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DEVELOPED COUNTRIES

North America

1. The economy of the United States has sustained an expansion for more than eight years, the longest peacetime growth without a recession. Although the strong pace of 4 per cent per annum for three years in a row will be difficult to extend for another year, GDP is still expected to grow by a 3.5 per cent in 1999. However, a noticeable slowdown is forecast for 2000. The major policy concern will focus on how to avoid a hard landing in the years to come.

2. Many factors, which may themselves be interrelated, have nurtured the expansion: sound macroeconomic policy; significant technological innovation, especially in the area of information technology, where the United States has the leading edge; and increasing global integration, in which, for the United States, the benefits have far outweighed the costs.

3. The international financial crises in the last two years and the subsequent large downward adjustments in the real economy in the rest of the world have had some certain adverse effects on the economy of the United States: a decline in exports, a drop in corporate profits, increased gyrations in stock markets, and a sudden deterioration in credit conditions, albeit for only a few months in the fall of 1998. However, the international financial crises have also generated some benefits for the United States economy. As the financial markets in the United States are much deeper and more liquid than those of other countries, the so-called "flight to quality" effect during the crises redirected a large amount of foreign capital from emerging markets to the United States, the abundant capital and lower interest rates further fueling the already strong domestic demand. Meanwhile, the significant decline in international commodity prices, leading to a favourable change in the country's terms of trade, has brought welfare benefits to consumers and producers. In all, the United States has gained more than it has lost from the international crises, at least in the short run.

4. Contributing to the strong GDP growth have been both robust private consumption and vigorous business investment. But both are expected to moderate in 1999-2000. Consumer spending rose by about 5 per cent in 1998, supported by a strong labour market and by the wealth effects accruing from the unprecedented surge of the stock market in recent years. Spending has been well

above the increase in disposable personal income. As a result, the measured saving rate has recently dropped near to zero. Given the already tight labour market and the high valuation of the stock market, the current pace of consumption cannot be sustained indefinitely. The pace of consumption will have to drop relative to the pace of growth in disposable incomes at some point, thus putting downward pressure on consumption demand and possibly weakening corporate profit expectations.

5. Business equipment investment has been growing at a double-digit annual rate for five years, boosted by the relatively low user cost of capital and the rapid pace of technological progress, especially in the computer-related industry. In contrast, investment in business structures has been flat. The wave in information technology does not seem to have ended, so high growth in business investment is likely to continue. However, the recent decline in capacity utilization and the increasing pressure on corporate profit margins are likely to curb growth of new capital investment.

6. Along with the vigorous economic growth, the labour market has also been operating at record levels. The unemployment rate of 4.5 per cent is a 30-year low and real wages, which stagnated in the early years of this expansion, have recently been on the rise. Nevertheless, some indicators suggest a possible over-tight labour market. The job-search cycle has much shortened; especially smaller business undertakings have been encountering problems in finding workers; and labour's bargaining power is increasing.

7. In spite of the tight labour market, inflation has been trending lower in recent years with the increase in the CPI falling to 1.6 per cent in 1998. A significant drop in import prices, a flexible economic structure, and sound macroeconomic policy have all contributed to holding inflation down. However, the latest changes in compiling official price indices have also lowered the measured magnitude. The current low inflation has also been reinforced by a continued slide in inflation expectations. The outlook for inflation in the near term remains benign.

8. The large and increasing external deficit, which reached \$240 billion in 1998, is raising some concern. Many factors have contributed to this rising external deficit, including declining exports, resulting from weakening demand from the rest of the world, especially Asia; strong appreciation of the dollar against other currencies; a favourable change in the terms of trade as a result of the decline in international commodity prices; and strong domestic demand for imports. Seen from

another perspective, the large deficit shows that rapid investment growth has been partly financed by the rise in capital inflows. The continuation of the post-crisis adjustments in external imbalances in many developing economies implies that the deficit is likely to extend further as strong import demand from the United States will help these economies with their economic recovery. However, the counter part — further foreign capital flows to the United States — will aggravate the still restrained external-financing conditions in emerging economies.

9. Throughout this expansion, the United States has used monetary policy actively. The Federal Reserve Board has frequently altered interest-rate targets in an attempt to fine-tune the economy in order to meet the dual goals of price stability and full employment. The adjustments in monetary policy also reflect to a certain extent the increasing difficulties in judging the state of the economy. For example, the advances in technology in recent years have yielded substantial productivity gains, and this may have lifted the potential growth rate well above the conventionally estimated rate of 2.5 per cent to perhaps 3 to 3.5 per cent. If so, the current high growth rate may not pose as big an inflationary threat as traditionally perceived. Meanwhile, the sharp contrast between a weakening world economy and a booming United States economy has also created a policy dilemma as United States monetary policy directly affects liquidity for the world economy.

10. In late summer and fall of 1998, the Fed shifted the main focus of policy concerns from fighting potential inflation to forestalling a weakening economy in the near term. Concerned about the “unusual strains” in financial markets and a possible credit crunch that could lead the economy to a sharp downturn, the Fed cut interest rates three times, with a cumulative 75 basis points reduction in the Federal fund rate. The rate is now at 4.75 per cent, the lowest in four years.

11. More recently, with financial conditions improving and stock markets reaching all-time highs in April 1999, the Fed may have once again moved its concern toward the possible inflationary implications of continued tight labour markets. It has therefore been considering, as the financial disturbances abate, “rolling back” the easing enacted in the fall of 1998. At the same time, the Fed recognizes that there are significant upside and downside risks so that it must be ready to move quickly in either direction.

12. In the baseline forecast, monetary policy in the United States is assumed to remain unchanged, with the Federal fund rate staying at 4.75 per cent for 1999-2000. For its part, the market has already factored in some of the worries about a resurgence of inflation by pushing up the yield on the benchmark 30-year Treasury bonds to 5.5 per cent from the 5 per cent at the beginning of 1999.

13. Reducing the Federal Government deficit mainly through spending cuts, has been the centrepiece of fiscal policy in the United States for the last decade. As a result, the budget balance has turned from a deficit of about 5 per cent of GDP into a surplus (about 1 per cent of GDP in 1998), for the first time in 40 years.

14. While the United States Administration has proposed using the surplus to strengthen and protect social security, various policy makers and other observers have proposed tax cuts or a reduction of the existing debt. Meanwhile, the sustainability of the surplus has been questioned. A large increase in government revenue in the last couple of years stemmed from unexpected tax revenues levied on extraordinary capital gains. These gains may end if the stock-market upturn of the last few years is not sustained. In the short run, fiscal policy is expected to remain under moderate restraint, with expenditure continuing to grow more slowly than GDP and no major tax cut. While the budget surplus is expected to continue for the next few years, the automatic stabilizers in the government budget will continue to be an important policy instrument for moderating fluctuations in the economy.

15. Stock prices in the United States have experienced a remarkable appreciation in the last few years. As measured by the S&P 500 index, stock prices have risen more than 25 per cent each year since 1995, compared with an average annual growth rate of 12 per cent for the century. With major market indices at all-time highs in April 1999, the valuation of the stock market seems to be excessive by any historical yardstick. First, the S&P 500-dividend yield never fell below 3 per cent from 1926 to 1992, but since 1993, especially since mid-1995, it has fallen significantly below 3 per cent and currently stands at 1.23 per cent. For the yield to return to 3 per cent, the S&P 500 index has to fall by about 60 per cent. Second, the price-earnings (P/E) ratio for the S&P 500 is at 34, using earnings of the last 12 months, or at 25, using expected earnings for the next 12 months. Historically, the average ratio has been about 14. For the P/E to revert to its mean value, the index has to fall by 45 to 60 per cent.

16. It may be argued that current nominal interest rates are very low and that therefore there is no reason to return to historical dividend or price-earning ratios. Even taking into account the low prevailing interest rates, one estimate suggests that prices of stocks are still overvalued by about 30 per cent.
17. The complexity of stock markets cannot be completely measured by these simple approaches. For those who believe in “efficient markets,” stock prices discount all information instantaneously and are therefore never over- or undervalued. Moreover, even if stock prices were overvalued, markets do not necessarily collapse immediately. It may take a long time for these indicators to return to their historical mean values. Nevertheless, it is legitimate to inquire into the impact on the economy of a collapse in stock-market prices that is much deeper and longer lasting than was experienced in the fall of 1998.
18. The impact on the real economy, such as on household and business spending, will pass through several channels, including mainly wealth effects, interest rates, and credit conditions. Wealth effects are based on the life-cycle theory of consumption, which implies that personal consumption depends not only on income, but also on accumulated wealth: a change in personal net worth will affect consumption today and in the future. According to some empirical studies, a change of \$1 in stock-market wealth changes personal consumption by 2 to 4 cents. This wealth effect will last for several years, but most of the adjustment will occur in the first year. Given today’s market capitalization, a decline of 10 per cent in stock prices would translate into a decrease of 0.5 per cent in personal consumption, which is equivalent to 0.3 per cent in GDP, owing to the wealth effect. However, other effects should also be taken into account. According to some simulations, a drop of stock prices by 40 per cent will lead to a decline of 1.5 per cent in GDP for the United States, with 1.2 per cent due to the wealth effect and 0.3 per cent due to other effects.
19. Meanwhile, a deterioration in financial-market conditions would depress business investment. One of the factors that have been spurring the remarkable pace of business investment in recent years has been the favourable terms for external funding. A sudden increase in risk aversion can change this condition abruptly, raising borrowing costs and limiting borrowing ability, as witnessed for a short period last fall.
20. Similar to the United States, the Canadian economy is growing at a stronger-than-expected rate. After a weak pace in the middle of 1998, Canada’s GDP expanded at an annualized rate of 4.6 per cent for the fourth quarter (equivalent to 6.2 per cent if the same chain-index price methodology of the United States were used). This strength is likely to continue, with GDP growing by 3.3 per cent in 1999.
21. Strong exports and business investment in equipment are driving the economy. But consumption has been weak, partly because of the lagged depressing effects from last year’s financial turmoil, which caused a sharp depreciation of Canadian dollar and a rise in interest rates to defend the Canadian currency. However, consumer confidence has rebounded recently and spending on durables is recovering, along with easing monetary conditions.
22. The labour market has been improving with the unemployment rate reaching an eight-year low of 7.8 per cent at the beginning of 1999. Meanwhile, inflation has been below 1 per cent, as persistent slack capacity has kept downward pressure on domestic prices and international commodity prices have remained weak.
23. Monetary policy in Canada has always been highly correlated with that of the United States because of the strong reciprocal economic linkages. During the worldwide financial crisis in 1998, the value of the Canadian dollar dropped significantly against the US dollar, reaching an historical low in August 1998. The Bank of Canada decided to stem the fall in the currency by raising short-term interest rates by 100 basis points. Since then, the Canadian dollar has been drifting slightly upward, and the Bank of Canada has followed the Fed in reducing interest rates. With the latest cut of 25 basis points at the end of March, interest rates are back to the level before last August. In the near term, monetary policy of Canada is likely to remain at the current stance, based on the following factors: the current inflation rate is below the lower bound of the Central Bank’s inflation target range, inflation expectations are benign, and the Fed is not expected to tighten its policy in the near term.
24. Canada has also experienced fiscal consolidation for the last decade or so as it faced a large public debt, which now stands at 60 per cent of GDP. Although the restoration of stability to government finances was completed in 1997 with the budget in surplus, fiscal policy has remained conservative. However, Canada’s

budget plan for 1999 marks a turning point. It includes a broad relaxation of fiscal policy, with a larger-than-expected increase in the personal-tax exemption, the elimination of the 3 per cent surtax for high-income earners, and an increase in spending for health care. Nevertheless, there are some concerns that by targeting budget balance fiscal policy could become pro-cyclical, no longer allowing the automatic stabilizers to work. This would shift the onus of fine-tuning macroeconomic policy to monetary policy, entailing unnecessary volatility in interest rates and in the exchange rate.

Europe

25. On 1 January 1999, the new European Central Bank (ECB) took over the responsibility of monetary policy for the eleven countries (EU-11) taking part in the single currency. By treaty, the ECB has the explicit task of maintaining price stability; this has been defined as a rate of inflation of below 2 per cent. As a new institution, a major goal of the ECB itself has been to establish its credibility.

26. The first major coordinated policy decision by the ECB, though technically enacted by the euro-zone members-to-be, was the 30 basis point cut in short-term rates made in December, implemented to combat the slowdown that occurred in the EU-11 in the fourth quarter of 1998. In the early part of 1999, there was reluctance to make further cuts in rates despite slowing growth and political pressure. However, in April the main refinancing rate was cut 50 basis points, bringing it to a level of 2.5 per cent.

27. In the forecast it is assumed that the current level of short-term rates will hold for the rest of 1999 and that these rates will gradually be tightened in 2000, with a cumulative increase of 60 basis points from the fourth quarter of 1999 to the fourth quarter of 2000, with similar increases for the rest of the forecast period. In the United Kingdom, short-term rates were repeatedly cut in 1998 to combat the downturn in the business cycle. The forecast assumes one further cut in short-term rates to 5 per cent from the current 5.25 per cent by mid-1999, with no further change in 2000 and 2001.

28. The introduction of the new European currency, the euro, at the beginning of the year proceeded smoothly. The average dollar value of the euro in January was 1.16, but it subsequently lost ground and reached 1.06 in the latter part of April. A number of factors

account for this. Most importantly, the United States economy is growing faster than expected, while forecasts of European growth have been revised downwards. Interest-rate differentials currently favour the dollar and are expected to continue to do so. A number of political factors have also played a role. Earlier in the year, a sense of political disarray made the direction of macroeconomic policies unclear. Recently, the situation in Kosovo, its economic disruptions and other costs have pushed the euro down further.

