point to strong downward pressures on prices in the medium-term, such as the intensifying competition from restructuring and deregulation, which has been given added impetus by the start of the EMU. For example in Germany the deregulation of the electricity sector resulted in a substantial drop in energy prices. Finally, the new currency zone has unleashed forces stemming from increased price transparency that should continue to put downward pressure on prices.

As mentioned, unemployment improved substantially in Western Europe in 1999. In September 1999, euro-area unemployment dipped below 10 per cent for the first time since 1993, and was 9.6 per cent in December. There was quite a varied performance in this regard, however. Rates of unemployment in October of 1999 (the latest month with complete country coverage) ranged from 15 per cent in Spain to 2.6 per cent in Luxembourg and the Netherlands. A number of the high unemployment countries made significant progress during 1999. As economic activity continues to expand, unemployment should continue to drift downwards. However, since the problem is mostly structural, labour-market reforms are still high on the agenda. The current environment of higher growth might facilitate the enactment of some appropriate structural reforms.

The new European currency, the euro, began life on 1 January 1999, with 11 participating members in the monetary union: Austria, Belgium, Italy, France, Germany, Finland, Ireland, Luxembourg, Netherlands, Spain and Portugal. Two countries, Denmark and Greece, entered into the new exchange rate mechanism, ERM II**,** whereby they pegged their respective currencies to the euro (Greece has since revalued its currency). The other members of the European Union, Sweden and the United Kingdom continued to allow their currencies to float.

The euro opened strongly against the U.S. dollar at 1.17, and drifted upwards for a while. For most of the year, however, it depreciated substantially, dipping below the psychologically important level of parity to the U.S. dollar at the end of January 2000. Since then it has continued to weaken (see figure 1). A number of factors help to explain this, but mostly it is a reflection of the continuingly surprising strength of the United States economy, in contrast to the very slowly emerging growth profile in the euro area, particularly in Germany and Italy. Another related factor is that the advanced cyclical position of the United States economy has led to substantial yield differentials. In recent months, the Fed has been aggressively tightening rates, with the European Central Bank always seeming one step behind. However, as the disparity in growth reverses in favour of the euro area, the euro is expected to appreciate moderately in the medium-term.

Figure 1: U.S. dollar/Euro exchange rate — January 1999-February 2000
(period averages)



Source: IMF/IFS.

The continuing strength of the U.K. pound sterling over the last year has been a great surprise to policy makers too. The resilience of the United Kingdom economy following the Asian crisis, particularly the recovery of the manufacturing sector in spite of the strength of the currency, in contrast to the slow recovery of the euro area, has probably played a role. It may have led market participants to believe that the current highly favourable yield differentials vis-à-vis the euro area will persist well into the future. Nevertheless the currency is still expected to depreciate in the future, albeit at a slower rate than previously assumed, as United Kingdom growth slows and growth in the euro area picks up.

With the new currency came also a new central bank, the ECB and the associated system of central banks, the ESCB, as well as a new policy regime. The Treaty of Maastricht had set out price stability as the ECB's primary goal, which the ECB made operational in a series of steps. The announced policy contained two pillars: a money target and an inflation target, leading to some confusion and debate as to whether the monetary policy of the ECB can be considered as true inflation-targeting. Currently in Western Europe, Sweden, Switzerland and the United Kingdom are declared inflation targeters. Denmark and Greece have exchange rate targets against the euro. In the case of Denmark, the policy is one of using monetary policy to target the exchange rate, while fiscal policy is used to stabilize the economy. Norway has had a similar policy to that of Denmark. With the gyrations in the world oil market, it has found it very difficult to maintain stability against the euro, and so has moved in the direction of inflation-targeting.

1999 was not an easy year for ECB. It first had to deal with a slowdown and then with the subsequent recovery, all with a new governing council and a multitude of data problems. The ECB's first action was to lower rates to 2.5 per cent in March 1999 but then, as growth began to recover, to raise them to 3 per cent in November. Since then rates have been raised twice, once in February 2000 and again in March, both times by 25 basis points to bring the repurchase rate to 3.5 per cent. Part of this tightening can be viewed as an effort to bring short-term rates to a more neutral level after the deflationary danger of the early part of 1999 had passed and euro-area growth firmed.

A new challenge has emerged, however, as inflation measured by the reference price index reached the upper bound of the ECB's declared price target in January 2000. Thus, the question of further tightening emerges. The ECB went to great pains in its February Bulletin to explain that this sharp rise, year on year, was due both to the sharp increase in oil prices from November to December, but also due to base effects, namely that the year over year comparison is to a time period when oil prices fell, exaggerating the overall effect. As oil prices fell at the beginning of 1999 but then rose substantially, these base effects first boosted but then dampened measured rates of inflation in the early part of 2000. If oil prices were to stabilize, the contribution of energy prices to overall inflation would decline over the near-term.

Other extenuating factors also pushed prices up. In Germany, for example, the eco tax was raised in January 2000. This is a classic case of a negative supply shock, where policy should smooth the negative output effects by accommodating the first-round effects but trying to minimize the second-round effects, namely the feed-through into prices and wages. Accordingly, the ECB issued several warnings about wage settlements in its February and March bulletins. In addition, despite the strengthening of activity, the prevailing strong competitive pressures together with a slowly appreciating euro should contain price pressures.

In the forecast, it is assumed that short-term rates will rise twice, by an additional 25 basis points each time, by the end of the year, bringing the repurchase rate to 4 percent. Over the medium-term it is expected that rates will rise moderately to the 4.5 to 5 per cent range, bringing policy to a neutral stance.

In the United Kingdom, the Monetary Policy Committee (MPC) also faces a difficult situation. Inflation remains under control, being well below the Bank of England's mandated target of 2.5 per cent. However, recent output growth, while slowing marginally in the fourth quarter of 1999, is estimated to have been above trend with attendant inflation problems in the medium-term. In addition, the British currency is historically high. While the strong currency has been a powerful check on inflation, the situation could turn around dramatically if the currency starts to depreciate in the medium-term, as expected by most observers. However, raising interest rates now risks further appreciation of the currency. It also risks further damaging the manufacturing sector, which has been very adversely affected by the combination of tight monetary conditions and a strong currency. These have been key concerns for the Bank of England, which has raised its short-term interest rate by 100 basis points since June 1999 (most recently on 10 February), citing the above-trend growth in the second half of 1999, but also the expectation of sustained depreciation of the currency over the medium-term.

Fiscal policy was on the whole mildly expansionary in 1999, as governments worried about the slowdown in growth and some of the pressure for achieving the Maastricht targets had lessened. However the recovery in growth in the second half of the year actually to improved government balances as tax revenues increased and payments declined. Low interest rates also led to lower interest payments on debt. This improvement, however, was not reflected in structural deficits, so there is pressure for further consolidation. According to the most recent stability programmes submitted to the European Commission, all member states are committed to achieving specific budget targets over the next few years. This is reflected in the very low rate of growth for government consumption assumed for 2000 and 2001.

The present outlook is subject to several risks. On the upside, growth could be higher than anticipated, given the favourable monetary environment and potential for strong export growth. Stronger employment growth is also possible, which would raise incomes and fuel consumption expenditure. However, this stronger growth could exacerbate price risks, especially if higher wage increases were to materialize. A major unknown is how the formation of the monetary union will affect the dynamics of the wage-bargaining process in key countries. From the external side, there are significant risks from the future movement of the euro. On the one hand, any further euro weakness would put additional upward pressure on inflation and elicit some response by the ECB. On the other hand, if the United States economy were to slow significantly, particularly if the United States stock market were to have a significant correction, the euro could appreciate dramatically, as it did at the end of 1998. Slowing United States demand and a loss in competitive position could impact a significant negative shock to economic activity in Western Europe. Finally, the possibility of policy mistakes should not be overlooked especially given the new institutional environment.

ECONOMIES IN TRANSITION

Positive economic growth returned to the economies in transition in 1999 thanks to the unexpectedly quick recovery in CIS countries, particularly after a major crisis triggered by the collapse of the rouble in August 1998. Growth, however, decelerated in Central and Eastern Europe. In the Baltic economies, deeply affected by the adverse effects of the Russian crisis, GDP declined as these countries faced a severe recession. Growth is expected to accelerate in the region in 2000-2001, reflecting improved economic performances by Central and Eastern Europe as well as the Baltic countries (see table 2).

Central and Eastern Europe—a mixed recovery

The economies in transition of Central and Eastern Europe continued to perform very unevenly in 1999. Economic performance was particularly poor at the beginning of 1999, when a significant slowdown occurred in almost all countries of the region. Output and exports grew very slowly in Central Europe and declined in most economies of South-

Table 2. Economies in transition: rates of growth of real GDP, 1997-2001

	1997	1998	1999[a]	2000[b]	2001[b]
Economies in transition	2.3	-0.7	2.0	3.2	3.6
Central and Eastern Europe	3.5	2.5	1.2	3.9	4.2
Baltic States	8.5	4.3	-2.4	2.5	4.3
Commonwealth of Independent States	1.1	-3.7	2.9	2.6	3.0

Source: UN/DESA, based on IMF and Project LINK.

a. Estimates.
b. Forecast

eastern Europe during the first half of the year. Industrial output in particular contracted almost everywhere in the region, with the notable exception of Hungary. Thanks to recovery in the second half of 1999, GDP growth for the region as a whole reached a modest 1.2 per cent in 1999, marking the fourth consecutive year of declining average growth. The year 2000, however, is expected to reverse this trend as international economic conditions improve. GDP growth is forecast at 3.9 per cent in 2000, but it will remain unevenly distributed across countries.

Both external and domestic factors contributed to the deceleration of growth in the region in 1999. Among the external factors, the weakened global demand in the aftermath of the Asian and Russian crises in 1997-1998 and the conflict in Kosovo adversely affected the region. Since the EU accounts for more than 60 per cent of region's external trade and the region has limited options for trade reorientation, slow growth in the EU in the first half of 1999 in particular led to lower exports by most countries. Similarly, the contraction of the Russian and Ukrainian markets affected Bulgaria and Poland in particular. Additionally, the conflict in Kosovo imposed a heavy toll on the economic growth of the region, especially on countries of South-eastern Europe. It disrupted trade, lowered tourism revenues, delayed foreign direct and portfolio investment and structural reforms, and contributed to raising the cost of external financing.

Weaker domestic demand, in many instances due to restrictive policies, also played a significant role in the economic slowdown. Tight fiscal and monetary policies were embraced because domestic absorption in 1997-1998 outpaced domestic production, leading to sizeable current-account imbalances, and fiscal deficits deteriorated. Romania and Slovakia enacted austerity measures to lower expenditures and increase revenues, due to an acute twin-deficit problem. Despite these measures, however, domestic consumption remained buoyant in 1999 in both Hungary and Poland. GDP growth in both countries was slightly over 4 per cent in 1999.