29. Looking to the future, narrowing interest-rate differential as well as the widening United States trade balance and EU trade surplus point to a rebound in the euro in the medium term. In addition, EU growth is expected to pick up in the latter half of 1999 and accelerate in the year 2000, while growth in the United States is expected to slow. A major restructuring — which is already being seen and is expected to continue — could boost growth significantly in Europe. It is also argued by some that current portfolios, if weighted by trade shares, are underweight in euro-denominated securities. A rebalancing of portfolios in this direction would lead to a long-term increase in demand for euros at the expense of the dollar. However, euro markets are not as deep and liquid as those in the United States, so this process could take a number of years. The LINK forecast assumes that the euro will appreciate to \$1.16 per euro in the third quarter, remain stable for the rest of 1999, and thereafter gradually rise by 2-3 per cent per annum for the rest of the forecast period.

30. Fiscal policy in the EU-11 in the recent past has been dominated by the difficulty most countries experienced in achieving the Maastricht criteria of a fiscal deficit-to-GDP ratio of 3 per cent and a debt-to-GDP ratio of 60 per cent. With the introduction of the single currency, these criteria were incorporated in the Pact for Growth and Stability, which calls for continued compliance with these targets and an additional target of approximate balance in government deficits over the medium term. Most countries will therefore continue to exert fiscal prudence and perhaps tighten their fiscal stance. Many countries used temporary measures in 1998 to achieve these targets which will have to be made up for in 1999. In addition, a number of countries remain significantly over the 60 per cent debt limit and will need to continue to reduce their debt for a number of years. Added to this, there is pressure for tax cuts as part of the drive to reduce the costs of employment and raise

productivity. The consequence is that government consumption grows by less than 1.5 per cent in most cases. One exception is the United Kingdom whose government plans to improve infrastructure and government services, contributing to the strong growth of government demand in 1999 and 2000.

31. In recent years, there has been a significant divergence in growth performance within Europe. On the one hand, the large countries (together with Austria and Belgium) have struggled to emerge from the slowdown of 1995 and early 1996. They experienced strong growth of exports and investment picked up — the usual path for an early stage of recovery. However, there was uncertainty whether consumption would expand as the recovery progressed; such a failure was the main reason that the previous recovery stalled. The other group was the fast-growing countries, led by those catching up to EU average levels of income and productivity (especially Ireland, Portugal, and Spain), but joined also by Denmark and the Netherlands. These countries have experienced strong and broadly-based growth, accompanied by fear of overheating. This was of particular concern at the time of the final interest-rate convergence for moving to the single currency, because of the extent of the drop in interest rates required for the catching-up group and because of the low initial level of interest rates for the rest. The United Kingdom has been slightly ahead of the rest of Europe in its phase of the business cycle, experiencing a long period of above-trend growth, which the monetary authorities have tried to slow to avoid inflationary pressures.

32. The beginning of 1998 saw fairly robust growth across Europe. In particular, consumption picked up strongly in France and Germany, investment (excepting the housing sector) was strong, inventories made a major contribution to growth, and net exports were still positive. Italy continued to be depressed because of the massive fiscal retrenchment required to fulfil the Maastricht criterion and because an appreciating lira depressed exports. In the United Kingdom, continuous tightening of monetary policy in the first three quarters failed to slow the service sector significantly, while manufacturing suffered as the pound appreciated. The fast-growing smaller countries continued their rapid pace. However, during the second half of the year the picture changed, triggered by the continuing crisis in Asia and then Russia. In the fourth quarter, there was a major slowdown in growth.

33. The slowdown stemmed from a number of factors. Of primary importance was the drop in export growth. The direct trade effect of the crises in Asia and Russia, particularly for Germany, was pronounced. Added to this was the slowdown in the United Kingdom, an important trading partner for both France and Germany. The appreciation of the main European currencies against the dollar in the fourth quarter further dampened exports. These negative external shocks were amplified as trade slowed down within the region. Rates of growth of imports also fell but not by as much so that net trade represented a negative contribution to growth in the fourth quarter.

34. In addition to the external-sector impact, in many countries, private investment, which had shown strong growth earlier in the year, slowed in the fourth quarter. By the end of 1998, industrial confidence was low, primarily due to weaker foreign demand and it continues to be depressed. Rising inventories supported growth throughout the first three quarters of the year, but destocking took place in the fourth quarter. Housing investment continued to decline in 1998. However, growth was bolstered by strong and accelerating consumption throughout the year. The increase in employment, together with some moderate wage increases and falling rates of inflation, pushed up disposable incomes. It also strengthened consumer confidence, which reached unusually high levels, and this in turn lowered savings rates. The increase in equity prices contributed to the strength of consumption, even though the wealth effect is estimated to be small in Europe.

35. The overall slowdown in the latter part of 1998 adversely affected manufacturing across Europe, particularly the capital goods sector because of its heavy dependence on foreign demand. This negative factor was mitigated somewhat by the strong performance of the consumer durables' sector, brought about by buoyant consumption demand; the latter also boosted the service sector.

36. Early 1999 has seen a continuation of these trends. Consumer confidence continues to be near-record highs, while industrial confidence is unusually low. Consumption is expected to continue to bolster growth but export demand is expected to continue to be weak and to drop significantly. Imports will continue to decline by less, so that net exports will continue to detract from growth. In most countries the ratio of inventories to GDP

remains high, with the result that destocking is expected to continue. The investment picture is more mixed, but in a number of countries the housing sector is expected finally to register positive growth. Overall, GDP growth is expected to decline in almost every country. For the EU as a whole, growth will decline from 2.8 per cent in 1998 to 1.9 per cent in 1999. However, it will pick up in second half of the year, driven by rebounding exports. Growth in 2000 is expected to be 2.5 per cent, with slightly increasing rates thereafter.

37. Among the major countries, GDP growth in France is forecast to fall from 3.4 per cent in 1998 to 2.1 per cent in 1999 and then recover to 2.6 per cent in 2000. Germany is expected to follow the same pattern, with growth of 2.8 per cent in 1998, 1.9 per cent in 1999 and 2.6 per cent in 2000. Capital goods' exports have been the most adversely affected exports. Since German exports are more heavily concentrated in this sector, a larger drop in export volume growth is expected for Germany than in France.

38. GDP growth in Italy is still affected by the difficulties experienced in satisfying the fiscal criteria. In addition, there was strong appreciation of the lira during 1998. GDP growth is expected to be the least robust from among the EU-11 countries, rising from 1.4 per cent in 1998 to 1.6 per cent in 1999 and to 2.5 per cent in 2000. The UK is expected to avoid recession in 1999 as the drop in interest rates and expansive fiscal policy help moderate the downward export shock. United Kingdom exports have had the additional challenge of contending with a strong currency and are expected to fall by 0.3 per cent in 1999. GDP is expected to fall from 2.1 per cent in 1998 to 0.5 per cent in 1999, rebounding to 2.1 per cent in 2000. The "catching-up" countries were also affected by the negative external shock, but growth is expected to remain at around 3 per cent or above in 1999, exceeding 6 per cent in the case of Ireland. For the rest of the forecast period, GDP growth is expected to moderate in these countries but remain strong.

39. At the beginning of 1999, consumer price inflation slowed to below 1 per cent annually in France, Germany and several other countries, while producer-price inflation turned negative in some cases. Average consumer-price inflation in the EU fell from 1.6 per cent in 1998 to 1.4 per cent in 1999. The slowdown in growth played a major role in lowering inflation, but the drop in commodity prices was a more important factor; part of the explanation may also lie in the process of

restructuring within the EU. The EU average inflation is forecast to remain at 1.4 per cent in 2000, rising towards 2 per cent by the end of the forecast period. Within this, the fast growing countries show rates of inflation in the 2.1-2.9 per cent range in 1999 and 2000. Rates of inflation are expected to converge somewhat by the end of the forecast period; in the low-inflation countries, inflation will approach 2 per cent, while in the higher-inflation countries it will decrease towards an average of 2.5 per cent.

40. Strong growth in employment has resulted in continuous declines in unemployment in almost every country in Europe since 1997. While there is evidence that this process may be slowing and there are significant regional differences in performance, unemployment rates are expected to improve steadily throughout the period, with the average rates of unemployment falling from 12.5 per cent in 1998 to 12.0 per cent in 1999 and to 11.5 per cent in 2000. By the end of the period, the average unemployment rate is expected to be below 11 per cent.

41. GDP growth in Cyprus accelerated to 4.0 per cent in 1998 from 2.3 per cent in 1997. The fiscal deficit widened, while the current-account deficit, unemployment and inflation declined. Improved domestic and external demand contributed to the economic upswing. Private consumption rose due to increased wages and transfer payments. Public consumption and investment soared because of expansionary fiscal policy. The economic expansion caused imports to grow, though marginally. Meanwhile, exports expanded sharply. The tourism sector, which provides the engine of economic growth, picked up as concerns over security faded. Reversing many years of consecutive declines, construction's output increased, responding to the economic recovery. Output in manufacturing industries, which had been declining for the last four years due to stiff competition, showed some signs of strengthening. Despite the continued drought, agriculture's output grew.

42. Fiscal and current-account deficits remain the binding constraints of the economy. Although government revenues increased, due in particular to income and value-added taxes, and government spending rose moderately, the budget deficit amounted to 7.0 per cent of GDP in 1998. This was mainly financed through domestic borrowing. Export earnings increased, benefiting mostly from the surge in agriculture and to lesser extent from manufacturing. Tourism receipts rose

as well. As imports virtually stagnated, the current-account deficit was reduced to 4.5 per cent of GDP in 1998. Foreign-exchange reserves helped in financing the deficit.

43. Monetary policy in 1998 aimed at providing adequate liquidity to the economy and keeping interest rates low to support the economic upturn. To this end, the central bank intervened in the money market, supplied reserves through repo operations, and furnished liquidity to commercial banks. Inflation decelerated, mostly due to lower oil prices and partly to reduced prices of agricultural products. The revival in tourism activity, which is highly labour-intensive and the major employer, was behind the decline in unemployment.

44. As for Malta, sluggish domestic demand, together with reduced external demand, led to a weakening of GDP growth to about 2 per cent in 1998. The fiscal deficit remained high at 12.4 per cent of GDP. Exports expanded, led by the electronics industry, but tourism earnings decreased. At the same time, import demand decelerated because of subdued domestic demand and the fall in oil prices. The current-account deficit, however, persisted. Lower tourism activity and a drop in public-sector employment caused unemployment to rise to 5.0 per cent. The monetary stance remained tight despite the slack in domestic demand. With a stable currency, subdued price and wage pressures domestically, inflation fell to 2.8 per cent in 1998 from 3.3 per cent in 1997.

45. The outlook for both countries is for continued growth. Combined GDP growth is projected at around 3.9 per cent in 1999 and 4.2 per cent for 2000. Cyprus has been hit by the sharp fall in import demand from Russia — which is the country's single largest export market. Exports are likely to remain weak. Private consumption growth might decline as an increased tax burden may constrain disposable incomes. Gross-fixed investment will remain subdued due to continued tight fiscal policy. Tourism, which remains the main driving force of the economy, is likely to decline because of uncertainty over security. Malta too is likely to face declining tourism activity in 1999. Its exports will remain weak, mainly due to the expected economic slowdown in the EU, which is Malta's largest market. In both countries, reduced exports and tourism may widen fiscal and current-account deficits.

Japan

46. Despite a series of stimulatory fiscal measures, output in Japan continued to fall in the last quarter of 1998, the fifth consecutive quarter in a row. The Japanese economy, which had been weakened by the premature fiscal-consolidation measures in April 1997, fell into the longest postwar recession in the last quarter of 1997 when the Asian financial crisis, combined with sluggish domestic demand, resulted in a credit crunch for the Japanese banking system. The weaknesses in the banking system, which are at the root of the problem, have not yet been resolved and fiscal measures have not been sufficient to reverse the deflationary environment.

47. The recession deepened in 1998 and was in danger of developing into a serious contractionary spiral. The ¥16 trillion April stimulus package, including government spending on public works and tax cuts, failed to halt the deterioration in confidence and stop domestic demand from falling further. In November, the Government had to draft another stimulus package of ¥17 trillion. Throughout the year, both business and consumer confidence remained depressed. All domestic demand components, except government consumption, declined. Personal consumption fell by 1.1 per cent and residential and non-residential investment fell by 14 per cent and 11.3 per cent, respectively. Only public consumption rose marginally. A substantial part of the announced increase in public spending is to be implemented in 1999. Although exports to East and South-east Asia fell by about 20 per cent, net exports gained somewhat due to an increase in exports to other regions and a substantial contraction of imports. Both retail sales and machinery orders (particularly from Asia) continued to fall throughout 1998. Faced with excess capacity, depressed sales, falling prices and weak profits, manufacturing industries remained depressed. Only small non-manufacturing firms and, in response to government spending on public projects, construction industries showed some positive signs. Real GDP in the year 1998 as a whole declined by 2.8 per cent, compared to growth of 1.4 per cent in 1997.

48. In early 1999, there still are no firm signs that the economy is bottoming out. Industrial production remained flat early this year. Banking reforms, the relaxation of monetary policy, fiscal stimuli and yen depreciation, if they are effectively implemented could provide some badly needed additional impetus to growth,

but recovery is likely to be delayed until 2000. Private consumption, which continued to weaken in 1998, is expected to slowly rebound in the second half in response to income-support policy measures, but for 1999 as a whole is expected to decline further. The expansion of government investment and net exports are not to be expected to reverse the downtrend this year.