Structural problems at the microeconomic level in some countries (especially in the Czech Republic, Romania and Slovakia) contributed to the region's poor economic outcome and will continue to constrain the feasible pace of economic recovery. Finally, lack of domestic savings, debt-payment arrears in the enterprise sector, increased fragility of domestic banks due to deterioration of assets, and low business confidence constrained investment activity in 1999. Gross fixed domestic investment actually contracted in Croatia, the Czech Republic, Romania and Slovakia, while it grew modestly in Hungary and Poland. Investment expanded strongly only in Bulgaria, albeit from a low base, and in the FYR of Macedonia. Investment is expected to grow slowly in 2000.

Inflation fell in most countries of the region during 1999. However, in contrast to 1998, when low international commodity prices moderated domestic inflation, disinflation in 1999 resulted mostly from weak domestic and export demand. In Bosnia and Herzegovina and Bulgaria, the currency board regime contributed to low inflation as well. Even Albania, in spite of the inflow of refugees from Kosovo, experienced deflation due to the appreciation of the exchange rate brought about by the high volume of humanitarian assistance and remittances from abroad, as well as spending by NATO forces. On the other hand, inflation remained high in Romania and accelerated in Yugoslavia.

Despite lower inflation, monetary policies were cautious during 1999. Although interest rates were cut and monetary policy was gradually relaxed in the first half of the year in the Czech Republic, Hungary and Poland, real interest rates remained high. This was due to the need to keep attracting foreign finance flows, the structural problems in the banking sector, and the existing fiscal imbalances. Additionally, with the rise in commodity prices, especially fuels, inflation began to pick up in the third quarter of 1999, thus preventing further reductions of interest rates. Hungary had to revise its inflation forecast upwards, while Poland switched to monetary tightening as a pre-emptive measure to curb inflationary pressures.

Countries remain committed to a low inflation environment as reflected in the lower inflation targets established for 2000. However, the inflation outlook may not be favourable as international oil and other commodity prices continue to rise and price deregulation advances as planned. Many administratively controlled prices will become subject to market forces in the Czech Republic and Slovakia in 2000. Further increases in state-controlled utility prices are expected in Bulgaria and in service prices in Romania. Moreover, most of the currencies of these countries are in some form pegged to the euro, though it is as yet unclear what final effect the expected appreciation of the euro against the dollar on domestic prices will have. Monetary policies in 2000 will therefore remain tight throughout the region. Possible exceptions are the Czech Republic; Hungary, where some loosening will occur due to the large inflow of speculative capital; and Slovakia, where some liquidity is likely be injected into the banking sector as unsterilized currency interventions to prevent appreciation of the koruna may continue in 2000.

Economic deceleration combined with continuing restructuring efforts adversely affected employment, which fell in 1999, with the rate of unemployment ranging from 9 per cent in the Czech Republic to 19 per cent in Croatia. Unemployment increased markedly in Poland and Slovakia, where it reached 18 per cent. Alarming numbers were recorded in Bulgaria at the beginning of 2000. The unemployment rate was at about 17 per cent in early March 2000. The outlook for labour markets in 2000 is unfavourable despite the expected acceleration in growth. Higher unemployment will exert pressure on social security spending, undermining budgetary reforms.

A decline in FDI in the first half of 1999 accompanied low domestic investment in Central and Eastern Europe. By the end of the year, FDI inflows recovered primarily in the Czech Republic and Poland, while they remained low in Hungary and in Slovakia. Strong FDI flows to the region are closely related to privatization as well as the prospect of accession to the EU.

Conditions of external financing improved for Hungary and Poland in 1999, which restored their access to international capital markets. However, the cost of borrowing still remains high for Bulgaria, Romania, Slovakia, and most of the former Yugoslav states.

External financial constraints during 1999 led these economies to reduce their current-account deficits during the year. In spite of this, FDI as a source of financing the current-account gap became more important in 1999, reinforcing in turn the need to accelerate reforms in these countries to attract such flows. The cost of borrowing abroad, however, may fall in 2000 if investors change the composition of their portfolios in favour of the region. However, the reduction of spreads will be only marginal, leaving most of the region dependent on borrowing from the multilaterals.

Despite the improvement of consumption demand in the second half of 1999, recovery in 2000 will be export-led. However, export growth will be constrained by the lower rates of investment in 1999 and 2000 and by the real appreciation of the currencies. None the less, the region is expected to benefit from the upturn in Western Europe as the Czech Republic and Hungary already experienced in the last quarter of 1999. Increased exports and the Government's revitalization programme should strengthen recovery in the Czech Republic. Hungary is expected to perform well in 2000, despite the vulnerability of its public finances and external accounts, while Slovakia needs to intensify its microeconomic reforms. To expand export revenues, the more advanced economies of the region need increasingly to concentrate their policies on export promotion, on investment in knowledge-based economic activities, and on bolstering FDI inflows. In the case of Poland, a well-functioning domestic market can provide its economy with a certain degree of independence from the cyclical movements in Western Europe. Accordingly, the business environment of the country is to be improved in 2000-2001, through the privatization of the remaining large state-owned enterprises (in telecommunications, energy sector and oil refineries), the restructuring of the troubled coal and steel industries, and continued reform of the welfare sector. However, large external imbalance—as the current-account deficit increased to 7.5 per cent of GDP in 1999 from 4.3 per cent in 1998—still remains a serious threat to the Polish economy. Therefore, Poland needs to continue to attract strong inflows of foreign finance in 2000 to cover its growing current-account deficit.

Prospects are less favourable for the other economies of the region. Bulgaria and Romania, with a wide range of problems in many economic sectors and at the enterprise level, are expected to experience modest growth in 2000. Exports will lead expansion in Bulgaria as growth of domestic demand is constrained by the currency board regime. In Romania, an upturn of the economy is predicated on reform of the banking sector and of loss-making enterprises.

Near-term growth outlook for the South-eastern economies also depends on the reopening of traditional transport routes to Western Europe that have been partially blocked due to the military confrontation over Kosovo. Delays in reconstruction efforts may discourage FDI flows into region, impeding the implementation of policies to establish and strengthen market institutions. Western Europe's role in assisting these countries to overcome the economic consequences of the Kosovo conflict cannot be overemphasized.

Despite support by the international community, the pace of reconstruction has been slower than anticipated. The Stability Pact, signed in June 1999, created great expectation. Disbursement of financial assistance has been rather slow. International donors pledged about $2 billion at the conference in March 2000 for the affected countries and regions.[2] It is still unclear, however, how much of this will actually be forthcoming and how quickly.

The possibility of accession to the EU will significantly affect economic prospects of the entire region over the medium to long term. The European Council met on 10-11 December 1999 in Helsinki and proposed several changes in the EU's strategy towards enlargement. Consequently, One is that the distinction between slow- and fast-track negotiations was abolished so that all 10 candidates from the eastern part of Europe will be actively negotiating for accession, but each at its own pace. Consequently, Bulgaria and Romania may not experience any serious negotiations over several years. Even for those most advanced with their negotiations, many sensitive issues remain to be resolved. Institutional readiness of the EU is predicated on the outcome of the Intergovernmental Conference which opened in February 2000.

The outlook for the region in 2000 carries several sources of uncertainties. One is primarily associated with the social costs of the further structural reforms. The high cost and low expected benefits in the short run may weaken the determination of policy makers, especially when presidential and parliamentary elections are scheduled, as in 2000-2001. Furthermore, there are several threats to political stability as governing parties in most of Central Europe are experiencing a decline in popular support and fractious coalition governments are held together by the fear of early elections. On the external front, the most important risk is the strength of the EU's recovery and how it translates itself into increased import demand from the region.

Commonwealth of Independent States: emerging from recession at long last?

1999 brought some surprises for the CIS countries. At the start of the year it was predicted that in view of the deepening economic crisis in Russia and weakened commodity prices, the CIS economies as a group would contract by over 3 per cent, following a 3.4 per cent fall in the region's output in 1998. Such an outcome would have further deferred recovery and have had far-reaching economic, political, and social consequences, possibly a reversal of the process of transformation throughout the region. Instead, the CIS economies grew by almost 3 per cent in 1999. Growth is expected for the region in 2000 as well, through it is likely to be somewhat weaker than registered in 1999.

In the first quarter of 1999, there was a sharp economic contraction in Russia as well as in Kazakhstan and Ukraine, the next largest economies of the region. Recession in these countries imposed a negative shock on the other economies of the group as

[2] Much of the money pledged in March 2000 reflects previous commitments.

interregional trade collapsed. Countries such as Belarus, Kyrgyzstan and Moldova were particularly hard hit. However, the strong recovery in oil prices, following the OPEC agreement in March, triggered a positive chain reaction by increasing export earnings and reducing pressures on fiscal and external balances. The large devaluation of the rouble gave a boost to import substitution in Russia. As the Russian industrial output growth stop declining and eventually recovered, a much more benign economic environment was created in the region in the second half of 1999. However, the prospect of tangible regionwide improvement in economic performance looked elusive until the end of 1999. There was a sharp turnaround in industrial production in Kazakhstan and Ukraine late in 1999 which, as in the case of Russia, was also largely brought about by import substitution due to the sizeable depreciation of the tenge and hrynnya, respectively. The gradual recovery of commodity prices and export volumes aided the upturn in the other countries. Accordingly, growth accelerated in all countries in 1999 with the exception of Belarus and Armenia.

Paradoxically, the persistent imbalances in the fiscal and external sectors, which had been the main threat to macroeconomic stability in the region in recent years, have eased as result of the dramatic adjustments imposed on the CIS countries in 1999. The sharp worsening of fiscal balances at the start of 1999, because of the heavy reliance of public revenues on exports, was forcefully tackled in most countries by additional austerity measures and renewed efforts to improve revenue collection. Recovery of export earnings towards the end of 1999 gave a further impetus to reaching more sustainable fiscal positions. As a result, the much-feared monetization of fiscal deficits did not occur. Structural fiscal balances have improved in most countries, except in Belarus and Turkmenistan. Especially impressive was the fiscal turnaround in Russia, where the federal budget deficit was reduced to 1.7 per cent of GDP in 1999 from 5 per cent in 1998, mostly due to improvements in revenue mobilization.

After the currency devaluations in several countries following the collapse of the rouble, inflation surged. It was subsequently successfully contained by tight monetary policy, with the notable exception of Belarus, where annual inflation reached 293 per cent inflation in 1999. The stabilization of the exchange rate in several countries (except Belarus, Tajikistan and Uzbekistan) also contributed to controlling inflation in the region. Although the annual average inflation substantially rose in a number of countries in 1999, regionwide inflationary pressures have recently receded and most countries have resumed their pre-crisis disinflation trend.

Due to the large compression of imports in all countries, external balances improved in 1999. Especially the unsustainably large current-account deficits in some of the smaller countries have been substantially reduced. For instance, Moldova's 20 per cent current account deficit contracted to 2 per cent, while the large deficits of Kyrgyzstan and Turkmenistan were at least halved. Ukraine, however, witnessed some deterioration in its current-account position.