49. Given large excess capacity, private non-residential investment is expected to continue its downtrend in 1999. A yen depreciation and corporate tax cuts would moderate the decline in profits in manufacturing industries over time and the banking bail-out efforts will slowly alleviate the credit crunch to some degree. But excess capacity, weak corporate balance sheets, still tight credit conditions, especially for small- and medium-size firms with limited access to stock-market financing, and poor business confidence will restrain investment for a while. Housing investment continues to fall but should begin to pick up in the second half due to policy measures such as low-interest loans and temporary tax relief on mortgages to promote housing construction and related industries. Depressed property prices and high unemployment, however, will offset this somewhat. Output growth for 1999 as a whole is likely to be negative again and the long-awaited recovery is likely to be postponed to 2000.

50. The inflation rate is expected to fall further to become near zero, reflecting weak demand, large slack in the labour market, a credit crunch, and low prices of primary commodities. Wholesale prices declined through the end of 1998. This, however, will provide a favourable environment for monetary easing. With deflationary forces at work, unemployment is expected to edge up from 4.1 per cent in 1998 to close to 5 per cent in 1999 — a postwar high. The employment situation is particularly grim in manufacturing and construction. Despite layoffs, there was no evidence of productivity improvement in manufacturing.

51. Currently, Japan faces three difficult interrelated policy problems; (1) stimulating domestic demand through macroeconomic policies; (2) removing structural impediments in the banking sector, which in the past was the major conduit of funds to the corporate sector and remains crucial for financing small- and medium-size firms; and (3) inducing a slightly weaker yen to promote exports. A series of massive fiscal stimuli since 1998 has failed to lift the economy out of the recession, partly due to the structural problems that caused a credit crunch and

the sharp appreciation of the yen in late 1998. To return to a self-sustainable long-term growth path, it is essential for the authorities simultaneously to tackle the balance-sheet problem of the financial system and to prolong the expansionary macroeconomic measures.

52. The budget for this year envisages the continuation of expansionary fiscal policy, with a further widening of the deficit due to the sluggish economy, tax cuts, and a spending increase of more than 5 per cent, including public works and social security. The ¥67 trillion fiscal injection into the banking system in 1998 to recapitalize banks, restore confidence, and ease liquidity has been insufficient. Even if the banks' capital base was strengthened, the credit crunch could be eliminated only if bank profit relative to perceived risks were to grow substantially.

53. Faced with the danger of deflation and concerned about the negative effects from rising long-term interest rates, in part because of the Government's need to raise funds by issuing bonds (the domestic long-term bond yield rose from 0.25 per cent last fall to nearly 2.44 per cent in early February 1999), and the strong yen in late 1998, Japan decided to further ease monetary policy and induce a weaker yen. The Bank of Japan (BOJ) lowered its overnight call rate from 0.25 per cent to 0.15 per cent. Also, the Ministry of Finance cut its planned March issuance of 10-year government bonds for financing the fiscal deficit by ¥400 billion (\$3.41 billion) by shifting it to shorter maturities. As a result, the benchmark 10-year government bond yield fell below 2 per cent and the yen depreciated to about 120 to the dollar. Given that there is no further room for lowering interest rates, the BOJ may have to monetize the fiscal deficit to help the economy emerge from the deflationary slump and to moderate the difficulty of structural adjustment. Despite low interest rates, banks continue to be very cautious in lending. To overcome this problem, the Government has also attempted to provide capital directly to firms.

54. The enhanced competitiveness from the recent yen depreciation is expected to boost Japan's exports. The expected economic upturn in Asian emerging economies will be conducive to Japan's exports while sluggish domestic demand in Japan and increased import prices in yen are expected to restrain imports. This may slow down the recovery in neighbouring Asian competitors (particularly the Republic of Korea and Taiwan Province of China) by discouraging their exports, which suggests that there is room for better policy coordination.

Combining the potential for export push with weak import demand, the net result is likely to be a strengthened current-account surplus, reinforced by low prices of primary commodities (particularly oil). The surplus is expected to rise to over 3.7 per cent of GDP in 1999 from 3.2 per cent in 1998. This might exacerbate frictions between Japan and its trading partners, especially the United States.

55. There are three major risks to the outlook. First, in addition to lower interest rates, Japan appears to lean toward expanding the money supply, even at the cost of rising inflation. Unless the structural problems in the financial system are resolved and the credit-creation mechanism is restored, the new package of fiscal measures and the monetary stimulus may not be sufficiently effective in encouraging domestic demand. Much of the liquidity created might leave Japan, resulting in further yen depreciation. Second, the increase in spending on public works (about ¥6 trillion) in the first quarter of 1999 is not likely to sustain growth. Although the new budget is also expansionary, considerable uncertainty remains about the extent of the stimulus and its effectiveness. Third, the fiscal deficit of about 10 per cent of GDP poses a problem that needs to be addressed as soon as Japan gets out of its recession, particularly in view of its aging population. This will limit the Government's capacity to increase spending in 2000 and beyond and will work as a brake on returning the Japanese economy to its long-term growth potential.

56. The prospects for Japan in the short run do not offer much prospective support for the restructuring efforts in neighbouring countries, but a steep decline of the yen/dollar exchange rate, say, to beyond 145, would be ruinous for these economies. Not only would the economic and social hardship sustained as a result of the financial crisis become much more serious, such a depreciation might lead to another currency crisis. This time, China might be forced to devalue as well. Furthermore, a yen depreciation might shift Japanese funds to Europe and the United States and force Japanese banks to withdraw their funds from Asia. Such a disengagement would pose an additional financial strain for these economies and exacerbate their adjustment problems.

Oceania

57. Despite the slump in exports to Asia, which

accounts for three fifths of its total exports, and a sharp fall in commodity prices, output in Australia grew at an unexpectedly strong pace of 4.9 per cent in 1998. A main thrust came from domestic demand, particularly strong private consumption fueled by employment gains and wage increases, low interest rates, and strong consumer confidence, fueled in part by the wealth effect of the buoyant stock market. A redirection of exports from Asia to Europe and North America and a sharp depreciation of the Australian dollar moderated the export setback. The collapse in tourism exports to Asia was also buffered by increased arrivals from elsewhere. With very small price pass-through from the depreciation partly as a result of falling prices of imports, inflation was subdued at 1.1 per cent in 1998. Unemployment fell to 7.5 per cent by year-end. Growth in 1999, however, is expected to slow to about 2.7 per cent, owing to weakening of investment of export demand and of private consumption as consumer confidence cools down and employment prospects worsen. Stronger growth is expected in 2000, boosted by the extra demand engendered by the Olympic Games in Sydney. But thereafter growth will slow markedly. Though inflation is likely to edge up, it is expected to remain within the target on account of lower prices of Asian imports and subdued domestic costs. Given slowing demand and low inflation, the Australian Reserve Bank lowered discount rate by 25 basis points in December 1998. Public investment is expected to expand significantly in 1999.

58. The current-account deficit is likely to widen in 1999 to beyond 5.5 per cent of GDP because of both volume and price effects. The weak upturn in Asia will not allow, later in the year, to redirect its exports away from slowing economies in Europe and North America. Commodity prices remain low and may lead to deteriorating terms of trade in spite of cheap imports from Asia. A significant upward movement in commodity prices would, however, lift export earnings. On the other hand, the decline in imports in 1999 will be moderate as domestic demand is not likely to dampen considerably, though it is due to experience a significant shift toward services in view of the Olympic Games.

59. In contrast to Australia, New Zealand was directly hit by the Asian crisis at the peak of its five-year long expansion. Apart from contagion in financial markets in October 1997, the real sector was affected as well since exports to Asia, which account for over a third, fell. This was compounded by the setback in agriculture due to

drought. These two negative factors drove the economy into recession in the first half of 1998, but the impact on domestic demand was not severe, and later in the year exports were diverted to Europe and North America. The recession was short-lived and the economy began to recover in the second half of the year. Real GDP for the year as a whole, however, declined by 0.7 per cent.

60. The main impetus to sustaining the recovery in 1999 should be domestic demand, given lower interest rates and a cut in personal income tax, though the high level of debt-to-disposable income will allow only a modest impulse. Exports too should help, bolstered by the expected upturn in Asian demand and the significant depreciation of the country's currency, but this will be offset to some degree by the slowdown in developed countries. Recovery in the near term, although broad-based, is expected to remain modest at best. Despite significant depreciation and the rise in food prices, inflation will remain within the target of up to 3 per cent due to excess capacity. The current-account deficit is expected to narrow slightly from its record high of 7 per cent of GDP in 1997.

ECONOMIES IN TRANSITION

61. The economic outlook for the economies of transition is gloomier than the one presented at the 1998 Fall LINK meeting. Most of the countries of Central and Eastern Europe are expected to register positive economic growth in 1999, but at a lower rate than in 1998; Russia and Ukraine show signs of a prolonged recession; the other members of the Commonwealth of Independent States (CIS) are suffering from the fallout from the Russian financial crisis and the subsequent recession in that country.

62. GDP growth in almost all economies in transition was lower in 1998 than in 1997, especially in the last quarter. The only country with strong growth performance in 1998 was Hungary; the Czech Republic and Poland exhibited a significant slowdown. Albania, Bosnia-Herzegovina, Croatia and Macedonia had relatively high growth rates, but from a very low base.

63. The performance of the economies in transition in 1998 was affected by two major external factors: a general loss of investor confidence in all emerging markets and a loss of export revenue as a result of declines in both volumes and prices. While the Asian

financial crisis in 1997-1998 affected most of the countries in transition only marginally, the consequences of the Russian financial crisis in August 1998 proved to be more serious. The moratorium on payments on Russian debt created turmoil in global financial markets; the breakdown of the Russian banking system and the disruption of payments aggravated the difficulties. The devaluation of the rouble reduced Russian imports. The CIS countries and Baltic states with strong trade links with Russia suffered a decline in exports, and their trade gaps widened

64. For Russia, 1998 was the most difficult year since the start of transition in 1991. The economy lost the stability and modest growth which began to appear in 1997 and which had brought an illusion of macroeconomic stability and rising income, despite chronic unsolved fiscal problems. GDP fell by 4.6 per cent and industrial production by 5.2 per cent in 1998. In addition, the monetary and exchange rate stability which had been gradually achieved during 1995-1996 was lost.

65. The Russian currency collapsed mainly due to the loss of confidence of foreign investors, compounded by the deterioration of the current account (due largely to the drop in prices of two key Russian export commodities – oil and natural gas). The Russian current account was in surplus in 1997 (unlike other economies in transition) and its rapid deterioration as 1998 progressed attracted the attention of foreign investors to all the structural deficiencies of the Russian economy. The most important of these were serious flaws in the fiscal system, including poor tax collection and a high government budget deficit.

66. The dependence of the government on foreign borrowing to cover the budget deficit was an important factor contributing to the collapse of the rouble. About 30 per cent of the government's short-term debt obligations was held by non-residents, and loss of confidence provoked massive capital flight.

67. To avoid financial collapse, Russia had agreed in mid-July with IMF, the World Bank and Japan on loans of \$22.6 bln. to be made available in 1998 and 1999; \$4.8 bln. was promptly provided by IMF. At the same time, Russia aimed to implement an anti-crisis programme, including cuts in government expenditures, improved tax collection, and a reduction in the use of volatile short-term financing for the government budget.

68. Despite the agreement and capital infusion,

Russian stock prices plummeted and interest rates on Russian government short-term borrowing rose sharply. The legislation necessary to implement the stabilization measures encountered obstacles. The loan programme was suspended and, on 17 August, the Russian government was forced to devalue the rouble, unilaterally reschedule most of its short-term debt (converting these assets into long-term securities) and impose a 90-day moratorium on payments by Russian banks and enterprises on much of their foreign debt.

69. *De facto*, both of these measures constituted default on a substantial amount of Russian public and private short-term debt. On September 15, the Russian currency again fell because the newly-appointed Russian government failed to adopt a tough fiscal and monetary policy and restore economic stability.

70. With the government bond market closed, the budget deficit can be financed only by monetizing it or by tightening fiscal policy. Since the monetizing of government debt will reduce the opportunities for further borrowing of much needed foreign capital in future, the Government is endeavouring to tighten fiscal policy. The budget for 1999 is the most restrictive since the transition began. Not only the Government, but also enterprises are now lacking financial resources, causing the Government to support potential foreign direct investors. One example of this is the creation of a legal basis for production-sharing agreements in the raw material sector. It is hoped this will bring FDI to the energy sector, possibly helping fixed-capital formation to recover.

71. The outlook for 1999 is for a further contraction of GDP, with a modest recovery starting only in 2001. Russia will be unable to fulfil most of its external obligations and will continue efforts to restructure its external debt. Inflation for 1999 is expected to be about 50-60 per cent, going down to 25 per cent in 2000-2002. The rouble will remain weak in this period. Investment activity, the main source of economic growth, also will remain weak. However, the recovery of oil prices could sharply improve the current-account balance.

72. The Russian crisis severely affected those CIS countries which have strong trade links with Russia, notably Ukraine. Like Russia, Ukraine has huge foreign debts, large external payment obligations and low foreign reserves, as well as poor fiscal performance and accumulated public sector wage arrears. In 1998, both economic and financial conditions deteriorated — GDP

fell by 1.7 per cent, while prices increased by 20 per cent. On 4 September 1998, the Central Bank of Ukraine decided to devalue the hryvnya to protect exports. About 25-30 per cent of Ukrainian exports go to Russia, but about two-thirds of all trade between Russia and Ukraine is conducted on a barter basis with dollar prices, so the main reason to devalue the hryvnya was the pressure on the currency, which investigators strongly associate with the rouble. The support of the hryvnya made necessary by the Russian crisis caused external reserves to become critically low.

73. The outlook for Ukraine is for a modest recovery only in 2000. Suppressed demand, cuts in government spending and the effects of the prolonged recession in Russia will result in a decline in real GDP of 3 per cent and about 25 per cent inflation in 1999. Export revenue should improve due to the recovery in the prices for unprocessed metals and chemicals. Weakened demand for domestic import will restrain imports, with the result that the current-account deficit is expected to remain low.

74. The other countries of the **CIS** suffered large negative external shocks in 1998 in the form of the fall in the world prices of primary commodities (which account for the lion's share of exports for most of them) and of the abrupt crisis and continuing recession in Russia. The impact of the latter is still unfolding. The closely integrated nature of these economies among themselves and with Russia is such that a downturn in one reverberates throughout the rest of the group through a multitude of channels, including such infrastructural props as transportation links. Primarily because of this abrupt change in the external environment, aggregate GDP fell by 2¾ per cent in 1998, nullifying the first regional recovery of 1.1 per cent in 1997.

75. Particularly affected by the Russian crisis are the **European CIS** countries, due to their closer integration with and larger trade dependence on Russia. The share of goods exports to Russia is 63 per cent in Moldova and 60 per cent in Belarus. Moldovan output fell by 8.6 per cent and inflation, the lowest in CIS in 1997, rose to 18.2 per cent in 1998. The current-account deficit reached almost 20 per cent of GDP and default on foreign debt was avoided only by the resumption of lending by international financial institutions in early 1999. There is likely to be a further decline in GDP in 1999, with continuing depreciation, increased inflation and a large current-account deficit. Prospects beyond 1999 are uncertain and will depend largely on the Russian

recovery and Moldova's ability to divert trade away from Russia through increased FDI into its agro-processing sector.

76. Belarus's policy of maintaining real wage and employment through credit support to enterprises is beginning to fail because of the collapse of the Russian markets for its exports. GDP growth slowed to 8.3 per cent in 1998, with inflation rising to 73 per cent. The excessive credit creation led to a currency crisis in March 1998 and growth is likely to come to a halt in 1999, with inflation rising to over 200 per cent. Given its economic structure and its high dependence on trade with Russia, Belarus is extremely sensitive to developments in that country. The prospects for the medium term are therefore very uncertain, especially given the extent of accumulated problems and the unpreparedness of the authorities to deal with them.

77. The countries of **Central Asia**, all landlocked and isolated from international markets, are affected by the Russian crisis through their rigid trade dependence on that country and also because Russia controls the main transit routes for their exports. They are also suffering from weak world prices for commodities which account for large shares of their output and exports: metals and oil in Kazakhstan, gold in Kyrgyzstan, aluminium in Tajikistan, gas and cotton in Turkmenistan and cotton, gold and hydrocarbons in Uzbekistan.

78. By the end of 1998, the combination of these factors had cut short the surge of growth in Kyrgyzstan from 10.4 per cent in 1997 to 3 per cent and had dampened the fragile recovery in the others, resulting in 1-2 per cent growth in Uzbekistan and Tajikistan and about 1 per cent decline in GDP in Kazakhstan and possibly Turkmenistan. The same factors are likely to continue to exert a strong negative influence in 1999, possibly resulting in a further decline of GDP by around 3 per cent in Kazakhstan and growth of only 0.5-2 per cent in the others. One exception is Turkmenistan where the disruption of gas supply to Ukraine caused a 25 per cent fall in GDP in 1997; resumption is expected to lead to 5-6 per cent growth rate in 1999.

79. The overall transition process in the region is still not advanced enough to sustain robust growth industry, barring the FDI-led developments in mining and exploration, is still contracting; the important agricultural sector, hampered by incomplete liberalization and privatization, is highly sensitive to weather; and the

relatively buoyant services sector is dependent on strong domestic demand. The needed structural reforms are particularly lagging in the southern republics, leading to a dangerous accumulation of financial imbalances, especially in the banking sector. In Kazakhstan and Kyrgyzstan, the continuation of reforms is made more difficult the recession and external weakening.

80. The collapse of revenues from exports is causing severe budgetary problems in all countries and there is some monetization of the deficit, due to the limited availability of domestic and foreign borrowing. Inflation, which was declining rapidly in recent years, has generally increased to 20-30 per cent (except in Kazakhstan) and 50-60 per cent in the case of Tajikistan. On the assumption of a recovery in world commodity prices and of the Russian economy in 2000, these economies are projected to gradually improve their growth rate to 2-4 per cent. The Russian devaluation initially hurt the competitiveness of their exports and boosted import demand, but these effects are being gradually eroded due to the continuing devaluation of the regional currencies. Trade and current-account balances are expected to improve slightly in 1999 and 2000 over 1998, except in Kyrgyzstan, mostly because of import contraction due to weak demand and curtailed access to financing.

81. These fairly open economies, with rather undiversified and rigid structures of trade and increasingly dependent on official financing, are vulnerable to balance-of-payments problems. Turkmenistan and Uzbekistan are already on the brink of default and the projected current-account deficit for Kyrgyzstan is unsustainably high (in all three, around 30 per cent of GDP on average over 1998-2000). With low private savings, limited availability of official aid in the future and the expected recovery of growth and investment, all countries need to give priority to fiscal discipline and to a radical improvement in the environment for FDI.

82. The **Transcaucasian region** as a whole had enjoyed in recent years high growth rates amid rapidly falling inflation and stable external financing, largely thanks to strong reform efforts in Armenia and Georgia and oil resources attracting large flows of FDI in Azerbaijan. However, the Russian crisis triggered an abrupt worsening of the external environment, mostly through their trade links with Russia and other CIS countries. This was exacerbated in the case of Azerbaijan

by the continued low price of oil. Growth in Georgia fell to 2.9 per cent in 1998 from a double-digit level in the previous two years and is forecast to stagnate at around 2 per cent in 1999. Although growth in Armenia and Azerbaijan held up in 1998 (registering 6 and 8 per cent), it is expected to weaken by about 2 percentage points in each country in 1999. The budgetary situation, especially in conflict-ridden Georgia, is becoming increasingly difficult to manage and inflationary pressure is accompanying the depreciation of the national currencies, reversing the trend of nominal appreciation of the previous years in the case of Azerbaijan. Nevertheless, current-account deficits are projected to remain rather high, although within expected financing inflows.

83. The countries are responding to the adversities with responsible macroeconomic policies and further intensification of their structural reforms. The gradually improving regional political situation should facilitate trade expansion and diversification (Armenia and Georgia hope to join the WTO in 1999). With the relative proximity of alternative markets, growth is expected to pick up later in 1999 and rebound to 6-7 per cent in 2000, with inflation at single digit levels. If the world oil price improves, making possible the completion of the strategically important Baku-Ceyhan oil pipeline, the prospects for Georgia will improve considerably.

84. Although production from the so-called "early" oil fields will shore up growth in the near term, the prospect of an oil-investment-driven surge in economic growth in Azerbaijan seems to be slipping away because of the poor results of exploration in the new off-shore fields and the difficulties with the financing of export pipelines. In such a case, Azerbaijan might start feeling the burdens of the imbalance between the oil and non-oil sectors, of insufficient and slow reforms, of political uncertainty and of weak governance, especially if the fall of the world oil price resumes.

85. The Baltic countries were severely affected by the Asian and Russian crises because they are very open economies and more integrated into international financial markets than other CIS countries. They were also pursuing, at the time, tighter policies because of the overheating that had resulted in large current-account deficits. Their aggregate GDP growth rate in 1998 dropped by some three percentage points from the 7.6 per cent level in 1997. The value of their exports and imports increased on average by some 3 and 7 per cent,

respectively, compared to 20 to 30 per cent in the previous two-three years. In particular, Estonia's growth rate fell from 11 per cent in 1997 to 4.2 per cent in 1998 and is expected to further decline to around 2 per cent in 1999. According to the latest government release, in 1998 Latvian GDP growth was 3.6 per cent, down from 8.6 per cent in 1997, and Lithuanian growth of 4.4 per cent compared with 6.1 per cent in the previous year. Forecasts for 1999 have been revised down to 2-4 per cent and 4-4.5 per cent, accordingly.

86. Given the successful and ongoing diversion of trade away from Russia, the increasing differentiation of investor perceptions in their favour, their strong macro policy framework and their progress in trade, privatization, fiscal and banking reform, there are strong grounds to argue that 1999 will see a soft landing for the Baltic economies. This is expected to be followed by gradual recovery in 2000, the extent of which will be largely determined by developments in Western Europe. All these countries are loosening their macro policy stance, while inflation is the lowest among the transition countries. It is likely to continue to stay low, aided by the lower price of imported energy and raw materials; both help maintain the countries' competitiveness vis-à-vis major trading partners.

87. For the countries of **Central and Eastern Europe (CEE)**, the effects of the Russian crisis through trade channels were generally small, though significant for some of them. During the years of transition, most CEE countries reoriented their trade towards the West. Bulgaria and Poland are the countries whose share of external trade with Russia is the largest but, even in those cases, Russia now accounts for only about 8 per cent of their exports.

88. Finance was the most important channel through which the region was affected by crisis. Losses in South-east Asia and in Russia provoked a general abandonment of emerging markets by private creditors and there was strong pressure on the currencies of these countries in the aftermath of Russia's crisis. For example, the Slovak central bank abandoned the fixed exchange rate on 1 October 1998 and the Hungarian and Slovak central banks had to intervene in the foreign exchange market, using a substantial share of their foreign exchange reserves. The Hungarian central bank raised interest rates to protect its currency. These concerns about pressure on their currencies meant that Central banks were reluctant to reduce (nominal) interest rates. Real interest rates

increased in most of these countries in 1998 due to lower-than-expected inflation. High real interest rates became one of the factors contributing to the slowdown of growth.

89. Foreign investors are beginning to return to Eastern Europe. They apparently have less concern about these countries than about Asia and Latin America. Some Central European borrowers (such as Croatia, Hungary, and Slovenia) have succeeded in restoring access to capital markets, although Bulgaria still faces high costs of borrowing.

90. The most advanced CEE economies are expected to exhibit mixed performance in 1999. Hungary, Poland, Slovakia, and Slovenia will register positive economic growth (although lower than in 1997), while the Czech Republic will remain in recession, with real GDP contracting by 0.5 per cent. Slovenia, which has the most stable macroeconomic position among these countries, is expected to grow by 4 per cent.

91. Poland strengthened its macroeconomic stability in first three quarters of 1998, reducing unemployment and improving export performance. Most of the growth came from private firms. However, in the last quarter of 1998, both the employment situation and export performance deteriorated. Economic growth in 1999 is expected to be 3.9 per cent, lower than in 1998. This is partially because of the decline of exports to Russia: although the share of trade with Russia is limited, it is concentrated in industries which have an economy-wide impact.

92. Bulgaria is expected to grow of 2.9 per cent in 1999, but further delay of key structural reforms and cuts in the budget deficit in Romania may result in the withdrawal of support by international lenders, prompting financial crisis and recession. GDP is expected to decline by more than 3 per cent in 1999, with recovery only in 2000.

93. Prospects for Albania, Bosnia-Herzegovina, Croatia and Macedonia depend on the evolution of the conflict in Kosovo. Some of these states were recovering from the earlier conflict in the former Yugoslavia and were expected to register positive growth rates, this is now unlikely.

94. For the most of CEE economies, disinflation is expected to continue. The annual rate of inflation is expected to range from 8 per cent in Hungary to 10 per cent in Poland and to remain in single-digits in Slovenia.

This should allow sizeable cuts in nominal interest rates. In Romania, on the other hand, the initial inflation target of 25 per cent seems unlikely to be attained and 40-50 per cent inflation is expected in 1999.

95. Monetary policy is expected to remain tight in Bulgaria in 1999, despite the pressure of rising wages in the public sector. The possible relaxation of policy through cuts in interest rates is possible in the Czech Republic, Hungary and Poland. For the Czech Republic, a cut in interest rates is not expected to be accompanied by domestic credit expansion because of the structural problems in the economy and a general credit crunch. In Poland, interest rate cuts could boost domestic demand and imports in the second half of 1999 and return the economy to high rates of growth in 2000-2001. However, the cuts in interest rates could aggravate the external position.

96. Trade and current-account balances are generally expected to deteriorate in 1999, especially for Hungary, Poland and Romania. For Hungary, the current-account deficit reached \$2.3 bln., or 4.8 per cent of GDP in 1997, despite the fact that the trade deficit shrunk to \$271 mln. from \$287 mln. The main source of the deficit was the repatriation of profits by foreign investors. In 1999, real wages are expected to rise, imports to grow and the foreign demand to weaken, with the result that the trade deficit will rise and the current-account deficit will increase to \$3bln., about 6 per cent of GDP. Growing import demand and weakening exports will similarly affect the current accounts of Bulgaria and Poland.

97. For the Czech and Slovak Republics, the current-account deficit in 1999 is expected to remain stable, due to weak import demand for the Czech Republic and increased FDI for the Slovak Republic. The current account is expected to be close to balance in Slovenia, but the deficit is already high for Albania and Macedonia and is expected to increase in 1999. For Bosnia-Herzegovina, the outlook is for a narrowing current-account gap.

98. The budget deficit is a persistent problem for almost all economies in transition. Slovenia is the main exception, with a budget deficit of about 1 per cent of GDP. The deficit is particularly high in Hungary, Poland and Slovakia; in Hungary and Poland this may necessitate policy adjustments in 2000. The budget in the Czech Republic may be adversely affected by the possibility of a capital injection into state-controlled banks in 1999.

For Bulgaria, the budget deficit turned to a surplus in 1998, but this is not likely to be repeated in 1999 when a deficit of 2 per cent of GDP is expected.

99. Gross-fixed investment is expected to increase in 1999 in Bulgaria, Hungary, Poland and Slovenia and to contract in Slovakia and Romania. For the Czech Republic, the recovery of fixed investment depends on further privatization and the recovery of foreign demand.