The prospects for the region look encouraging with on average positive growth for the second year in a row. The favourable changes in the external environment, both inside the region and elsewhere, are most likely to continue in the medium-term. Given the incipient recovery in exports, external balances in the CIS region will continue to improve in 2000. In contrast to 1998 and 1999, economic growth in 2000 will also benefit from the reduced policy uncertainty resulting from the parliamentary and presidential elections held in key countries in 1999 and early 2000. None the less, the presence of large, obsolete, capital-intensive heavy industry in the major CIS economies continues to pose a persistent challenge for restructuring and will constrain growth over the medium-term. The outlook for the region is subject to risks. It depends critically on sustaining the growth momentum in Russia and other large economies such as Kazakhstan and Ukraine in the coming months.

The Russian economy has been performing well so far. Industrial production has consistently grown at annual double-digit rates over the last eight months into March 2000. More importantly, investment and consumption also seem to be expanding. For the first time since transition began, investment is reported to be edging up and is expected to rise somewhat in 2000. Real disposable income grew by 4.4 per cent in the first two months of 2000, following a 15 per cent fall in 1999. Additionally, there are increasing signs of improved confidence in the Russian economy. For instance, the stock market index has recovered rather strongly recently. More significantly, foreign direct investment reached $4.2 billion in 1999 compared to $3.3 billion in 1998 but still below the peak of $5.3 billion reached in 1997. The government is currently predicting a 4-5 per cent increase in industrial output and a 3 per cent growth in agriculture in 2000. This will support a GDP growth of about 2.5 per cent in 2000, thus providing at least an ambient regional environment for the other CIS economies that are still heavily dependent on Russian markets.

However, there are some risks to this outlook. Despite the fiscal and current-account improvements in 1999 and early 2000, a possible strain on the budget can develop during the year due to debt-servicing difficulties and increased spending on the conflict in Chechnya. The scheduled external debt repayments for 2000 are large (estimated at $10.2 billion), despite the February 2000 restructuring of $32 billion of international bonds which led to a $10.6 billion write-off by the London Club creditors. Russia would like the Paris Club to restructure $42 billion of official debt on similar terms, but it is still not clear what the outcome of these negotiations will be. Furthermore, if these pressures endanger the macroeconomic framework and additional shocks (such as an abrupt fall in oil prices) hit the economy, the current recovery can easily be derailed. There is not enough internal dynamism in the economy, from domestic consumption and investment, to sustain growth under such circumstances. Impoverishment is one such cause. Another is the still incipient structural reforms, including a bankrupt banking sector and weak governance mechanisms. Although the prospect of political stability has improved, that of renewed reform remains for now uncertain.

In contrast, Kazakhstan's economic recovery seems to be more robust. GDP growth is likely to reach 3 per cent in 2000, and possibly higher thereafter, due not only to the firming of prices of its major exports and increased Russian demand, but also to its continuing reorientation of trade towards western markets as well as accelerated reform efforts. The record oil exports in 1999 and the anticipation of the oil pipeline connecting the Tengiz and other oil fields to the Black sea, which is scheduled to come on stream in October 2001, will further bolster investment and growth. Foreign direct investment is expected to accelerate in 2000 and access to international capital markets, which was already restored in 1999, is expected to improve in 2000. Privatization of internationally well-positioned firms, after protracted delays, and a new tax code to improve the investment environment should further buttress the outlook.

The economic outlook for Ukraine has also improved. Following its slow recovery in the second half of 1999, industrial production increased by 10 per cent, leading to a 6.1 per cent rise in GDP, in the first two months of 2000. This is Ukraine's first positive growth since the transition's inception. External demand is expected to pick up in 2000, providing additional support to economic activity. Contrary to earlier fears of default, Ukraine is likely to be able to restructure its external debt and ease its servicing obligations in 2000. Monetary and fiscal policies are expected to be firm and inflation and currency depreciation will slow down further in 2000. However, the limited progress achieved with structural reforms is likely to constrain growth.

The other CIS economies are expected to improve their performance in 1999, with the possible exception of Belarus and Uzbekistan. The major factors to support such an optimistic outlook are the above-mentioned strengthening of recovery in the major economies of the region, the further firming of non-fuel commodity prices, and the buoyant outlook for global trade. For oil and gas producers, the recent advances in the implementation of planned pipelines will help in sustaining the exceptionally high growth rates recorded in 1999.

Growth in the CIS region as a whole, therefore, is likely to reach 2.6 per cent in 2000. Average inflation rate is expected to be about 25 per cent, less than half the 1999 level. The current-account deficit will increase slightly due to the recovery of imports. Risks are in particular the weakness of the underlying fundamentals in many countries and any unexpected external shock such as a faltering recovery in Russia, weakening of world demand for primary commodities, or an abrupt tightening of external financing. The still large structural budgetary imbalances and current-account deficits coupled with rapidly growing foreign debt in countries such as Armenia, Kyrgyzstan and Moldova make these economies particularly vulnerable to such potential shocks. The lack of reforms, especially the absence of real sector restructuring, is troubling. The extension of loose credit to unviable enterprises persists and is leading to further accumulation of quasi-fiscal liabilities in the banking sector in some countries such as Belarus, Turkmenistan, and Uzbekistan, thus rendering their medium-term economic prospects less promising.

Baltic Countries: hit by the Russian crises but recovering

The impact of the Russian crisis proved to be more severe than expected, bringing overheating and fast growth in the Baltic countries to a halt. All three economies slid into sharp recession in early 1999 due to the sudden fall in exports of sectors that rely heavily on the Russian market. However, the recession bottomed out by mid-year and the Baltic economies started recovering in the second half of 1999. The sharp adverse trade shocks and disturbances to domestic banking systems and stock markets have been successfully overcome, due in part to a resumption of export growth. Nevertheless, for the year as a whole regional GDP contracted by 2.4 percent.

The crisis forced the Baltic countries to address their macroeconomic imbalances. The recession led to import curbs, which improved external balances. These had been the main policy concern prior to the crisis. The cut has been dramatic in some terms. In Estonia, for example, it was cut by more than half. Inflation, which had been declining over the past few years, was further reduced to low single-digit levels. None the less, the recession led to a worsening of fiscal positions, which briefly threatened, especially in Latvia and Lithuania, the sustainability of the macroeconomic framework based on a fixed exchange-rate regime. All three countries have adopted additional austerity measures and embarked on a tight schedule to eliminate the fiscal slippages incurred in early 1999.

The strength of the recovery in individual countries was a function of the depth and breadth of earlier reforms, with Estonia emerging first and fastest from the recession. Economic growth is expected to reach 2.5 per cent in the region in 2000. Individual country performance varies, with Estonia recovering faster than the other two. But growth in both Latvia and Lithuania is expected to accelerate later in 2000 and beyond, more than doubling the forecasts for 2000 in 2001. Inflation will be uniformly low, in part because of their exchange regimes. Current-account deficits are expected to be further reduced, especially for Latvia and Lithuania, where they are still relatively high – reaching 9.9 per cent and 10.3 per cent of GDP, respectively, in 1999.

There are some risks to the current optimistic scenario. Since these countries do not use the exchange rate to facilitate adjustment, fiscal discipline and deepening institutional and structural reforms are a prerequisite for continued success. Tough fiscal policy remains a major policy challenge in 2000, especially for Lithuania. Latvia and Lithuania need to accelerate the relatively slow pace of structural reforms. An additional concern is the relatively poor prospects for sustaining revenues from the transshipment of Russian oil exports. The recent decision by Russia to build a new pipeline to the Gulf of Finland in order to reduce reliance on the existing export routes through the Baltic states, can have a large negative impact on the Baltic economies, especially on Latvia.[3]

DEVELOPING COUNTRIES

Growth accelerated in developing countries in 1999, albeit with sharp differences across regions. Asia, except for its Western sub-region, showed a remarkable performance in 1999.The recovery in the countries affected by the currency and financial crisis, which started in 1997, was much stronger than anticipated. China was able to

[3] 12-15 million tonnes of Russian oil (around 15 per cent of total oil exports to non-CIS states) are shipped through Latvia, generating sizeable fees for the country.

maintain respectable—albeit slower—growth, and GDP growth picked up in South Asia. In contrast, economic growth decelerated sharply in Western Asia and Latin America, while Africa maintained a modest rate of growth (see table 3). The year 2000 should witness a more balanced performance within the developing region as countries solidify their recoveries and growth resumes in those countries that suffered recession in 1999. Differences in GDP growth will be further reduced in 2001. More important, perhaps, the pace of growth during the period 2000-2001 is expected to approach pre-crisis levels.

Africa: growth acceleration expected in 2000

Africa's real GDP growth reached 2.8 per cent in 1999, marginally above the 2.7 per cent growth in 1998. Growth in 1999 was largely export-driven, and attributable mainly to significant growth in export earnings of the region's oil exporting countries as a result higher oil prices. Additionally, the recovery of demand in Asia and Europe for Africa's exports of industrial raw materials contributed to improved export earnings of other countries, even though prices many other commodities remained weak or declined further. Strong macroeconomic policies in a large number of countries contributed to macroeconomic stability, but growth in domestic demand was generally weak and provided little stimulus to output growth. GDP growth is expected to accelerate to 4.6 per cent in 2000 as domestic political conditions improve further and exports strengthen their recovery.

Table 3. Developed countries: rates of growth of real GDP, 1997-2001

	1997	1998	1999[a]	2000[b]	2001[b]
Developing countries	5.4	1.5	3.3	5.1	5.3
Latin America and the Caribbean	5.1	1.9	0.2	3.7	4.2
East Asia (including China)	5.1	-4.6	5.6	6.0	5.7
China	8.8	7.8	7.1	7.0	7.0
South Asia	4.8	5.3	5.6	6.1	6.4
Western Asia	5.5	3.7	0.3	3.9	4.7
Africa	3.0	2.7	2.8	4.6	4.8
Sub-Saharan Africa (excluding Nigeria and South Africa)	4.1	3.2	3.4	4.2	4.7

Source: UN/DESA, based on IMF and Project LINK.

a. Estimates.
b. Forecast

Continuing armed conflicts contributed to weak economic performance in a number of countries but there has been progress in several other areas. Post-conflict reconstruction efforts in Burundi, Liberia, Rwanda and Sierra Leone advanced with only limited setbacks in 1999. Recent multi-party elections in Namibia, Nigeria, Senegal, South Africa and 12 other African countries—in addition to an important constitutional review by popular vote in Zimbabwe in February 2000—provided evidence of significant advances African countries have made towards achieving political stability that is often a precondition for sustained social and economic development. The December 1999 military coup in Côte d'Ivoire, however, toppled a record of more than three decades of political stability. Fresh outbreaks of violence based on religious and ethnic tensions in Nigeria after the elections, similarly, threaten to undermine implementation of country's economic reforms under the new civilian administration.

GDP growth accelerated in the majority of the 38 countries regularly monitored by the Department of Economic and Social Affairs. Only three countries (the Democratic Republic of the Congo, Morocco and Zimbabwe) suffered economic recession in 1999, compared to six countries in the previous year. Per capita GDP growth, however, increased just marginally in 1999.

The combined GDP of the eight major oil-exporting countries (Algeria, Angola, Cameroon, Congo Republic, Egypt, Gabon, Libya and Nigeria) increased by a full percentage point to 4 per cent from 3 per cent in 1998, even though the volume of petroleum output and exports declined in most of the oil-exporting countries. Production declines in Algeria, Libya and Nigeria, African countries that are members of OPEC, were directly related to voluntary cutbacks under OPEC quota agreement. In Nigeria, oil output also declined due to frequent power supply disruptions, fuel shortages and civil unrest in oil-producing regions. A more encouraging development, however, was the commencement of production and exports of liquefied natural gas from new facilities in October 1999. This is, reportedly, the largest industrial project in Africa in recent years. It provided a significant boost to Nigeria's export earnings and represented a major diversification of the country's energy sector.

Libya's economic prospects were further improved the suspension of United Nations economic sanctions in April 1999 and the resumption of trade and investment ties with trading partners in Europe and other African countries. Increased oil revenues in Angola—which was substantial because of significant increases in output—benefited the economy only marginally because of the intensification of the civil war in 1999 and lack of development of the country's vast agricultural and mineral resources. Similarly, oil export revenues provided the major boost to Cameroon, Congo Republic, Gabon and, notably, Equatorial Guinea and Sudan that recently joined the ranks of Africa's oil-exporting countries.

Among oil-importing countries, at least 12 countries in sub-Saharan Africa registered growth rates of 5 per cent or higher with Botswana, Mozambique and Uganda ranked among fastest-growing developing countries in the world with GDP growth rates of 7 per cent or higher. Favorable weather and increased agriculture output were the most important factors underlying growth performance in the majority of countries. Economic activity related to agriculture in the services and manufacturing sectors also improved somewhat as a result of the increase in agricultural output. Agricultural output, however, declined in Ethiopia, Mauritius, Morocco, Somalia, and several other countries, because of drought. In both Mauritius—where sugar output dropped almost 50 per cent of 1998 crop levels—and Morocco as much as 30 per cent of the agricultural production was lost to drought. Somalia recorded its seventh consecutive year of poor harvest, which combined with civil conflict led to a major food crisis in the south of the country. Furthermore, according to a recent FAO report, drought continued to affect several areas in Eastern Africa during the so-called "short-rain" season (November1999-January2000), thus compromising agricultural output growth and leading to severe food shortages in the region.[4]

Among the mineral producing countries, increased demand for copper, gold and diamonds benefited producers of those commodities, although prices, which strengthen slightly during the year from steep declines in 1998, still hovered around historical lows in 1999. In Zambia, delays in the privatization of the Zambia Consolidated Copper Mines (ZCCM) lowered output in the mining sector, which accounts for 13 per cent of the country's GDP, by 15 per cent. The completion of the sale of 70 per cent of ZCCM's assets in January 2000, however, brings renewed hope of a significant recovery in Zambia's copper-mining industry through revitalized management and substantial investment in new plant and equipment.

Most sub-Saharan African countries benefited from an improved policy environment, low or moderate inflation and slight improvements in domestic and foreign investment. South Africa's economy—the largest in the region—regained its growth momentum after sluggish performance in 1998 and early 1999, which was caused by the turbulence of the Asian financial crisis. Capital flight, depletion of the country's international reserves, currency depreciation, high domestic interest rates and escalating inflation in the first half of 1999 were halted and reversed as international investors regained confidence in the economy in response to tight monetary and fiscal policies. FDI and portfolio capital inflows increased, and the country recorded an overall surplus on the current account by the end of the second quarter of 1999.

Manufacturing output growth remained sluggish in many countries as a result of low effective demand. Increased competition from lower cost (and often, higher quality) imports also contributed to poor performance of the sector. In Nigeria, the level of capacity utilization remains very low at about 34 per cent due to severe bottlenecks in production schedules caused by frequent power outages and shortages in petroleum products. Similarly, fuel shortages were particularly acute in Zimbabwe leading to decreased capacity utilization in the manufacturing sector. In many countries the lack of foreign exchange limited imports of necessary raw materials, modern equipment, machinery and spare parts, thus contributing to the poor performance in the manufacturing sector. Conversely, manufacturing output in export-processing zones of

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[4] FAO/GIEWS, A*frica Report No 1*, April 2000.
(http://www.fao.org/WAICENT/faoinfo/economic/giews/english/eaf/eaf0004/AF00043.htm)

Mauritius, and to a lesser extent, Botswana, Namibia and Madagascar, showed strong growth in 1999.

African manufacturing is expected to benefit from trade preferences given by the United States with the approval of the Africa Growth and Opportunity Act in November 1999. The Act grants duty- and quota-free access to the United States market of exports of manufactured goods from sub-Saharan African countries. Mauritius, which currently accounts for almost 50 per cent of exports of clothing and textiles to the United States, is expected to be one of the main beneficiaries of the Act. But other large exporters of manufactures in sub-Saharan Africa—Kenya, South Africa, and Zimbabwe and a few other countries—will benefit as well.

Macroeconomic policy in Africa has been largely influenced by commitments of individual countries to targets, goals and implementation of policies recommended by international financial institutions and donor countries. Policies of countries under an IMF programme have emphasized tight monetary and fiscal policies to achieve internal and external balance as well as structural and institutional reforms to improve the investment climate and encourage private sector led growth. As of December 1999, 16 African countries had programmes with the IMF—either under the enhanced structural adjustment facility (ESAF) or the poverty reduction and growth facility (PRGF), which replaced the ESAF in September 1999.[5]

Economic reforms received a further boost with the new administrations in Nigeria and South Africa, two of the largest economies of the region. In the particular case of Nigeria, the new civilian administration unveiled a comprehensive set of policy proposals that strongly emphasize a more prominent role for the private sector in the economic development of the country. The immediate concern of the new government, however, has been the introduction of reform policies aimed at combating corruption, waste and mismanagement in the public sector, the armed forces and the lucrative oil industry. Meanwhile, in South Africa the new administration reconfirmed the Government's commitment to the Growth, Employment and Redistribution (GEAR) macroeconomic strategy, which emphasizes improved employment creation and delivery of vital social services to the poor through strong private-sector growth within a framework of fiscal consolidation by the central government. The GEAR strategy achieved some degree of success in the previous administration in delivering social services to the poor but had fallen far short of its employment objectives. The unemployment rate in the formal sectors of the economy remains at a disturbingly high level, estimated at 34 percent. [6]

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[5] The PRGF is the new framework under which the IMF will conduct concessional lending programmes to low-income countries, including financial support for enhanced debt relief under the HIPC initiative, in coordination with the World Bank, other financial institutions and donor countries. For further information see the following documents that available on the IMF's website in April 2000: *The Poverty Reduction and Growth Facility (PRGF)—Operational Issues* (www.imf.org/external/np/pdr/prsp/poverty2.htm) and *Poverty Reduction Strategy Papers—Operational Issues* (www.imf.org/external/np/pdr/prsp/poverty1.htm).

[6] Since the 1994 elections, job losses in the formal sector of the economy have been estimated at over 500,000 as a result of the re-integration of the South African economy into world markets, efficiency gains in mining and manufacturing operations and huge cutbacks in public sector employment. See Habib, Adam

Despite austerity efforts, the fiscal position of many African countries remained fragile in 1999. Fiscal deficits persisted in most oil-exporting countries in 1999 although improvements have been recorded. Algeria and Egypt maintained existing policies of fiscal restraint while increased oil revenues and proceeds from privatization provided some room for increased expenditure on social programmes. Libya, on the other hand, embarked on an expansionary fiscal policy after the suspension of sanctions. Increased government expenditures were concentrated on large-scale infrastructure projects and the acquisition of a wide range of goods and services that were unobtainable while the sanctions were in effect.

For the oil-importing countries, the combined effects of depressed non-oil primary commodity prices and increased oil-import prices caused fiscal balance to widen further. Continued budget deficits underlie the structural weakness of these countries where the tax base is very narrow and tax collection inefficient. Integration efforts, in some cases, have led to lower public revenues. For instance, the adoption of a common tariff structure by members of the Union Economique et Monetaire Ouest Africaine (UEMOA) translated into reduced customs receipts and government revenues.[7]

Consumer price inflation was largely subdued in most other countries as a result of lower food prices, stable money-supply growth, fiscal prudence and stable exchange rates. The average rate of inflation for the region as a whole has been declining steadily over the past few years to an historical low of 6 per cent in 1999. High rates of inflation, however, were recorded in Ghana, Libya, Malawi, Nigeria, Sudan, Tanzania, Zambia and Zimbabwe under local conditions of food shortages, large fiscal deficits, high rates of money supply growth and currency depreciation. Toward the end of 1999, inflation rates started to accelerate somewhat due to sharp increases in fuel prices.

With GDP growth projected to accelerate to 4.6 per cent in 2000, growth in per capita GDP is expected to improve slightly to some 2 per cent, compared to negligible growth in 1999. This is far below the rate of 7 per cent that the Economic Commission for Africa (ECA) estimates that sub-Saharan African economies need to grow in order to reduce poverty by half by 2015.

Much of the growth in 2000 is likely to come from the North African sub-region, where economies are set to expand strongly. Sub-Saharan Africa's contributions might give an additional stimulus to Africa's prospects provided the majority of countries continue to reap the benefits of structural reforms, better economic management, and consolidation of recent gains in the areas of political stability and good governance. Among the largest economies of the sub-region, GDP growth is expected to accelerate in South Africa and moderate slightly in Nigeria in 2000.

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and Vishnu Padayachee, "Economic Policy and Policy Relations in South Africa's Transition to Democracy," *World Development*, Vol. 28, No. 2, pp. 256-258, 2000.

[7] UEMOA members are: Benin, Burkina Fasso, Cote d'Ivoire, Guinea Bissau, Mali, the Niger, Senegal and Togo.

African economies, however, remain vulnerable to unpredictable weather patterns and natural disasters, as evidenced by the destructive floods that wrecked havoc in the Southern African region in the aftermath of two tropical storms in February 2000. Botswana, Madagascar, Mozambique, Namibia, Zambia and Zimbabwe were all affected to some degree by heavy rains and flood damage which caused significant loss of lives, displacement of large numbers of persons and extensive damage to crops and infrastructure throughout the region. Mozambique sustained the most crippling damage, and the country's GDP is expected to shrink significantly—by as much as a third of 1999 output, according to official estimates.

African exports will continue to benefit for gains in oil export earnings, mainly from increases in export volumes as oil prices are expected to lose some of the 1999 gains. Strong growth in the EU and acceleration of the recovery in Asian countries will also help in supporting Africa's export expansion. Imports are expected to rise but with uncertain benefits to the region. Increased costs of manufactured goods and high fuel prices will consume a significant share of import budgets, as will the need for imports to cover losses in flood-damaged countries in southern Africa and war-torn countries in other areas. Both trade and current account balances are projected to remain in deficit, although in some oil-exporting countries external balances will continue to improve. Weak capital inflows and financing of current-account deficits remain the most difficult obstacles faced by African policymakers.