100. The conflict in Kosovo also has to be taken into consideration in evaluating growth prospects for 1999. Most of the states in the region will be affected: Bulgaria and Romania, because of the increased cost of transit to and from the European Union, and Croatia and Slovenia, because of the high share of tourism revenues in GDP. In the short-run, the currencies of CEE states depreciated slightly against the dollar with the outbreak of the conflict and the prices of their international bonds fell. Foreign investment in the region is likely to decline if the conflict spills over to other countries or if it lasts for an extended period.

DEVELOPING COUNTRIES

Africa

101. Real GDP growth in Africa decelerated to 2.5 per cent in 1998 from 3.7 per in 1997, an outcome which represented another year of decline from the peak rate of 4.5 per cent attained in 1996. Per capita GDP growth also declined in 1998, for the first time since 1995, since Africa's real GDP needs to grow at least 2.6 per cent to outpace the rate of population increase. Growth decelerated sharply in Nigeria, South Africa and Zimbabwe, among the largest economies in the region, as well as in other countries such as Ethiopia, Gabon, Kenya and Sudan that had performed well during the past three years. Libya and Zambia experienced negative growth in 1998 while the Democratic Republic of the Congo lapsed into a second consecutive year of recession.

102. The slowdown in Africa's output growth in 1998 could largely be attributed to external factors: a significant decline in the (dollar) value of Africa's merchandise exports with only a slight reduction in import demand led to widening merchandise trade and current-account deficits. The sharp drop in export earnings amounted to a loss of \$18 billion, or about 15 per cent of the value of exports in 1997. The collapse of oil prices and steep price declines for several non-oil

commodities led to terms-of-trade losses that were mitigated only by a corresponding decline in import prices of oil and manufactured goods. The value of imports contracted by less than 1 per cent but Africa's overall merchandise trade balance climbed to a deficit of \$22 billion in 1998 from a deficit of less than \$5 billion in 1997.

103. The Asian financial crisis contributed to lower demand for African exports of minerals, base metals and other industrial raw materials. There was also a fall-off in foreign direct investment from Asia to several African countries, but financial contagion as a result of the Asian crisis was largely limited to direct effects on the South African economy and neighbouring countries.

104. The deterioration in Africa's growth performance in 1998 could also be attributed to a variety of domestic factors such as adverse weather conditions in several countries, which depressed agricultural output and slowed economic activity in other sectors. Armed conflicts, civil disturbances and political instability also disrupted normal economic and commercial activities in several countries and undermined progress in economic and social development in those countries with repercussions for the region.

105. The heavy burden of external debt and largely unsustainable debt-service obligations, together with increasingly scarce inflows of financial resources, further compounded the inability of most African countries to address some of the region's persistent structural weaknesses. Africa's economic performance in 1998 provided little room for increased investments in human capital, technological and entrepreneurial capacities, physical infrastructure and institutions that would remove some of the constraints to sustained growth and long-term economic and social development.

106. The region's output is likely to accelerate to 3.0 per cent in 1999 and to 3.5 per cent in 2000 from weak growth of around 2.5 per cent in 1998. With only 1.3 per cent in 1999, growth in South-Africa — the largest economy in the region — will remain weak, but might accelerate to about 2.8 per cent in 2000, thus recovering from a meager 0.1 per cent in 1998. Economic growth in Nigeria — the second largest economy — is expected to remain flat for both years 1999 and 2000, at around 3.4 per cent. Because the economic setback in 1998 has proved to be much deeper, and recovery for the two years ahead much slower, than anticipated, only 14 African

countries are expected to grow at around 5.0 per cent in 1999 and 2000.

107. Africa's export is expected to remain depressed in 1999 and sharply increase in 2000 if firming oil prices hold up and non-oil primary commodity prices improve together with external demand. Meanwhile, the region's import demand may well increase, responding to tariff cuts on intermediate and capital goods, and also to emergency needs. As a result, the trade deficit is likely to soar. With the chronic deficits in invisible accounts, the current-account deficit will also increase. Financing the current-account deficit remains the major challenge faced by African countries. Foreign direct investment might relieve external payments pressures, but such investment goes to only a few countries, mostly oil-producers. Also, those developing Asian countries, such as Malaysia, which have become significant investors in Africa are not likely to continue their investments in Africa for some time to come.

108. Many African countries have had a debt-service overhang for some time, and 1999 and 2000 will not be different. The total debt of many countries is well above 400 per cent of GDP. Although many will qualify for the Highly Indebted Poor Countries (HIPC) initiative, so far only Burkina Faso, Côte d'Ivoire, Mozambique and Uganda have obtained a commitment of assistance. Uganda was the first country to complete its programme, having reached the "decision point" in April 1998. The total amount of debt relief expected for these four countries from the international community is almost \$4.5 billion. Preliminary discussions are held for Guinea-Bissau and Mali.

109. In addition to the external debt treat, economic diversification is another challenge that still must be addressed if rates of output growth for sustaining increases in per capita incomes are to be attained in many countries. Sustained growth around 7.0 per cent per year is needed to make significant gains in arresting and reversing the spread of poverty (it is estimated that almost two thirds of the population still subsists at or below the absolute poverty line). Accelerating growth to at least this rate is achievable, as a number of countries have already demonstrated. But it will require deeper reforms in order to attain sufficient investment and bolster productivity.

Asia

East and South Asia

110. A year and half after the dramatic tumble from the previous high growth path into recession, the region's economy appears to be stabilizing. The turmoil in Asian financial markets has been weathered and signs of improvement have begun to emerge in an increasing number of countries. In crisis-hit countries, Indonesia, the Republic of Korea, Malaysia and Thailand, inflation fell sharply, exchange rates stabilized, interest rates (except for Indonesia) were lowered close to the pre-crisis levels, the trade gap shifted to a huge surplus, reserves increased substantially, and pessimism began to wane by late 1998. Other emerging economies in the region that had been pulled into recession during 1998 have also begun to show some improvement since late last year while most countries in South Asia, except perhaps Nepal and Pakistan, sustain a relatively robust growth pace.

111. Given the expected slowdown in developed countries and dwindling foreign capital inflows, domestic demand is likely to lead this year's recovery in most countries that were significantly affected by the Asian crisis. The expected recovery, however, is likely to be anemic with considerable diversity among countries. Conditioned by rising unemployment, reduced asset values, and excess capacity, the upturn in both private consumption and investment in these countries is expected to be mild. Export growth is also expected to be constrained by the slowdown in developed countries. To offset deflationary forces, these affected countries are increasingly opting for expansionary macroeconomic policy.

112. GDP growth in the region as a whole is expected to recover slowly from -2.0 per cent in 1998 to 2.9 and 4.5 per cent in 1999 and 2000, respectively. Output trends in the hardest-hit countries, except Indonesia, suggest that the trough have been passed in the past several months. A modest upturn in the second half of this year is now likely. In Hong Kong S.A.R., the Philippines and Singapore, the rapid growth deceleration that began during 1998 has been slowing down in recent months. A turnaround during the second half is also expected. On the other hand, Taiwan Province of China and VietNam, which had survived the initial contagion more or less unscathed, have exhibited some slowdown during the

past several months. The impacts of the Asian crisis on South Asian countries have been modest.

113. Given many interrelated underlying forces, some of which are inherently uncertain and even offset each other, this divergent economic outlook -- particularly concerning the timing and strength of the recovery -- is subject to considerable uncertainties. One crucial positive development in the past several months has been the relaxation of macroeconomic policy in an increasing number of countries. In particular, in view of the stabilized exchange rate, moderating inflation, and the need to reduce the social pains from surging unemployment as well as to jump-start the depressed domestic demand, most crisis-hit countries have increasingly eased their fiscal and monetary policies from the extreme stringency imposed at the initial phase of the crisis. In the Republic of Korea, Malaysia and Thailand, interest rates fell substantially from their peaks in the first half of 1998 to their pre-crisis levels and reserve requirements were lowered. In the case of Indonesia, interest rates were also lowered to half of their peak of September 1998, but are still stuck at twice the pre-crisis level.

114. With the agreement of the IMF, the Republic of Korea and Thailand recently raised their fiscal deficit targets considerably — up to 6 per cent of GDP for 1999. Their fiscal packages include tax cuts and increases in spending on employment creation, on infrastructure projects, and on alleviating other social problems including strengthening the social safety net. Indonesia and Malaysia also budgeted a comparable fiscal deficit this year. In addition, a huge amount is being allocated to banks, but even this large sum may not be sufficient.

115. Several other countries, but not in South Asia, have also cautiously cut interest rates, lowered capital ratio requirement, and increased fiscal spending to prop up sagging domestic demand.

116. Countries in South Asia, on the other hand, given their chronically high fiscal deficit at 5-6 per cent of GDP, are under pressure to maintain fiscal prudence.

117. The effectiveness of the stimulatory policy measures, particularly in crisis-hit countries, however, depends crucially on successfully restructuring the banking and corporate sectors. In addition, even if the huge private-debt overhang is reduced and credit conditions improve through restructuring, the responses of private consumers to policy stimuli, given rising

layoffs, reduced personal assets and weak confidence, will be lacklustre. In a number of economies such as Hong Kong S.A.R., although lower nominal interest rates will reduce debt-service burdens of firms, the prevailing high real costs of borrowing, combined with pessimism in the market, will make domestic demand less responsive than it would be otherwise.

118. Building a more resilient base for financial and corporate sectors by eliminating bad debts, by reducing labour market rigidities, and by trimming excess capacity and restoring investors confidence are crucial for the resumption of investment and self-sustained recovery, particularly in crisis-hit countries. It is especially critical to clean up the bad-debt overhang from bank balance sheets in order to create room for normal lending and render the stimulatory policy more effective.

119. The cost of restructuring the financial system promises to be huge, and part of this will have to be financed by foreign capital. To induce private foreign capital flows, restrictions on foreign ownership have been eliminated across these countries. Because a quick massive return of private funds is unlikely at the moment due mainly to investors' increased risk aversion, foreign official loans or aid will be necessary.

120. Resistance from labour and business tends to weaken the intensity of reform and to prolong the process. The costs of the social safety net and of creating employment to ease social pains, which have also risen, are exacerbating the fiscal debt burdens well into the future.

121. If structural adjustment in Asian countries can be quickly accomplished without complications, it will help to secure a base for self-sustained recovery in 1999. If the restructuring process drags on, however, the region may fall into protracted stagnation and instability, similar to what Japan has been passing through this decade.

Four crises-hit countries

122. The recession in four crises-hit countries that followed the imposition of stringent policy after the financial crisis deepened during 1998. On the supply side, sharply falling domestic demand, collapsing regional trade, and acute bottlenecks in the financial sectors caused a drastic output decline, particularly in manufacturing, construction and financial-service sectors. Labor strikes and riots also interrupted

production off and on. In Indonesia, the “El Niño” effect had severe adverse impacts on agricultural production.

123. All domestic demand components, except perhaps government spending, fell sharply with real private investment and consumption declining dramatically. Most of these countries have fallen into the trap set by a downward spiral of falling property prices, mounting bad debts, credit tightening, and weakening domestic demand. Despite the sharp depreciation of the currencies, total exports were not as strong as earlier expected, but gains in net exports were still substantial due to the drastic contraction of imports. Nevertheless, net export gains fell far short of compensating for the loss in domestic demand, and so GDP fell by 6 to 13 per cent in 1998 — a stark contrast with growth of 0 to 5 per cent in 1997.

124. By late 1998, however, the situations calmed down and sporadic signs of bottoming out began to show up in the Republic of Korea, Malaysia and Thailand. First, exchange rates were stabilized and inflation fell rapidly. Second, this stabilization allowed fiscal and monetary policy to be measurably relaxed. Third, the current account shifted from a combined deficit of \$21.1 billion in 1997 to a huge surplus of \$71.3 billion in 1998, resulting in a large reserve build-up. Fourth, demand in the United States was stronger than expected and the world electronics’ market improved somewhat. Finally, FDI mostly on account of mergers and acquisitions, doubled in the Republic of Korea and Thailand in 1998.

125. As the constraints on growth of these economies eased, signs of an upturn began to appear in a number of countries from the fourth quarter of 1998. As a result of reflationary policies and the gradual resumption of bank lending in step with bank recapitalization and corporate-debt restructuring, these economies, except Indonesia, are expected to exhibit a mild recovery in the second half of 1999. This upturn in domestic demand and the need to replenish stocks of raw materials and intermediate inputs, are expected to lead to a modest rebound in intraregional trade, which will offset to some extent the expected slowdown in trade with developed countries.

126. Among the four hardest-hit countries, the Republic of Korea has progressed most with its structural adjustment and appears to emerge from the crisis, though it was the last to be hit; Malaysia and Thailand appear to be following. In the Republic of Korea, ample signs of incipient recovery in domestic demand as well as

production since the fourth quarter of last year have emerged. Malaysia and Thailand also began to exhibit signs, although somewhat more sporadic and weaker, of bottoming out late last year. Their growth is expected to gather pace during 1999 and lead to sustainable recovery later this year. Indonesia, although its pace of contraction markedly decelerated late last year, is expected to exhibit a further modest decline in output in 1999.

127. Except for Indonesia, modest growth in most components of demand is anticipated this year.

128. Both consumption and investment are expected to exhibit modest growth with public investment taking the lead. In the Republic of Korea, consumer confidence has already been improving and the upturn in private consumption has been spreading to a wider range of consumer goods in recent months. Fiscal stimuli in most countries, given the emphasis on strengthening the social safety net and on labour-intensive projects, are expected to play a major role to stimulate private consumption. Especially the recently announced fiscal package of baht 30 billion in Thailand is expected to impart some vigour into private consumption in the second half. However, rising layoffs, falling wages, and reduced personal wealth will restrain the increase in private consumption. Private consumption in Indonesia, although the decline is likely to halt, will remain feeble.