East Asia: broadening the recovery

East Asia witnessed a remarkable recovery in 1999. The region's aggregate GDP (excluding China) grew by an estimated 5.6 per cent in 1999 after a contraction of 2.3 per cent in 1998. All Asian emerging economies that had fallen into recession during 1998 resumed growth during the first half of 1999. Most other countries in the region, which had been less severely affected by the crisis, performed relatively well.

The recovery of the crisis-hit countries[8] other than Indonesia has been stronger than expected. It has been supported by macroeconomic policy stimuli, an upturn in domestic demand, and increased exports. The timing and strength of the recovery varied across countries but the gap has been narrowing over time. Indonesia, however, lagged behind other countries because of political turmoil and problems in implementing its adjustment programmes. It resumed growth in the second quarter of 1999 mainly as a result of increasing private consumption but the recovery remained tepid.

The main thrusts for the upturn in domestic demand in the cited crisis-hit countries came from inventory adjustment and private consumption. Private consumption began to pick up during 1999 in response to policy stimuli, rising income and wealth, and improved consumer confidence. Private investment remained weak due to excess capacities, cautious bank lending, and weak business sentiment. In a number of countries,

[8] Crisis-hit countries are Indonesia, Malaysia,Republic of Korea and Thailand.

machinery and equipment investment in export-related industries began to increase.[9] On the supply side, growth of industrial output, particularly manufacturing, regained strength in the second half of 1999 and led the recovery. The capacity utilization rate reached 80 per cent in the Republic of Korea and Malaysia late last year, as compared to about 65 per cent at the height of the crisis. Countries with large export-driven electronics sector experienced the largest output gains. The construction sector, although improving, remained weak. The service sector improved. In Indonesia, on the other hand, industrial output was rather unstable, while agricultural output recovered in the first half of 1999 as weather condition improved.

Export revenues (measured in U.S. dollars) began to rise in the first half of 1999, and soared at a double-digit pace in most crisis-hit countries during the second half of the year. Exports were driven by the strong import demand from the major developed countries, as well as by the resumption of regional trade as domestic demand picked up in these countries – intraregional trade accounts for about 40-50 per cent of their trade. The uptrend in the world electronics industry cycle, which had started in the fourth quarter of 1998, combined with the Y2K demand, was also a significant conducive factor. Despite the substantial recovery observed in the second half of 1999, currencies remained competitive and were an important factor in supporting exports. Rising exports in turn contributed to the upturn in domestic production and investment, particularly in the manufacturing sector. In Indonesia, however, the persistence of acute financing problems hampered exports.

In most other Asian emerging economies, an upturn in exports supported the recovery in 1999, while domestic demand, though strengthening too, reacted more slowly. Growth in Singapore accelerated to 8.2 per cent in the fourth quarter (when compared to the same period in 1998) from 0.6 per cent in the first quarter, led by exports of electronics and chemicals. In line with growing exports, domestic demand began to recover slowly. This was especially the case for private consumption as a result of declining unemployment and the recovery of asset prices. In the Philippines, as in Indonesia, agricultural output recovered with the return of normal weather and led the recovery in 1999. Growth in manufacturing output has been modest, attributed largely to lacklustre private consumption. Domestic demand gradually recovered in Hong Kong Special Administrative Region (SAR) as labour market conditions stabilized and equity markets rebounded. The economy of Taiwan Province of China remained strong despite damages from the September earthquake, thanks to surging exports of personal computers and semiconductors as well as reconstruction efforts. Though industrial output was robust, overall domestic demand was rather weak.

Reflecting the recovery in production (particularly manufacturing) and/or job creation programmes, the unemployment rate began to fall in an increasing number of countries in the region. In crisis-hit countries, however, unemployment rates are still well above the pre-crisis levels as layoffs from the ongoing corporate restructuring continue.

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[9] When compared with the same period in 1998, equipment investment in the Republic of Korea increased by almost 12.9 per cent in the first quarter of 1999 and expanded further by 37 per cent in the second quarter.

In the Republic of Korea, the unemployment rate fell fairly rapidly from the peak of 8.6 per cent in February 1999 to 4.4 per cent in November 1999 (seasonally unadjusted).

Inflation in most countries of the region continued to fall through mid-1999 to a significantly lower level than their long-term trend despite higher oil prices. Such an outcome reflects excess capacities, competitive pressures, and, in a number of countries, improved agricultural production and currency appreciation. In Indonesia, annual inflation fell to 0.3 per cent in November 1999 from the 82 per cent peak in September 1998. Inflation is expected to rise moderately in 2000 due to the lagged effects of expansionary policies and risen oil prices, as well as rising capacity utilization and wages. In countries with an appreciating currency, the pressure of imported inflation will be more moderate than elsewhere. In Indonesia, inflation is expected to rise above 5 per cent due largely to the reduction in a number of government price subsidies and the planned increase in civil servants' wages.

Crisis-hit countries adjusted to the massive withdrawal of private foreign finance by sharply curtailing imports. This was reversed rapidly in 1999 along with the easing of balance-of-payments constraints in these countries. As domestic demand picked up, depleted raw materials were replenished, and oil prices surged, import values in U.S. dollar in 1999 have increased in most countries. As a result, current-account surpluses narrowed but remained sizeable. As investor confidence improved, net foreign capital inflows, particularly for mergers and acquisitions (M&A), increased markedly. This, combined with the current-account surplus, contributed to a further build-up of foreign reserves. In the Republic of Korea, for instance, the level of foreign exchange reserves reached $74 billion by the end of 1999, compared with $8.9 billion at the end of 1997.

Macroeconomic policies in virtually all emerging market economies of the region remained expansionary in 1999. In fact, a series of fiscal stimuli, together with adequate liquidity and low interest rates, was a major contributing factor to the recovery. The stabilized exchange rate and inflation allowed these countries to cut interest rates and lower reserve requirements to boost domestic demand in 1999. In many countries, interest rates fell below the pre-crisis level and have already reached the pre-crisis levels.

In Indonesia, for instance, interest rates fell to 12 per cent by the end of 1999 from the peak of 70 per cent in August 1998. Real interest rates, however, are higher than before the crisis and may have to come down further to support the recovery. In Thailand, the central bank lowered its discount rate from 12.5 per cent in early 1999 to a historically low of 4 per cent in July 1999, and has kept it at this level. Credit tightness was eased somewhat as banks were recapitalized. On the other hand, the Republic of Korea may have to tighten monetary policy if inflation accelerates in the second half of 2000. Rising inflows of foreign portfolio capital and the won appreciation relative to the Japanese yen present a policy challenge.

Expansionary fiscal policy has played a key role in reviving domestic demand in these countries through the multiplier effect and, in the cases of crisis-hit countries, in facilitating the structural adjustment. This resulted in large fiscal deficits in most countries of the region. The expansionary policy stance will be maintained in most countries during 2000 to sustain the growth momentum and/or to continue with restructuring and finance social programmes. Indonesia, Malaysia and Thailand are cases in point. However, as the recovery widens, an increasing number of countries will begin to shift their policy towards a more neutral one to address large public debts and/or to avoid overheating. The Korean Government, for instance, will be addressing its fiscal imbalance in 2000, and its fiscal deficit is expected to decline somewhat during the year.

Other countries in the region also maintained an accommodative policy stance in 1999, but some began to tilt their policy towards a more neutral one to tackle fiscal deficits. The Philippines and Singapore are cases in point. But the trend is not uniform across the region. In Taiwan Province of China, for instance, the government budget will remain expansionary in 2000.

The implementation of structural reforms in crisis-hit Asian countries, after a slow start, accelerated in the latter half of 1999. Reforms have focused on overhauling the interrelated structural weaknesses of financial and corporate sectors that were at the root of the Asian crisis. Financial sector reform has been geared mainly to the elimination of non-performing loans, the recapitalization of weak financial institutions, the reorganization of the financial system, and enhancement of transparency and supervisory functions of the financial system. The restructuring of the corporate sector, on the other hand, includes the reduction of excess capacity, corporate debt reduction, good governance, and, in the case of the Republic of Korea, specialization of the large conglomerates and the elimination of cross-loan guarantees among enterprises. However, this issue had not been given much priority until the deflationary effects from the financial crisis began to force the real economy into a deep recession, leading to a dramatic surge in corporate bankruptcies and in non-performing loans. As the links between the financial and corporate sectors became evident, the restructuring of the corporate sector began to receive attention. Progress on this front has been hampered by the lack of funds, ineffective enforcement, and resistance from vested interests. As a result, on balance, financial sector restructuring has advanced faster than corporate sector restructuring. The progress in implementing both tasks has been uneven in speed and scope across the countries, however.

Among the crisis-hit Asian countries, progress in the structural reform is most advanced in the Republic of Korea. By the end of 1999, the major tasks of its first round of reforms had been successfully implemented: 328 non-viable financial institutions, including 10 banks, were merged or liquidated and public funds of 59.7 trillion won (about $45 billion) were injected to rescue weak financial institutions. The overall debt-equity ratio of the top-five conglomerates (excluding Daewoo) had been reduced from 470 per cent in mid-1997 to below 200 per cent. Labour market flexibility had improved. Currently, Korea is about to embark on the second round reform to solidify and broaden the reform further, particularly to the secondary financial market.

Malaysia pushed ahead on its own with the structural reforms of its financial and corporate sectors in a broadly similar pattern as that recommended by the Fund to other crisis-hit countries. The reduction of non-performing loans and the recapitalization of banks have progressed well. By the end of August 1999, total non-performing loans accounted for about 8 per cent of total loans, far below the 30 to 60 per cent in other crisis-hit countries. As in the Republic of Korea, the government played a leading role and progress has been faster than in other two crisis-hit countries. Recently, it has stepped up the reorganization of the banking system. The major part of the formal restructuring is expected to be finished by late 2000. However, the banking system is still plagued by low-quality assets.

Indonesia and Thailand stepped up their restructuring efforts during 1999, but progress remained slow until late in the year. Indonesia had a substantial amount of low-quality corporate debts to many foreign banks (estimated $80 billion), complicating the already difficult task of corporate sector restructuring. About three quarters of this corporate debt still remains unresolved. Structural adjustment in Indonesia has gained renewed momentum in recent months as the new government has taken initiatives to speed up the process. In January 2000, an ambitious banking reform programme was adopted. It stresses four elements; capitalizing all banks to at least 8 per cent capital adequacy rate by 2001, restructuring the banking system at the least public cost, strengthening supervision and governance, and deepening bond and equity markets. This new initiative will accelerate the restructuring process. The resumption of international aid, together with lower interest rates and improving macroeconomic conditions, provide a better setting for the reform in 2000.

The restructuring of financial and corporate sectors in Thailand was left to the private sector and, despite the adoption of amended bankruptcy and foreclosure laws in spring 1999, progress has also been slow, although faster than in Indonesia. By November, the volume of non-performing loans had only gradually declined from its peak in mid-1999. The share remains large – about 39 per cent of total bank loans at the end of 1999.

As the recovery solidifies, complacency may erode the momentum of reform efforts. In spite of a modest turnaround recently, the banking system is still not fully operative in any of the crisis-hit countries. Much needs to be done for these institutions to resume normal lending. In particular, unless the huge bad debt overhang is cleaned up, the ability of banks to effect financial intermediation will continue to be severely constrained. The vulnerability of financial systems in these countries to exogenous shocks will also persist. Intensive restructuring is especially needed in Indonesia. Even in Malaysia, where the share of non-performing loans is much smaller than in other countries, problems remain. Completing reforms to a reasonable extent and building up resilient and competitive financial systems are crucial in reducing the vulnerability of the financial sectors, strengthening the ongoing recovery, and securing a base for sustainable long-term growth.

The recovery in the region will accelerate and become more broad-based. GDP growth (excluding China) is expected to reach a peak of 6 per cent in 2000, settling onto a sustainable growth path in 2001. The latter is likely to be lower than the average pace of

6.4 per cent in the first half of the 1990s because of the reduction in excess production capacity, lower capital inflows, and the expected policy shift towards a more sustainable growth. Growth of individual countries will converge to a narrower band. Following the Republic of Korea, Malaysia and Singapore are expected to exhibit an impressive performance this year. With the smooth transition to the new democratic government and the oil price boom, Indonesia is poised to get on a stable recovery track, in spite of uncertainties related with rising cessationist movements. Prospects for most other countries in the region have also improved. The accommodative macroeconomic policy, the progress made in banking restructuring, improved fundamentals, and the generally favourable external environment are the factors behind the ongoing recovery in most countries.

Strengthening domestic demand and sustaining export growth will continue to lead the recovery in these economies. Domestic demand will play an increasing role in 2000. Particularly private consumption will gain further momentum and assume a major role as the inventory cycle fades. In some crisis-hit countries, the pent-up demand for consumer durables has already begun to emerge as evidenced in the spectacular auto sales in recent months[10]. Private consumption will be supported by rising real disposable income and wealth, recovery in consumer confidence, and low interest rates.[11] Private investment (particularly equipment investment), which has been lagging, will begin to strengthen this year in line with increasing sales and profits, eased credit conditions, improving investor confidence, and the need for upgrading or replacing production facilities. Bank lending will increasingly support investment. Increased domestic demand in turn will set off favourable multiplier effects through trade in goods and services, thus supporting output growth in both industry and service sectors. Surging imports, combined with a larger oil import bill, will narrow current-account surpluses in many economies.

On the supply side, the recovery will continue to be led by the strong upswing in manufacturing sectors, thanks to continued strong external demand and the continuing uptrend in the global electronics cycle, as well as the pent-up local demand and restocking. However, heavy reliance of these economies on narrow lines of products makes them vulnerable to the global industry cycle. In Taiwan Province of China, the construction sector will be strong in 2000. Agricultural and service sectors are expected to steadily improve in most countries. In the Philippines, however, industrial output will pick up slowly. Its agricultural production also faces a possible return of “El Niño” in 2000.

The sustainability of the recovery in Asian emerging economies crucially hinges on several factors. Though the strength of external demand is pivotal in supporting their exports, several risks weigh against favourable conditions for exports. The possibility of further interest rate hikes in the United States and their potential for triggering a slowdown of the United States economy and a major correction in stock markets this year present important risks. Another significant risk is intensifying protectionism as a result

[10] In the case of Thailand, auto sales increased by 62 per cent in January 2000 relative to January 1999.
[11] However, if Indonesia and Thailand engage in serious restructuring and lay off workers, the upturn in private consumption in their countries will temporarily moderate.

of large trade imbalances, particularly in the United States. Also rising primary commodity prices will adversely affect most of these economies.

The return of large foreign capital inflows, particularly long-term, is a key element to the sustainability of higher growth in the region, as they are all resource-constrained economies. Insufficient investment in the past two years needs to be reversed in order to strengthen the competitive position of these economies and expand their growth potential. Thus, the speedy and successful completion of economic restructuring and the restoration of foreign investors' confidence are essential. Compared with two years ago, the vulnerability of these economies to volatile capital flows has been reduced significantly. Remaining fragilities in financial and corporate sectors need to be tackled in full to make them more resilient to renewed financial turmoil.

China: the challenges ahead

The deceleration of economic growth slowed in 1999, and the accompanying deflation in the general price level stopped, owing largely to policies designed to stimulate the economy. Albeit lower than in 1998, GDP registered a 7.1 per cent increase in 1999. The main reason for the slowdown in 1999 was the weak – external and domestic – demand, particularly during the first half of the year. However, the domestic economy noticeably improved during the year, especially the state-owned enterprises (SOEs) and exports. The short-term outlook is positive, with performance of GDP growth around 7 per cent for 2000-2001, assuming continued expansionary macroeconomic policies to boost effective domestic demand and a stable international economic environment. In the longer run, however, some major events will have a significant impact on Chinese economic prospects, including the country's entry into the World Trade Organization (WTO) and the subsequent structural adjustments; and the continued reform of the SOEs.

China started 1999 with a general worsening economic situation. Exports dropped by about 10 per cent in the first half of 1999, relative to the first half of 1998, due to weak global demand, especially in Asia. Private consumption demand stagnated due to large layoffs by the SOEs which led to a continued decline in prices. However, by mid-1999 economic conditions started to improve, including a significant turnaround of exports. Prices stabilized and started to rise by the beginning of 2000 after a continuous decline for more than two years. Nevertheless, domestic demand remains weak. Total fixed investment grew only by 5 per cent in 1999, the lowest in a decade, as investment growth in the state sector decelerated sharply from 23 per cent in the first quarter of 1999 to 4 per cent in the fourth quarter.

The external balance remained positive, although the current-account surplus dropped by $10 billion in 1999 due to strong import growth and relatively weak export performance[12]. Foreign direct investment at $40 billion contracted by 11 per cent.

[12] Import growth registered 18 per cent in 1999, but a large part was on account of a successful crackdown on smuggling activities, as reflected by the almost doubling in tariff revenues.

Foreign reserves reached $155 billion by the end of 1999. The yuan/ U.S. dollar exchange rate remained stable; but the yuan devalued in real terms due to domestic deflation. Some commentators have recently proposed to widen the band of the managed floating exchange regime. None the less, pressures for devaluing the yuan have recently subsided due to the real devaluation that took place as well as the fact that the currencies of Asian crisis-hit countries – some of China's main competitors – have appreciated to some degree.

Since the beginning of 1999, economic policies have increasingly been focused on efforts to further bolster domestic demand. New measures were adopted. Monetary policy has become more accommodative. In mid-1999, the central bank of China lowered reserve requirements and made its seventh and most aggressive reduction of interest rates in three years. The interest rate for one-year deposits now stands at 2.25 per cent, substantially lower than the peak of 11 per cent in 1996. Owing to the deflation, the difference in real terms is much smaller as current real interest rates are only about 1 to 2 per cent lower than in 1996.

Similarly, fiscal spending has accelerated and has been financed by issuing bonds in the domestic market. The Government has raised public spending on wages, pensions and unemployment benefits by an additional 60 billion yuan to stimulate private consumption demand more directly. As a result, the budget deficit for 1999 reached 180 billion yuan, about 2 per cent of GDP. Additionally, a new bill has been passed to tax interest income from saving deposits in order to reduce the high saving rate and encourage more consumption.

Macroeconomic policies are expected to remain expansionary. The newly released budget for 2000 features an increase of expenditure by 12 per cent and projects a deficit of 230 billion yuan[13]. On the monetary front, room for further lowering interest rates seems to be limited.

As a result of the reforms implemented to date, the financial situation of the SOEs has recently improved. The total loss of the sector declined by 16 per cent in 1999, and, especially some large and medium-size enterprises in traditional industries, such as textiles, construction materials, and railroad transportation, reported profits. However, the scale of redundant employees, the problem of high indebtedness, and the heavy burden of providing social services remain serious. The SOEs laid off some 5.6 million workers in 1999, which led to the deterioration of consumer confidence and weak consumption demand.

By the end of 1999, the authorities made a considerable adjustment in their strategy for reforming the SOEs. First, reforms will be implemented over a longer period. They are now planned to be completed by 2010. Second, SOEs will concentrate operations in just a few sectors of the economy related to the so-called "lifeline of the national economy." A large number of them will be reorganized in various types of

[13] There was an accounting change in budget 2000 by including the interest payment as current spending. Otherwise the planned deficit would have been 155 billion yuan.

ownership-sharing arrangements. Third, debt-to-equity swaps will be implemented to reduce their indebtedness, which will also improve the balance sheets of state-owned banks[14]. Fourth, SOEs will be gradually released from their functions as providers of social services. These measures, including training programmes for laid-off workers, are expected to alleviate the problems of the SOEs in the long run.

China's entry into the WTO presents a major challenge as well as an opportunity for sustaining fast economic growth. Following the agreement with the United States in November 1999 on the terms for China's proposed accession to the WTO, China has reached bilateral agreements with a large number of other WTO members (altogether 37 members require bilateral negotiations with China).

According to these agreements, China will reduce both tariff and non-tariff barriers for agricultural and industrial products, as well as remove export subsidies. It will also open more sectors of its economy, especially services, to foreign companies and investors. Foreign companies will be allowed to operate a full range of services in the travel and tourism industry. They will also be allowed to engage in transport and distribution activities. Full foreign ownership will be allowed in the banking sector after 2005. In turn, China will be entitled to all rights of a WTO member, including permanent Most-Favoured Nation (MFN) treatment. If all the legal and protocol procedures proceed well, as expected, China is likely to become a full member of the WTO later this year.

The impact of these agreements will be deep and widespread. Tariff reduction is likely to benefit consumers and bring welfare gains to the economy at large through more efficient reallocation of resources. The opening of economic sectors to foreign companies and investors is expected to attract foreign investment and new technology to the country. On the other hand, many sectors in China, such as agriculture, automobile production, telecommunication, and banking will be exposed to continued competition. This may lead to losses and layoffs by some of these sectors. However, the direct effects from the trade liberalization measures, in terms of gains and losses across sectors, will be modest.[15] The significant impact of the WTO membership lies in the need for ongoing economic reforms in both economic and financial sectors and for domestic legislation, regulatory measures and new institutions supporting the systematic integration of China into the global market.

China's entry into the WTO is also likely to have a significant impact on the world economy, especially its neighbours. Trade liberalization in China implies that existing patterns of comparative advantages among developing and developed economies

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[14]Four asset management corporations (AMCs) have been established to handle the debt-equity swap programme. The debt to be swapped amounts to one half of the outstanding loans of the state-owned commercial banks. The programme involves two linked transactions: the swap of selected enterprise debt into equity to be held by the AMCs and the purchase of the swapped debt from banks by the AMCs. As a major shareholder, the AMCs will supervise and participate in restructuring the selected enterprises. The programme has already made remarkable progress so far.