129. The upturn in domestic demand and lower borrowing costs are expected to have favourable effects on private investment. In the Republic of Korea, although overall investment remains weak, investment in a number of major sectors such as shipbuilding, general machinery and autos has been expanding. In Malaysia too investment in manufacturing sectors appears to be bottoming out. In response to the relaxation of restrictions on foreign ownership, FDI flows have been maintained or are increasing, and they will further prop in investments. However, as long as banks are reluctant to lend, investment will remain constrained. Progress with bank restructuring could enable banks to resume normal lending later this year and thus lessen somewhat the constraint on investment. Since capacity utilization is low, the upturn in investment will be slow. From 2000, gradual recovery of investment is expected.

130. Export earnings by crisis-hit countries declined by 5 to 12 per cent (in US dollar terms) in 1998, owing to acute financing difficulties, collapsed import demand in the region, and a substantial fall in dollar export prices.

In the Republic of Korea and Thailand, the sharp fall in export prices more than offset their robust increase. Also, much of their competitiveness gain has since been eroded because their currency has appreciated in terms of the currency of their main competitors, high inflation, and increased cost of imported inputs.

131. Prospects for exports from these countries in 1999 remain bleak, due mainly to the expected slowdown in the United States and Europe, the continuing recession in Japan, and the real appreciation of their currencies. The export sector is not expected to contribute much to their economic growth. The extent of the expected upturn of demand in the region and of the world electronics' market will also have implications on their export performance. In the first couple of months, their overall exports failed to bounce back. Both the volume and value of exports are forecast to grow only modestly, even with the easing of constraints on their exports. In Indonesia, the new export-financing agency, if effective, can help ameliorate financial conditions for exporters, while in Thailand drought in the northern areas may limit its export capacity for agricultural products this year.

132. With the expected upturn in domestic demand, stabilized currencies, improved payment conditions, and the need to replenish input inventories, imports are expected to increase rapidly from a dramatic contraction in 1998, in part because of the high import content of exports. The combined current-account surplus of these countries, while still sizeable, is expected to shrink significantly, from over \$71 billion in 1998 to some \$55 billion this year. There is room for policy cooperation among countries to enable the crisis-hit countries to bolster their exports as a way out of the recession.

133. In these countries, except for Indonesia, while growth is expected to gather pace in the second half, 1999 as a whole is expected to result in 1-3.5 per cent growth in 1999, with the Republic of Korea leading the recovery, while thereafter it may rise to 4 to 5 per cent, still markedly below the pre-crisis growth performance. For Indonesia, real GDP contracted by 13.1 per cent last year and is expected to decline further this year. Assuming normal weather, a modest upturn is possible only in late 1999, provided socio-political stability can be maintained in the election this year.

134. Unemployment in crisis-hit countries rose rapidly because of the drastic cutback in production, rising bankruptcies and progressing restructuring. The

combined unemployment in these four countries already exceeded 20 million in mid-1998. As the restructuring proceeds in these countries, unemployment continues to rise and exacerbates further the already serious social and political problems, particularly on the labour front. For example, unemployment in the Republic of Korea reached 8.7 per cent in February 1999, the highest in three decades, compared with less than 3 per cent before the crisis. Job creation has therefore become an important policy objective. In Thailand, the new policy package also aims at creating half a million new jobs in 1999. Given modest recovery, however, high unemployment, except for Malaysia, where unemployment has stabilized at around 3 per cent, is expected to persist for a while with some divergence among countries in spite of efforts designed to ease the situation.

135. Inflation surged rapidly in crisis-hit countries in early 1998 as a result of the sharp depreciation of the currencies, the shortage of imports and, in a number of countries, the easing of price controls, the elimination of subsidies and poor agricultural production. In Indonesia, inflation reached 77.6 per cent in 1998 and rising food prices caused civil unrest; but inflationary pressures have eased substantially since the last quarter of 1998. For other crisis-hit countries, the price rise was below 10 per cent, yet nearly double that of 1998. However, with their strengthening currencies and large slack in the economy, more recently inflation has been falling rapidly in all of these countries and is expected to reach a low-level platform this year.

China and China, Hong Kong Special Administrative Region

136. Compared with its neighbouring economies, China's growth performance remains striking. In spite of many unexpected difficulties, exogenous and endogenous, China managed to register GDP growth of 7.8 per cent for 1998, very close to the target of 8 per cent set at the beginning of the year but the lowest since the early 1990s. The impact of the worsening Asian economic crisis, weakening domestic demand due to the restructuring of state-owned enterprises (SOEs), and one of the most severe floods in decades were the three major hurdles that dragged down China's growth in 1998. The first two factors are likely to remain major policy concerns in the near term. The outlook for 1999-2000 is cautiously optimistic: GDP is expected to grow about 7 per cent with economic policies continuing to focus on

stimulating domestic demand.

137. One direct impact of the Asian crisis on China's economy has been a sharp decline of China's exports to the region. As the economies in crisis cut their imports dramatically, China's exports to Asia declined by 9 per cent in 1998, with a drop of 7 per cent to Japan, 31 per cent to Korea, and 14 per cent to ASEAN. Since more than 50 per cent of China's total exports go to Asia, the impact of the Asian crisis on the country's export revenue and on industrial production has been significant. However, China has been able to keep its market share in other regions and managed to raise total exports by 0.5 per cent. In 1998, its exports to Africa increased by 27 per cent, to Europe by 18 per cent, to Latin America by 16 per cent and to the United States by 16 per cent. The overall export growth has dramatically lower than the 21 per cent gain in 1997 and the average of 17 per cent sustained since the inception of China's "opening-up" policy in 1979.

138. China has been exposed to sizeable competitive pressures from Asian economies. For example, the increased competition from Korea's iron and steel producers due to the devaluation of the won has created tremendous pressure on iron and steel producers in China. The effect of the devaluation in Asian countries on China's exports is expected to linger more into the near future. China's exports in the first quarter of 1999 continued declining by about 8 per cent. The total value of exports is expected to be flat for 1999 and to experience only a mild rebound of 6 per cent in 2000.

139. China's imports were also weak in 1998, in spite of continued reduction of tariffs, as domestic demand was not strong. The value of total imports actually fell by 1.5 per cent, leading to a trade surplus of \$40 billion in 1998, about the same as in 1997. At the same time, China registered a surplus of \$45 billion, or 3 per cent of GDP, on current account. The surplus is expected to moderate to about \$30 billion per year in 1999-2000, as import demand is forecast to rebound driven by further trade liberalization and acceleration in domestic investment.

140. Other contagion effects of the Asian crisis, especially those through financial channels, have been relatively small, partly because China's capital account is substantially delinked from its domestic financial system. The inconvertibility of the yuan on capital account and other capital controls have not only worked as a firewall to avoid direct speculative attacks, but also

prevented Chinese financial institutions from borrowing excessively abroad. But the crisis has revealed some weakness in China's financial sector just the same.

141. Total foreign capital inflows into China declined by about 8 per cent last year. Bank loans and portfolio investment dropped. But foreign direct investment (FDI), which accounts for 80 per cent of total foreign capital inflows, reached \$45 billion, a slight increase over the 1997 level. Similar to the changes in trade direction, a substantial decline in foreign capital inflows from Asia has been offset by an increase from America and Europe. However, FDI inflows declined in the early months of 1999, although the contracted, or pledged, foreign investment is still increasing.

142. In spite of China's delinked capital account, the closure last October of a heavily indebted provincial International Trust and Investment Company (ITIC), with debt totaling \$4.4 billion, caused concerns about the solvency of other ITICs; there are 239 in all in China. Moreover, concerns about the large volume of non-performing loans of the state banks, variously estimated between 15 and 25 per cent, have led international agencies to downgrade the rating of those institutions. In the case of a few state-owned banks, the rating has recently been reduced to the lowest investment grade; for ITICs it has been lowered to below investment grade.

143. One of the most sensitive issues during the Asian crisis, and also in the recent Brazilian crisis, has been China's exchange-rate policy. Speculation over a yuan devaluation emerged when several Asian countries, starting with the Thai baht in the summer of 1997, devalued their currency. This fear was rekindled at the beginning of 1999 when Brazil devalued the real. So far, however, China has kept its early promise not to devalue the yuan, which has been pegged at 8.3 yuan to the dollar since 1994. It may not be a sound policy for China to continue the peg to the US dollar at a constant rate in the long run. In the short run, however, a significant devaluation of the yuan is neither inevitable from the speculative point of view nor necessary from the policy perspective.

144. China is running a sizable current-account surplus, its foreign reserves rose slightly to \$145 billion by end 1998, and it has a foreign debt of \$140 billion with 80 per cent long-term. These sound fundamentals do not require a devaluation. The only conceivable argument for devaluing is to stimulate exports, and therefore overall

economic growth. A devaluation could increase exports to some extent. But the uncertainties and the shocks that a yuan devaluation would introduce for other sectors of the economy probably make it, at least for now, a sub-optimal policy for stimulating growth. As discussed below, China has chosen other policies, especially fiscal spending, to bolster economic growth by stimulating domestic demand rather than by stimulating exports, at least in the near term.

145. Accompanying weakening external demand, China's domestic demand also started to decelerate by the end of 1997, a trend that continued into the first half of 1998 largely due to some short-term side-effects from restructuring SOEs. While an increasing number of layoffs from SOEs curbed the growth of private consumption, uncertainties about the long-term viability of SOEs reduced the growth of investment.

146. In order to reverse the downturn in domestic demand, China has adopted a strong fiscal stimulus since mid-1998. Government spending on infrastructure has increased significantly, financed by bond issues (about Y100 billion or \$12 billion in 1998). Meanwhile, monetary policy has also been accommodative, with interest rates lowered by an average of 300 basis points in several steps. As a result, total fixed investment increased by 14 per cent in 1998, raising growth of industrial production by about 9 per cent. However, private consumption, which grew by only 5 per cent in 1998, remained weak. The labour market is very weak. The number of layoffs from SOEs is still growing, although six million were re-employed in 1998. Meanwhile, weak consumer spending has translated into a mild deflation in retail prices, with the index of retail prices dropping by 2 per cent in 1998.

147. In the summer of 1998, one of the most severe floods devastated a large area of China, claiming a direct loss of Y20 billion (2 per cent of 1998 GDP). Nevertheless, the agricultural sector managed moderate growth, with grain production registering 490 million tons, above the average annual production of the 1990s.

148. Given the continued weakness in the world economy, China's economic policy for 1999-2000 will remain focused on stimulating domestic demand. The expansionary fiscal policy is expected to continue, as a significant increase in government deficit is foreseen in the 1999 budget. The deficit is expected to be Y150 billion, below 2 per cent of GDP, increasing from the

Y96 billion in 1998. While the ratios of budget deficit to GDP and of public debt to GDP (about 10 per cent) are both modest by international standards, some worries about the strain in state finances are justified because the central government revenues amount to only 12 per cent of GDP.

149. Monetary policy, meanwhile, is expected to remain accommodative. In order to stimulate consumer spending, consumer loans, which have so far been limited, are expected to be promoted.

150. The Government expects a growth of 7 per cent to be attainable for 1999-2000, led by investment growth. While inflation is expected to remain low, unemployment, especially the layoffs from SOEs, will continue to be the key policy concern.

151. Major internal uncertainties remain in SOEs. Amid weakening domestic demand, the pace of some restructuring reforms has slowed. So the problems with those loss-making SOEs are being postponed rather than resolved. Moreover, the recent government stimulus has poured more investment spending into the less efficient state sector rather than allowing those funds to be allotted to the more efficient non-state sector. Nevertheless, a rapid close-down of those loss-making SOEs will raise substantially the already large number of layoffs, thus further depressing demand and heightening the risk of social turmoil. How to balance economic efficiency and social stability and to trade off long- and short-run goals pose dilemmas for Chinese policy makers. It is most likely that the SOE reform will move forward slowly along with enhancement of the social safety net. At the same time, major external risks include a possible slowdown in foreign investment, which is an important source of finance for the most dynamic non-state sector, offsetting drags from the SOEs. A sudden large drop in foreign investment would inevitably exacerbate weak domestic demand and lead in time to a devaluation of the Chinese yuan.

152. China, Hong Kong SAR suffered a severe impact from the Asian crisis, with GDP falling by 5.1 per cent in 1998, the first recession in four decades. Total exports fell 7.3 per cent in 1998, with domestically produced exports falling even more. Prices of its equity market and real estate dropped very sharply during the crisis and the HK dollar, which is pegged to the US dollar through a currency board, was under severe speculative attack for quite a long period. Interest rates surged as a result of

defending the speculative attack on the HK dollar. The peg survived, the financial market has been under a moderate recovery, and interest rates have been lowered to normal levels. But the impact on the real economy has been significant. Both private consumption and investment fell sharply in real terms, industrial production declined, and the unemployment rate rose significantly. A continued, but much milder, decline of 0.5 per cent in GDP is expected for 1999, to be followed by a moderate recovery in 2000.

Western Asia

153. The collapse of oil prices in 1998 to their lowest level in more than two decades has hit the region hard. Economic growth in all but two countries contracted, and unemployment, fiscal and current-account deficits mounted. Economic growth in the region was also affected by the continuing sanctions on Iraq and uncertainties over the Middle East peace process, two events that continue to create political instability and continue the room for intraregional flows of trade and investment.

154. The region's real GDP growth declined to 0.5 per cent in 1998 compared to almost 5.4 per cent in 1997. The oil-exporting countries suffered the most. Both public consumption and investment were substantially cut, reflecting the unexpected shortfall in oil revenue. With a small non-oil sector, oil revenues provide the major source of funds for development as they accrue directly to the Governments of the oil-exporting countries. This means that the rate of government expenditure is the major determinant in stimulating aggregate demand, influencing activity of the private sector and determining the rate of domestic liquidity. Private investment as a result was reduced response to the general lack of confidence, liquidity shortage and import compression. Exports have fallen significantly, owing to high inventories in Western Europe and weak oil demand in East Asia. Depressed economic activity and reduced government spending led to a decline in import demand of goods and services.

155. On the supply side, the mining sector in all oil-exporting countries performed poorly mainly due to reduced oil production and declining oil prices. Manufacturing, namely, the processing of oil, petrochemicals, chemicals and aluminium, was constrained by weak domestic and external demand. The

construction sector has suffered a severe setback as many industrial and infrastructural projects were canceled or postponed. The crisis in consumer confidence, together with the tight financial position, held banking activity down.

156. The oil-importing countries in the region have not been immune from the oil slump¹ (through transmission mechanisms such as trade, unrequited transfers and soft loans from oil-exporting countries to the oil-importing countries), because two groups are interdependent. Reduced imports of goods and services from the oil-exporting countries of the region coupled with declining workers' remittances, grants and soft loans created difficulties for the oil-importing countries. GDP growth contracted in some countries (Jordan and Syria) and sharply decelerated in others (Lebanon, Israel and Yemen) in 1998. Industrial output declined and construction activities plummeted in most countries. Private consumption growth remained sluggish, while public consumption was constrained to meet budgetary targets. Investment growth slowed as reduced inward workers' remittances affected domestic savings.

157. The LINK baseline assumes a slight recovery of oil prices in 1999 with a limited acceleration in the year 2000. Against that backdrop, prospects for 1999 are very poor as GDP growth in all oil-exporting countries are expected to decline further. As a result, the group's GDP growth (including Israel) is likely to further decline from -0.5 per cent in 1998 to -1.0 per cent this year. Although fiscal consolidation, with further expenditure cuts and other measures aimed at diversifying government revenues, is expected to intensify, in fact fiscal and current-account deficits are likely to rise substantially in all countries of the region except Bahrain and the United Arab Emirates. Accelerated privatization and more increased borrowing will only cushion the impact of lower oil-tax revenue. The external-debt burden for the region remains high and debt-service continues to divert

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Among the 13 countries comprising the region, only three (Israel, Jordan and Lebanon) do not produce and export oil. Syria and Yemen export oil but in small quantities. Jordan, Lebanon, Syria and Yemen are labour-exporting countries, hence dependent on workers' remittances, and are also large recipients of aid and soft loans from inside and outside the region. Trade and transit trade play a key role in the region. The oil-exporting countries remain the main markets for agricultural and manufacturing products from the oil-importing countries.

scare resources from productive investments, particularly in the oil-importing countries. Aid, soft loans and workers' remittances are expected to decline. Although, there is more acceptance of the need to streamline large and costly welfare systems in most countries of the region, the complete dismantling of subsidies or the introduction of taxes remains politically difficult.

158. If oil prices firm later in 1999 and into 2000, as expected, economic recovery might occur. But the twin deficit that the region has been facing for many years is unlikely to disappear.

159. Continued economic slowdown, rising unemployment and fiscal deficits, reduced inflation together with external imbalance, and declining financial inflows were the main features of the Israeli economy in 1998. Israel's GDP growth decelerated from 2.2 per cent in 1997 to 2.0 per cent in 1998, entailing a decline in per capita GDP. The economy has remained weak for nearly four years — the longest since the mid-1970s. The downturn in 1998 was partly due to a drastic decline in consumer demand, to a slump in construction activities, and partly to the Russian and East Asian- crises.

160. Between 1990 and 1995, immigration from Russia was estimated at 170,000 a year, which boosted private consumption as well as construction. Since 1996, however, this immigration flow has slowed to less than 50,000 a year, weakening support for private consumption and construction. Private investment growth also dropped because of high real interest rates and the crisis of confidence about economic prospects, thus deterring investment. But government spending increased mainly due to rising defence outlays. External demand of Israeli goods and services — the driving force of economic growth — has weakened. Much of the decline in export growth can be attributed to the steep fall in diamond exports to Asia in 1998 — some 40.0 per cent in the first half of the year. Import growth slowed due to slack consumer demand and reduced industrial activity.

161. Tourism too, which is a major source of employment and foreign-exchange earnings, performed poorly in 1998 as the momentum of the peace process faded and fears over security mounted. Credit shortages together with reduced demand prevented the recovery of construction which in turn affected performance in mining and quarrying. Most manufacturing sectors, except for chemicals and electronics, were hit hard by weak external and domestic demand, thus leading to

contraction.

162. The restrictive monetary policy to which Israel has adhered for some time aims to reduce inflation and prevent any significant devaluation of the shekel. In the first half of 1998, inflation was estimated at an annual 4-5 per cent rate — the lowest for almost three decades. The turmoil in international markets since August 1998 has led to a marked depreciation of the shekel. Given the large size of the tradable sector in Israel, the price rise for imports interrupted the rapid progress made with lowering inflation. The Bank of Israel responded to the currency depreciation by raising the interest rate by four percentage points to restore investor confidence. As a result CPI rates slowed notably and inflationary expectations fell in November, suggesting that, the sharp hike in prices in reaction to currency depreciation was a short-lived phenomenon. In spite of the low inflation in early 1998, the drop in inflation toward year's end has been estimated at 8.6 per cent.

163. Fiscal policy has remained tight as well. Government expenditures rose because of rises in public-sector employment and transfer payments. But capital spending slowed, mainly due to the fall in infrastructure investment. Because the economic slowdown was deeper than anticipated when the budget was planned, the intended intensification of tax-collection did not materialize, thus resulting in a shortfall in government revenue. Fiscal deficit amounted to 3.3 per cent of GDP, considerably higher than the government target of 2.4 per cent. Treasury bills and development bonds were the main sources of deficit financing.

164. Weak economic growth together with tight monetary and fiscal policies caused unemployment to rise again in 1998 to about 9.0 per cent. Because the persistent and rising unemployment is a matter of deep concern, the government introduced some safety net measures, such as increasing the number of civil servants and offering training and vocational retraining to job seekers.

165. Israel's terms of trade improved in 1998, which helped to reduce the current-account deficit from 5.1 per cent of GDP in 1997 to 3.6 per cent in 1998. The improvement in the current account came at a time when export growth was slowing. It stemmed largely from the decline in imports owing to falling import prices, particularly for oil, and slack consumption demand.

166. The adverse impacts of the South-east Asian and

Russian crises were not limited to foreign trade. Also the capital account came under severe strains during the second half of 1998. In the first half of the year, private capital inflows amounted to \$1.7 billion but an outflow of around \$308 million was observed between September and November 1998. The rise in the foreign-exchange risk premium and the subsequent rise in the liquidity requirement of foreign investors pushed nonresidents to sell some of their financial investments and Israelis to increase their foreign-currency deposits. As a result total foreign financial investments in Israeli stocks listed on the Tel Aviv Stock Exchange and abroad dropped sharply, falling to \$525 million in 1998 from \$1.99 billion the previous year, as foreign investors remained reluctant to return to emerging markets following the Asian and Russian financial crises. In addition, net foreign investment (including both portfolio and direct investment) dropped by over 40.0 per cent, from \$3.5 billion in 1997 to \$2 billion in 1998. Reduced capital flows led to a steep depreciation of the shekel and it was only after the interest rate was raised in November that the currency gradually recovered some of its losses. The current-account deficit was financed mainly by drawing down foreign-exchange reserves.

167. With the monetary stance tight in 1999, but fiscal policy loosening on account of the forthcoming elections in May, possibly to about 3.0 per cent of GDP, economic performance in 1999 will remain subdued. The high unemployment rate prevents any sizeable rise in spite of inflation, although its pace has been abating. Tax reforms are not expected in 1999 and 2000. It is also assumed that the peace process will remain on track, allowing a further easing of the defense burden and deepening Israel's integration into the world economy.

168. Weak demand is therefore set to continue in 1999. Private consumption growth is likely to further decelerate, due to high and rising unemployment and the increased cost of credit. Gross-fixed investment which fell sharply in 1998 will remain restrained by high interest rates and low confidence about economic prospects. Exports continue to be affected by the adverse impact of the Asian crisis and the widening slowdown in growth in developed countries. Import demand will be constrained by slack economic activity. Nevertheless, increased government spending due to fiscal relaxation might lift GDP growth to 2.5 per cent in 1999. The current-account deficit is likely to decline, while internal imbalance will rise.

169. Following the election, an overall economic programme is likely to be implemented in order to boost economic activity, which will transpire mainly in 2000. It forms might be on bolstering investments, particularly in infrastructure and housing might increase. As a result, GDP growth is expected to be at around 4.5 per cent for the year 2000.

170. In Turkey, the Asian and Russian financial crises, and restrictive fiscal policy together with an accommodative monetary stance led to a decline in GDP growth from 7.3 per cent in 1997 to 3.0 per cent in 1998 — a four-year low. In the process, inflation slowed though it was still at a high double-digit level. Inflation therefore remains Turkey's paramount economic problem. External and internal imbalances persisted, while the unemployment rate declined slightly to 6.0 per cent. The drastic reversal in capital flows led the monetary authorities to raise the already-high interest rates.

171. The economic slowdown in 1998 is due mainly to the contraction in final demand. Private consumption remained weak, despite the increase in public-sector nominal wages, owing to high interest rates and deferred consumer spending. Private investment dropped because of the credit squeeze, the lack of confidence in Turkey's economic prospects, and continued political uncertainty.

172. The slowdown stemmed also from the sharp decline in exports to Russia, which is the country's second-largest trading partner. One fifth of the country's trade in recent years was with Russia. Also Turkish construction companies have been very active in Russia. Both activities were affected in a major way by Russia's financial crisis and its repercussions on other economies in transition, especially in Central Asia. But exports dropped sharply also because of stiff competition from cheaper Asian products. Imports plummeted significantly because of weak domestic demand. Despite the 5 per cent improvement in its terms of trade, Turkey's current-account deficit widened from 2.5 of GDP in 1997 to 2.7 per cent in 1998.

173. Weak external and domestic demand caused manufacturing output to shrink. But agricultural production rose, owing to good weather conditions. Tourism performed poorly because of political instability.

174. Fiscal policy in 1998 aimed at curbing inflation, improving tax collection, and reducing the heavy burden

of interest payments, and succeeded in raising real tax revenue. As a result, the primary fiscal surplus increased from 0.3 per cent of GNP in 1997 to about 3.0 per cent in 1998. Nonetheless, the overall fiscal deficit widened to 7.7 per cent of GNP in 1998 from 7.3 per cent in 1997, mainly because of the rise in interest rates.

175. Financing the fiscal deficit has been the main source of inflation partly because it was monetized and high interest rates. In mid-1998, the Treasury ceased to borrow from the central bank, contributing to a steep decline in credit expansion. The 1998 fiscal deficit was partly financed through development bonds and partly through securities indexed to inflation and the exchange rate. Inflation slowed to 70.0 per cent in 1998 from just under 100.0 per cent in 1997, but it was higher than the Government's target rate of 50.0 per cent.

176. Monetary policy aimed at providing enough liquidity to the economy, while depreciating the currency to maintain the competitiveness of Turkish exports. Prior to the Russian crisis, Turkey experienced huge capital inflows attracted by high domestic interest rates, forcing the central bank to sterilize liquidity if it wanted to adhere to its monetary programme. The central bank became also less aggressive in managing day-to-day liquidity, allowing short-term interest rates to move more freely. The Russian crisis induced capital flight, forcing the Turkish monetary authorities to raise interest rates.

177. Economic growth may well increase to 3.5 per cent in 1999 and accelerate sharply in 2000. The expected modest improvement in 1999 might be driven by private consumer demand, reflecting mainly the lagged effects of the increased wages and agricultural support prices in 1998. Public consumption and investment are likely to decelerate significantly, responding to the continued tight fiscal stance as the main macroeconomic objective remains sustaining the primary budget balance and reducing the overall fiscal deficit thus public sector borrowing, to manageable levels. Private investment is expected to increase because of the greater participation of the private sector in utilities, telecomm and energy. As a result, imports might rise. Exports, however, will continue to decelerate as the Russian market remains weak. Domestic demand together with exports is likely to pick up in 2000, thus leading to robust GDP growth of about 5.2 per cent.

Latin America and the Caribbean

178. Reliance on foreign capital and the large share of commodity production in aggregate output have made many economies in Latin America highly vulnerable to external shocks. As a result of increasing external capital constraints and falling international prices of commodities, a significant slowdown spread over the region in 1998. GDP growth dropped to 2.3 per cent, less than half the previous year's and well below the average rate of 3.5 per cent for the 1990s. Meanwhile, El Niño effects and hurricane damage also contributed to the slowdown in the region. The near-term outlook for the region is gloomy. Brazil's currency crisis at the beginning of 1999 has further exacerbated the prospects for the region. Nevertheless, owing to the relatively resilient banking and financial systems in most countries, the ripple effects of the Brazilian crisis are likely to be moderate and be felt chiefly in a few economies. The downward adjustments in the region will be less severe and less protracted than those in some Asian countries since mid-1997. A mild recession with about a 0.3 per cent drop in the region's GDP is expected in 1999, to be followed by a moderate recovery in 2000.