[15] Li, Xuesong and Arjan Lejour, *Impact of China's Access to WTO – a Dynamic CGE Analysis* (Joint Study Programme by the Central Planning Bureau of Netherlands and the Chinese Academy of Social Sciences), 1999, memo.

are likely to be redefined. While some countries will be facing increased competition from China in some current lines of export production, all countries will be gaining access to imports at lower real cost in terms of domestic production forgone. Given its potential market size, a more efficient and open Chinese economy should on balance bring considerable benefits to the global economy over the longer run, both in the form of enhanced specialization, hence efficiency, in world production and greater diversification, hence welfare, in consumption.

South Asia: mixed performances

Economic performance of South Asian countries, which had escaped the major negative impacts from the Asian crisis, was rather mixed in 1999. Growth in India, Nepal and Pakistan was somewhat higher than in 1999, but it slowed marginally in Bangladesh and Sri Lanka. Economic growth picked up in most countries during the second half of 1999. This gradual uptrend is expected to continue in the near-term. Growth in the region is estimated to have reached 5.6 per cent in 1999 and, barring exogenous shocks, is expected to increase by 6.1 and 6.4 per cent in 2000 and 2001, respectively.

The mixed growth performance in 1999 mainly reflects differences in domestic factors, particularly climatic conditions, political circumstances, policy and structural problems. Favourable weather led to increased agricultural output, which supported GDP growth in a number of countries. On the other hand, pervasive political uncertainties in most countries in the region have impaired the effectiveness of government policies, increased fiscal expenditures, and discouraged economic activity. Accordingly, reforms to address structural problems and macroeconomic adjustment policies often have been delayed, interrupted, or enacted with difficulties.

During the year, the region faced improved external conditions as international demand picked up and the currencies moved in opposite directions from those of the East Asian crisis-hit countries, thus bolstering the region’s competitive position. Additionally, prices of their non-oil primary commodity exports, workers remittances from West Asia and tourist visits have recently begun to increase. For India and Pakistan, the negative effects of economic sanctions enacted in 1999 have mostly faded.

Growth accelerated in India, led mainly by rising domestic demand (increased fixed capital formation in the first place) and industrial output. Exports also recovered as the U.S. dollar export value rebounded strongly by 13 per cent in 1999 after the contraction recorded the previous year. The recovery was fairly broad in the industrial sector, while agricultural output growth was strong and the service sector was supported by rising IT-related demand and tourism. In Nepal, growth was led by exports and manufacturing as well as by the bumper crop late in the year. In Bangladesh, recovery from the severe flood damage in July-September 1998 has been faster than expected led by two bumper crops. However, growth declined in 1999 due mainly to the weakness in exports and manufacturing output.

The overall performance of Pakistan and Sri Lanka remained poor in 1999. Pakistan's economy continued to be hampered by political uncertainty, acute balance-of-payments problems, the lagged effects of the poor harvest in late 1998, and the restrictive macroeconomic policy. None the less growth accelerated in 1999 due to the bumper crop late in the year. Growth in Sri Lanka continued to slow down in the first half of 1999. However, a modest recovery occurred in the second half of the year, led by an upturn in the service sector, strong export growth, and the external impetus given to export-oriented industries.

Inflation, which had risen sharply during 1998 in most countries, fell substantially to single-digit levels in the first half of 1999 mainly as a result of the recovery in food production,[16] low commodity prices, and sluggish domestic demand. In view of subdued inflation, a stabilized exchange rate, and the need to stimulate growth and/or reduce the debt-service burden, monetary policy was eased in an increasing number of countries. Most countries lowered interest rates and the cash reserve ratio (CRR) last year.

Inflation in India, Pakistan and Sri Lanka, however, is expected to pick up moderately in 2000 year in line with rising domestic demand, higher oil prices, and a one-off increase in utility rates and the sales tax. They are anticipated to remain below their trend level, however, on account of policy prudence, adequate supplies of agricultural products, and increasing competition. In Bangladesh and Nepal, on the other hand, inflation will continue to ease.

Most countries of the region continue to face unsustainably large fiscal deficits. If not addressed, these will fuel inflation, restrain private investment, and hamper growth in the longer run. These countries suffer from severe tax collection problems, given the size of the informal economy and lack of good governance. Fiscal consolidation continues to remain a critical policy issue in the region, but especially in India and Sri Lanka given the large fiscal deficits in 1999.

In India, the fiscal deficit widened to 6.5 per cent of GDP in fiscal 1998/1999 (ending March), well above its target 4.5 per cent, due largely to increased government spending and delays in the privatization programme. Interest payments on the public debt alone absorbed about half of government revenue. The deficit in 1999/2000 is estimated to have narrowed somewhat but remained above 5 per cent of GDP. A major fiscal reform is envisaged for fiscal 2000/2001, but the new budget foreshadows increased defence spending[17] (by 30 per cent) and fails to cut subsidies and other expenditures deep enough. Thus, the deficit is not expected to decline much in the near future.

Sri Lanka made some progress in improving revenue collection and controlling defence spending in the recent past. As a result, its deficit declined only modestly due to low privatization proceeds, the high cost of civil war, and rigidities in spending such as the large interest payments on public debt and civil servants' payroll. Conversely,

[16] Food constitutes the major share in the consumer basket; in the case of Bangladesh, for example, its share is 60 per cent.
[17] Reflecting the hightened tension with Pakistan since the Kargil crisis.

Pakistan kept its fiscal policy tight and has been somewhat successful in reducing its fiscal deficit further to 4.3 per cent of GDP in fiscal 1998/1999 (ending June) from 5.6 per cent in the previous year. The public debt service burden, amounting to two thirds of revenues in 1999, remains unsustainably large, however.

Growth in the region in 2000 is expected to be modestly higher and more broad-based than in 1999. The return of normal weather, favourable external conditions, relaxed monetary policy, and, in a number of countries, improved political stability and renewed reform efforts will be the main driving forces. Domestic demand in most South Asian countries will be supported by rising income, easy monetary policy, and increasing confidence. Agricultural output is also expected to be favourable in 2000. Increased rural income in a number countries, including India, Nepal and Pakistan, will support private consumption. The upturn in domestic demand, together with rising exports, will boost industrial output. In India, surging stock prices also seem to have a tangible positive wealth effect. However, pervasive large fiscal deficits and political uncertainties continue to restrain private investment.

India is likely to be the best performer in the region in 2000, given the pervasive signals of a strengthening recovery. With the strong commitment of the new government coalition to eliminate structural obstacles to growth and the easing monetary policy, India's economy appears to be on the road to a higher sustainable growth path. Similarly, strong growth is expected in Nepal in 2000 due to the lagged effects of the 1999 bumper crop. On the other hand, growth is not expected to accelerate in Bangladesh in 2000. Exports have been weak and the strong recovery in the agricultural sector has not yet led to buoyant recovery in industry and service sectors. Problems in infrastructure, political instability, structural problems, and the slow pace of reform continue to constrain economic activity.

Economic prospects for Pakistan have improved somewhat in recent months due mainly to a bumper cotton harvest late in 1999, which will support exports and industrial output, and reduced political uncertainty. The expected resumption of financial assistance by the IMF, together with increasing exports, will ease its tight balance-of-payments situation somewhat. None the less, large debt-servicing obligations falling due by year-end will maintain pressure on the country's external position.

Western Asia: increased windfall revenue without economic growth

Despite increased oil prices, economic growth in Western Asia decelerated sharply in 1999 to 0.3 per cent from 3.7 per cent in 1998. With the exception of Iraq, oil-exporting countries in the region reduced their oil production as per the OPEC quota policy agreed in March 1999. Meanwhile, agricultural production declined as a severe drought affected major producers of the region (Iran, Iraq, Jordan and Syria) in 1999. In addition to the drought, oil-importing countries were confronted with declining private and official unrequited transfers, reduced trade and transit flows, and depressed tourism activities. A severe earthquake devastated Turkey and caused the economy to contract sharply in 1999.

Internal and external imbalances improved in 1999. All oil-exporting countries had framed their 1999 budget under the assumption of lower oil prices, and tightened their fiscal policies further. As oil prices rebounded during 1999 these countries enjoyed an unexpected windfall. Yet they maintained their fiscal stance. On the expenditure side, capital spending was drastically cut as infrastructural, industrial and agricultural projects were frozen, delayed or simply canceled. Current spending, aid grants and soft loans were reduced, although moderately. Recruitment of civil servants continued to be frozen and money wages rose only slightly. Consumer subsidies were reduced, though only marginally. As in the past, defence and security outlays have proved to be difficult to curtail. Additionally, no attempt was made in reforming the huge welfare system as the issue remains politically highly sensitive. Notwithstanding this, some countries used the extra revenues to address some long-standing issues confronting their public finances. In Iran, for example, the extra revenues contributed to financing the external debt service and helped in avoiding debt rescheduling. But more importantly, most countries began to clear their arrears with local private contractors in late 1999, thus giving a boost to the depressed private sector.

On the revenue front, no new initiative was launched in 1999 although import duties, some fees and user charges on utilities were raised. The corporate income tax rate was also raised in some countries. In Oman, for instance, it increased from 7.5 per cent to 12 per cent in 1999. These efforts coupled with the unexpected windfall revenue helped in releasing pressure on public finances.

With the exception of Iran and Iraq, budget deficits were dramatically reduced in most oil-exporting countries. For instance, fiscal deficits in Saudi Arabia improved from 9.4 per cent of GDP in 1998 to 4 per cent in 1999. The improvement is more pronounced for the United Arab Emirates, where budget deficits declined from 17 per cent of GDP in 1998 to an estimated 5 per cent in 1999. Fiscal deficits in most oil-exporting countries were financed with development bonds and treasury bills sold to domestic financial institutions such as state pension, insurance and social security, and commercial banks. Most oil-importing countries also conducted tight fiscal policy. Current capital spending declined in 1999 except for Turkey due to the reconstruction efforts in the aftermath of the August 1999 earthquake. Duties on some imported products such as foodstuffs, tobacco, clothing, perfumes and flowers increased. Income and corporate tax rates also rose. With the exception of Lebanon and Turkey, budget deficits as ratio to GDP improved sharply in the oil-importing countries.

External imbalance improved as well. Although the volume of oil exports declined, the rise in oil prices boosted export revenues. Petrochemical exports also increased in view of the upturn in South-east Asian markets. In oil-exporting countries import demand was subdued mainly due to restrictive fiscal policy. Current account deficits improved sharply in most oil-exporting countries. Conversely, oil-importing countries faced deteriorating terms of trade as non-oil commodity prices remained depressed in 1999. Nevertheless, most countries managed to increase their export earnings slightly, while imports were drastically cut reflecting the fiscal consolidation pursued by these countries. As a result, trade deficits have narrowed in 1999. But, current account deficits widened in most countries due to the heavy debt-service burden and reduced inward workers' remittances, grants and soft loans.