179. The peg of the Brazilian real to the US dollar under the 1994 Real Plan had successfully been used as the policy anchor to eliminate Brazil's hyperinflation. As the real appreciated in real terms in recent years, the currency became overvalued. Devaluation pressures escalated with the Asian crisis in the summer of 1997 as Brazil's large and increasing fiscal and external deficits became of growing concern to financial markets. By the end of 1998, the fiscal deficit was about 8 per cent of GDP and the current-account deficit about 6 per cent of GDP. Without the IMF rescue package of \$41 billion offered in November, the real would probably have collapsed in the fall of 1998. In January 1999, the decision of the state Governor of Minas Gerais to suspend payment for 90 days on debt owed to the federal Government further eroded confidence. When international reserves reached about \$30 billion, down from the \$70 billion held before the Russian crisis in August 1998, the central bank decided to let the real float. By March 1999, it had lost about 50 per cent of its value against the US dollar; but it has stabilized and indeed recovered since then from over 2.2 real per dollar to about 1.6-1.7 real per dollar. With the redesigned IMF

programme, the Brazilian authorities have been making an attempt to establish a clear framework for intervention in the new floating exchange regime.

180. Immediately following Brazil's devaluation, Ecuador also abandoned its four-year-old crawling-peg exchange-rate band in February 1999 and allowed the sucre to float. Within a month, it lost 40 per cent of its value against the US dollar. In order to stop panic withdrawals from financial institutions, the Government shut down the country's banks for a week in March and declared a state of national emergency.

181. The contagion of the Brazilian crisis has been, and will continue to be, transmitted to the rest of the region through trade linkages and financial markets. The immediate impact on the external financial conditions for the region so far has been modest. The financial contagion has been much less severe than that from the Asian and Russian crises.

182. Historically, risk premiums of financial assets across Latin America have tended to be highly correlated. However, the yield spreads between sovereign bonds and the treasury bonds of the United States observed since the Brazilian crisis show that international investors are now more likely to differentiate risk premiums based on the differences in macroeconomic fundamentals of individual countries. For example, the spreads for Argentina and Mexico have been much smaller and less volatile in comparison with the one observed for Brazil. Meanwhile, access to primary-market issues has improved: Within days of the Brazilian devaluation, Argentina and Mexico were able to raise more than \$1 billion via bond issue. This contrasts sharply with the more than four months it took after the 1994 Mexican crisis for international investors to buy any Latin American debt and about two months during both the Asian and the Russian crises. Even Brazil was able to return to the market in March, just two months after the crisis.

183. However, the external borrowing for Latin American economies remains constrained and is likely to remain so for 1999. These countries will face strong competition from Asia in raising external funds, as the Asian economies recover from the crisis. For example, the spread in global debt markets for Mexico is 150 basis points more than that for Korea.

184. In addition to the external-financing constraints, another adverse external condition for the region has

been the sharp drop in international commodity prices. Prices of commodities that are major exports of Latin American economies, such as coffee, sugar, copper, petroleum and grains, have declined markedly since the Asian crisis, with many prices reaching their lowest level in decades. For example, the prices of oil, coffee and copper declined by more than one third in 1998. As a result, export and government revenues have been falling substantially, contributing directly to a deterioration in both the external and internal balances in many Latin American economies, and substantial overall welfare losses have been incurred as a result of the severe deterioration in the terms of trade for these economies.

185. The recent rebound in the price of oil, in response to an agreed cut in oil production by oil producers worldwide, may entail a modest rise in many commodity prices. But these prices in 1999-2000 are not expected to return to their pre-Asian-crisis levels.

186. Despite some notable improvements in the region's financial markets and in commodity prices, downward adjustments in the real sector of many economies, which started in 1998, will continue at least for the first half of 1999. Several countries are expected to register a decline or zero growth in GDP for 1999, for an average decline of the region's total GDP of 0.3 per cent.

187. At the centre of the region's falling GDP is one of the worst recessions on record in Brazil, which accounts for about 40 per cent of the region's GDP. The fiscal austerity measures and the extremely high interest rates will no doubt depress the economy, at least in the short run. As a result, Brazil's GDP is expected to shrink by 3.2 per cent in 1999, after the slow growth of 0.4 per cent in 1998. While the planned fiscal spending cut will lead to a large decline in public consumption by 15 per cent, fixed investment is expected to have a large drop by about 7 per cent, partly because of the external-financing constraints and the tightening monetary policy, although interest rates have been coming down. As a result, Brazilian import demand is likely to drop by 15 per cent.

188. The spillover effects from Brazil's recession to the rest of the region is expected to be limited to a few south American economies that have strong direct trade links with Brazil. Argentina is one of the most significantly affected, as 30 per cent of its exports go to the Brazilian market and Brazil's recession is likely to reduce Argentina's exports. This together with weakness in both investment and consumption, partly due to credit

tightening and high employment respectively, is expected to push Argentina into a mild recession, with 1.0 per cent decline of GDP in 1999, compared with 4.5 per cent growth in 1998. Paraguay and Uruguay too, which also have strong trade links with Brazil, are expected to experience a mild recession or zero growth in 1999.

189. The direct effects of the Brazilian crisis on other south American economies are much less significant, but the outlook for most of them is also gloomy. Venezuela has the worst prospect among them. As 70 per cent of its exports and 50 per cent of its fiscal revenues depend on the oil sector, the decline in the price of oil sent Venezuela's economy into a mild recession in 1998, with GDP declining by 0.5 per cent. Along with further fiscal strains, the recession is expected to deepen in 1999, with GDP dropping by 2.0 per cent. At the same time, Ecuador is expected to have zero growth or even a recession, partly because of its dependence on oil but also on account of the post-devaluation fiscal adjustment that will need to be undertaken. Chile, Colombia and Peru are all expected to have low growth in 1999, ranging from 1 to 3 per cent. For Chile, this will be the lowest growth rate for more than a decade, as the low price of copper has hit the economy hard. Bolivia is the only southern country that is expected to have a growth rate above 4 per cent, as it has attracted only a small volume of short-term capital flows and maintained a stable currency.

190. In contrast, the slowdown in Mexico and in the economies of Central America is expected to be much less significant than that of the southern neighbours. Because of the strong trade and investment links with the United States, these economies have been benefiting from the robust economic growth sustained by the United States.

191. The low price of oil and the external financial shocks have adversely impacted on Mexico's economy, as its GDP growth decelerated in 1998 to 4.5 per cent from 7 per cent in 1997. However, strong United States import demand and a flexible Mexican peso have raised non-oil exports. The rebound in the non-oil sector in combination with prudent fiscal policy and improved external public-debt management, will permit 3 per cent growth in 1999.

192. Despite the severe hurricane damage to some Central American economies, most countries managed to register about 4 per cent growth on average in 1998 as a

result of the strong United States import demand. For example, Guatemala's GDP grew by 4.7 per cent in 1998 with exports rising by 8 per cent and Costa Rica's GDP grew by 6 per cent with exports increasing by 20 per cent. However, growth of the region is expected to moderate in 1999 with the post-hurricane reconstruction, the hurricane-induced inflation, and some expected adjustments in external imbalances being a drag on economic buoyancy.

193. Latin America and the Caribbean as a whole is forecast to have a moderate recovery of economic growth in 2000. However, its strength will depend not only on improvement in external conditions, but also on the macroeconomic policies in these economies.

194. Most economies in the region have been facing deteriorating fiscal positions, due directly to tightening external financing conditions and falling commodity prices in 1998. This holds especially for Brazil, Ecuador and Venezuela whose fiscal deficits exceeded 5 per cent of GDP by the end of 1998. Fiscal policy in the region has been tightened as many economies have adopted austerity measures in response to the international financial turmoil.

195. In the near term, fiscal policy in the region will continue to remain tight so as to cope with adverse external pressures. In Brazil, for example, the redesigned programme with the International Monetary Fund following the real devaluation has raised the primary budget surplus by an additional 0.5 per cent of GDP per year between 1999 and 2001. This is to be attained mainly by cutting expenditures. Further tax increases are likely in many countries, such as Colombia, Ecuador and Venezuela.

196. Along with the tightened fiscal policy, monetary policy has also been restrictive. Many countries in the region experienced a significantly slower, even negative growth of real money supply in 1998. Meanwhile, rising interest rates to attract foreign capital and to protect the currency have raised the cost of credit. High interest rates have curbed domestic demand in the region, but also weakened financial sectors in some countries by rising the magnitude of non-performing loans, thus weakening bank assets.

197. The restrictive monetary policy is likely to continue in some countries. But an easing of policy has recently been implemented in others, especially in countries with stronger fiscal positions. Countries such as

Argentina, Chile, Colombia and Mexico have begun to cut interest rates substantially. Even in Brazil, interest rates have also been cut, although they are still high.

198. Combating inflation has been the main target of macroeconomic policy in most Latin American economies in the 1990s. Further domestic price stabilization was achieved in the region in 1998, though Ecuador was one of the few exceptions, with the average regional inflation index reaching its lowest level in 50 years. Currency devaluation in some countries during the Asian and the Russian crises was not directly translated into inflation, partly because of deflationary pressures worldwide but also owing to the policy efforts in these economies. Except Brazil and Ecuador, inflation is likely to remain under control throughout the region.

199. In most countries, the external sector deteriorated in 1998 due to a decline in export revenues as export prices dropped significantly and world demand slowed. The region's current-account deficit increased to 4 per cent of GDP in 1998, up from 3 per cent in 1997. International reserves declined in many economies, most seriously in Brazil, Chile and Venezuela. Reduced import demand from Asia was a major factor for weak exports of the region, but intraregional trade has also slowed down markedly. Only Mexico and a few Central American economies registered a good export performance, due to their links to the United States economy and Mexico's membership in the North American Free Trade Agreement (NAFTA).

200. The region's current-account deficit is expected to improve in 1999, but mainly through cuts in imports as many economies are lowering their domestic demand in view of the worsened external constraints. The most dramatic adjustment will be in Brazil, whose current-account deficit is expected to be cut by half, or \$15 billion. This will reduce intraregional trade, especially the exports of countries in Mercosur. The region's exports to the rest of the world are not expected to grow significantly in 1999 as world demand remains weak.

201. The labour market usually responded with a time lag to changes in economic growth. In fact, when economic growth decelerated in 1998 many countries in the region experienced an improvement in labour markets. For example, Argentina lowered its persistently high unemployment rate by two points to 13 per cent in 1998. Although the average unemployment rate for the region rose to 7.9 per cent in 1998, from 7.3 per cent the

previous year, this was mainly due to a worsening in Brazil and Colombia. But the improvement in the labour market is likely to be halted, or even reversed, as economic growth in the region continues to decline. Unemployment rates are expected to surge in some countries. In Brazil, for instance, the recession is expected to push the unemployment rate to 11 per cent in 1999, up from 8 per cent. At the same time, real wages, which have been stagnating or falling slightly in most economies, are expected to shrink.

202. The current outlook for the region assumes that the Brazilian crisis will not deteriorate and its contagion to the region will not go beyond what was experienced by April of 1999. However, downside risks still exist. If the crisis in Brazil deepens, as investor confidence reverses because of either policy difficulties in the country or some exogenous economic factors, the currency's weakness would continue, raising the risk of debt default with reverberating adverse effects throughout the region. Likewise, if the United States economy cannot avoid a hard landing, led by a collapse of the equity market, for example, economic growth of the region, especially in Mexico and Central America, would be further depressed. Moreover, the uncertainties surrounding elections in many economies of the region in 1990-2000 are not negligible.

203. As domestic saving rates in most Latin American economies are relatively low, the region's growth depends importantly on external financing. Unless this dependency is reduced, many economies in the region will remain vulnerable to changing conditions in global capital markets and to other external shocks.

204. After the recent shifts to more floating-exchange regimes by Brazil and Ecuador, only two countries in the region, Argentina and Panama, are left with fixed exchange-rate regimes. In the current debate on exchange policies, however, there still seems to be strong support for the argument that Latin American countries should fix their exchange rate to the United States dollar through a currency board, as in Argentina, or simply replace their national currencies with the United States dollar, as in Panama.

205. Latin American economies have explored different exchange regimes for many years. The debt crisis in the early 1980s made most Latin American countries abandon fixed exchange-rate arrangements. Later, as inflation became a central concern for policy makers,

countries began to search for an exchange system that could function as a price anchor, but with some flexibility. So-called “backward looking crawling pegs” were then widely adopted to protect the real exchange rate from misalignment. In the early 1990s, an increase of large capital inflows put such arrangements under stress and some countries, such as Chile, Colombia and Mexico, adopted “exchange-rate bands.” With one currency crisis after another in the 1990s, more countries, such as Brazil and Mexico, in the region have tended, or have been forced by the currency crises, to adopt more flexible arrangements, including managed floats or crawling bands. Contrary to this trend, only Argentina, with the adoption of a currency board in 1991, has moved to a highly fixed regime.

206. Argentina’s currency board, which was established in 1991, has survived the international financial crises in the 1990s and has drawn growing interest from Latin America. Argentina has been very successful in stabilizing the economy from its early hyperinflation. However, the true test of a successful policy is not merely conquering inflation by an open-ended sacrifice of prosperity but by doing so while achieving full employment and reasonable growth. Argentina’s high unemployment rate has always been cited as one shortcoming of the currency board.

207. Argentina and some other economies in the region are giving serious thought to a full dollarization, that is, replacing the national currencies by the US dollar. Advocates of dollarization believe that by giving up currency independence and by sacrificing the loss of seigniorage (the government’s ability to borrow by issuing national currency below market rates), Latin American countries can defend themselves better from financial speculation and strengthen their access to global capital markets. Opponents, on the other hand, argue that in addition to the obvious political cost of yielding currency sovereignty, external shocks would directly lead to higher unemployment and a larger fall in the domestic real wage without an exchange-rate buffer. Moreover, the United States Fed would most likely not include in its monetary-policy configuration the economic conditions in and interests of the dollarized economies.

208. The debate on exchange regimes is likely to continue. However, the most important issue may not be the exchange regime itself but the consistency between the regime chosen and the corresponding macroeconomic policies. A “wrong” exchange arrangement can cause economic problems, but a “right” exchange-rate regime by itself cannot solve all economic problems.