Foreign-exchange reserves sharply rose in most oil-exporting countries in 1999. Most currencies appreciated in view of their U.S.dollar peg. Monetary authorities maintained a positive interest rate differential with regard to United States interest rates. The tight monetary policy helped to reduce inflation and, with the exception of Iran and Iraq, most countries have been experiencing low inflation. But, inflationary pressures picked up somewhat in 1999 mostly due to the partial removal of subsidies on utilities, health care and other public services. Nevertheless, inflation remained subdued with some countries enjoying annual inflation rates below 2 per cent. In oil-importing countries, restrictive monetary and fiscal policies helped to keep inflation low in spite of rising oil prices. Israel tightened monetary policy in early 1999 to contain inflationary pressures. As a result, inflation decreased to 1.3 per cent, the lowest in the last three decades, and well below the government's target of 4 per cent in 1999. Inflation in Turkey, albeit lower than in 1998, remained high at 65 per cent.

Unemployment continued to rise, affecting younger workers in particular. In most oil-exporting countries, the indigenization of the labour force has been high on the policy agenda for some time and was extended in 1999. Unemployment, however, continued to be high in these countries.

Among the large oil-importing countries of the region, the Turkish economy suffered a severe recession in 1999. Prior to the earthquake, the Turkish economy had already been hard hit by the Asian and Russian financial crises. One fifth of the country's trade in recent years has been with Russia, and Turkish companies have been very active in Russia. Because of the Russian crisis exports dropped sharply, while domestic industrial production suffered from the stiff competition from cheaper Asian products. To boost economic growth and address the problem of inflation, at the beginning of 1999 Turkey introduced reforms in the banking sector, the social security system, and the agricultural sector, and privatized some public enterprises. But the earthquake derailed these initiatives as over 15,000 lives were lost and there was extensive damage to the country's industrial base. GDP declined by 6.4 per cent in 1999.

The region's economic prospects for 2000 are positive. Oil production will increase as countries respond to the new OPEC agreement, while oil prices will be on average 40 per cent higher than in 1999. Non-oil commodity prices are also expected to recover somewhat. Many large-scale investment projects that were frozen during 1998-1999 due to the oil price slump will be reactivated thanks to higher oil revenues. Recovering export markets in South-east Asia are also providing a boost to some countries in the region. Agricultural output might soar as major producers recover from the devastating drought. Increased workers' remittances, together with official transfers and expanded tourism activities, may well give a boost to oil-importing countries of the region. In addition, reconstruction efforts in Lebanon and in Turkey might also help provide a strong stimulus to the region's economic growth. As a result, growth is expected to accelerate to 3.9 per cent in 2000.

Latin America and the Caribbean: economic recovery under way

Following the slowdown in 1998, GDP growth stagnated in Latin America and the Caribbean in 1999. There were, however, sharp contrasts: while Mexico and several Central American and Caribbean economies expanded at moderate to high rates, most South American countries experienced severe recessions. Contrary to initial expectations, the regional economic crisis proved to be short-lived, and by the end of 1999 there were clear signs of a turnaround. Nevertheless, out of the 24 economies monitored by UN/DESA, 12 failed to register positive per capita GDP growth during the year. The region is expected to rebound strongly in 2000 and further accelerate in 2001.

Several negative shocks affected the region during the period 1998-1999. Adverse weather conditions and natural disasters implied high costs in terms of human lives, physical infrastructure, and lost crops. The collapse of prices for non-fuel commodities observed in 1998 continued for most of 1999, and it was only towards the end of the year that prices of minerals and metals began to reverse. On balance, the terms-of-trade for many economies of the region deteriorated further in 1999. Foreign finance became increasingly unavailable. Private capital inflows to the region, except foreign direct investment, which had contracted in the aftermath of the Russian crisis, became even scarcer and costlier after the devaluation of the Brazilian real in January 1999.

Latin American authorities took tough adjustment measures to address such adverse shocks. Initially, monetary policy was tightened to preserve existing exchange-rate arrangements and maintain price stability. A firm grip was kept on fiscal policy in most countries, but none the less the fiscal gap widened. Higher interest rates at the end of 1998 and beginning 1999 constrained domestic demand and led to an economic slowdown in some countries and accentuated or brought about a recession in several others, particularly in South America. Interest-rate adjustments were insufficient to sustain the exchange-rate regimes, and so several countries were forced to abandon their crawling bands and devalue their currencies. The collapse of regional markets (especially Mercosur) and lower international demand for commodities exported by the region compounded the problem. In the second half of 1999, however, a more enabling external economic environment created the conditions for a gradual and cautious relaxation of monetary policy. Fiscal austerity was also relaxed in a few countries and the region slowly started to recover.

In contrast to the East Asian crisis-hit countries, financial markets in Latin America did not melt down. Implementation of reforms, including improved banking regulation and supervision, and the increasing presence of foreign financial institutions helped to avoid an acute crisis in the sector; Ecuador was the notable exception. The deep recession in many countries, however, weakened the domestic banking systems and reduced the availability of credit, especially for small and medium-sized enterprises.

The better-than-expected, if still dismal, performance of the region was due to the surprising upturn of Brazil, which accounts for over 40 per cent of the region's output. Expectations of a sharp contraction in Brazil's GDP did not materialize. Output grew by 0.8 per cent in 1999, supported by a vigorous rise in agricultural production and a small expansion of services, while industry contracted slightly. By the end of 1999, signs of a broadening recovery were present as manufacturing stopped its decline and resumed growth. None the less, the persistence of weak economic conditions, the decreased demand in Brazil, and the devaluation of the real had negative impacts on the country's regional trading partners. GDP contracted in Argentina and Uruguay.

Economic performance was rather poor in other South American countries as well. Chile, which had been growing uninterruptedly since 1984, saw its GDP contract by 1 per cent in 1999. Recession was particularly acute in Ecuador due to the severe external shocks suffered in 1998, a political crisis that hampered economic reforms, and a debt crisis that emerged in the second half of 1999. In Colombia and Venezuela, domestic political difficulties exacerbated economic problems due to the flight of capital and delays in investment.

In contrast, economic performance in the northern part of the region was in general more positive. In Mexico, which grew faster than anticipated, growth accelerated at the end of the year with all the economic sectors benefiting from the surge in domestic demand. During 1999, Mexico continued to take advantage of its increasing integration with the United States and the strength of that country's economy. The latter also had a positive influence in most of the Caribbean and Central America. The majority of the economies in this area registered moderate to strong growth in 1999. Jamaica continued its recession while Honduras was still coming to grips with the aftermath of hurricane Mitch.

Decreasing economic growth in many countries in the region was reflected in deteriorating employment conditions. The increase of urban unemployment was especially acute in Chile, Colombia, Ecuador and Venezuela. Urban unemployment increased in Argentina and Uruguay as well, while it remained rather high (above 13 per cent) in countries such as Jamaica, Panama and Trinidad and Tobago.

At the regional level, inflation reached an annual average rate of 7.5 per cent in 1999 – the lowest in decades. Except for a few countries, inflation fell as the price-dampening effect of weaker domestic demand dominated the cost-push pressures emanating from depreciating exchange rates. In Brazil in particular, in spite of an annual average devaluation of the currency of over 30 per cent, inflation remained within the target range established by the authorities. The Brazilian experience showcases the transformation that has taken place in some economies of the region. Economic reforms implemented in recent years and modernization of production processes combined with more disciplined financial and monetary policies seem to have broken the chronic inflationary inertia, especially in the larger economies, that was earlier typical for the region. At the end of 1999, inflationary pressures appeared in some countries. With the expected economic recovery, a small increase in the average inflation cannot be ruled out in 2000. Accordingly, central banks are expected to tighten their monetary policy somewhat. Chile and Colombia, for instance, started to increase interest rates in early 2000 to offset the monetary stimulus of 1999. In Brazil, however, interest rates were reduced in the first quarter of 2000 and are expected to experience modest further falls by the end of 2000, in line with a slow downward trend in the rate of inflation.

The region's trade deficit fell due to the sharp reduction in imports, especially in countries in recession. Despite the devaluation of some currencies, exports performed poorly in 1999 due to lower prices, weak international demand, and the collapse of intraregional trade in South America. The adjustment to the negative external shocks was reflected in the contraction of the current account deficit from 4.5 per cent of the regional GDP in 1998 to around 3.1 per cent in 1999.

The region suffered a sharp reduction of private lending and portfolio investment in 1999. Although spreads for Latin American sovereign bonds increased significantly following the Brazilian crisis in early 1999, access to international capital markets was restored relatively quickly. With the improvement of investors' sentiment, sovereign spreads gradually moderated, narrowing further at the end of 1999, after they had picked up with Ecuador's default on its Brady bond debt in September. In spite of the credit crunch affecting the region, FDI was strong in 1999 due mainly to privatization and foreign mergers with local companies. This inflow of less volatile capital provided support to the region's balance of payment and may help to solidify the foundations for future growth.

After the difficulties of the last two years, prospects for the main Latin American countries in 2000 are positive, with countries such as Brazil, Chile and Mexico growing by at least 3.5 per cent. Argentina, Colombia and Venezuela are back on a growth track but their recovery is expected to be slower. The region's GDP is expected to register a rate of growth close to 4 per cent in 2000 and a higher rate in 2001.

Stronger and more balanced growth in the international economy is likely to push the demand for Latin American exports. The upswing in economic activity in the Asian economies in particular is expected to stimulate the demand for most Latin American commodities. On the other hand, as the United States economy slows down towards the end of 2000, exports of manufactures by Mexico but also by other Central American and Caribbean countries may be adversely affected.

International capital markets are also expected to recover somewhat. As investor confidence strengthens, the high spreads charged for the region may decline further, thus improving credit conditions. Mexico's international credit rating was upgraded in early 2000. This is likely to contribute to narrowing bond spreads for other Latin American countries, as high-return markets, such as Argentina and Brazil, are likely to become again destinations of funds allocated to investments in emerging markets. As growth resumes and confidence returns, investment is expected to grow, especially in several countries of South America. Some projects have already been announced in sectors such as mining, energy, transport infrastructure and telecommunications. In the case of Mexico, FDI is likely to increase in the short to medium-term due to the free-trade agreement signed with the European Union, which will come into force in July 2000.

In general, however, domestic demand in Latin America is expected to pick up slowly, as in several countries it remains depressed by the credit squeeze and high level of unemployment. Moreover, fiscal retrenchment is likely to constrain the pace of recovery of some Latin American economies in 2000 such as Argentina and Colombia.

For some countries, weak and/or troubled financial markets are likely to be a major obstacle to faster growth. This is the case of Colombia, Peru, Venezuela and especially Ecuador. A very gradual recovery of the banking sector is expected, however, due to improving economic conditions and the measures and reforms that authorities are expected to implement. Another source of vulnerability lies in the high current-account deficits and external indebtedness of several countries. In particular, Ecuador after its default needs to restructure its external debt as a preliminary to regaining access to foreign capital.

Notwithstanding the optimistic forecast, a number of risks remain. Significant hikes in global interest rates and instability in the international economic environment can adversely affect the nascent recovery in the region, given its vulnerability to external shocks. On the domestic front, political uncertainties due to electoral processes, institutional weaknesses, unresolved internal conflicts and civic unrest, and poverty and income inequality might slow economic growth and further delay progress with structural reform.