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# Project LINK Meeting

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# WORLD ECONOMIC OUTLOOK

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## INTRODUCTION

The agenda of the May 1999 Project LINK meeting, held at United Nations, New York, 3-6 May 1999, includes (1) discussion of the short- and medium-term outlook for the world economy, based on assessment of new international and national developments since the 1998 September LINK meeting; (2) discussion of current international economic policy issues, such as policy aspects of an eastward enlargement of the European Union, developments in international financial markets, and broader issues of globalization for developing countries in particular.

With inputs from the national LINK centres and information from other sources, as of 26 April 1999, the LINK team at the United Nations prepared a pre-meeting world economic forecast, using the LINK econometric modelling system. This report summarizes the main features of the pre-meeting forecast. The outlook projected here is an interim exercise and will be updated with a post-meeting forecast in several weeks. Most of the *LINK COUNTRY REPORTS*, which contain detailed forecasts and policy analyses submitted by the national LINK centres can be found on the websites at both the United Nations and the University of Toronto.

## GLOBAL OUTLOOK

The world economy finds itself in a healing process, overcoming gradually the traumatic shocks of the recent international financial crises. After a significant slowdown in 1998, global growth is expected to regain some strength in 1999-2000. World GDP is forecast to be 2 per cent for 1999, slightly higher than the 1.7 per cent registered for 1998, with a further rebound to 2.5 per cent in 2000 (table 1). However, the divergence in growth performance across nations, which has widened since the Asian currency crisis in mid-1997, remains worrisome. While a number of economies, mostly developing and transition economies, are striving to recover, others remain in or are still falling into recession. More importantly, given the uneven distribution of wealth across nations and within countries, the mediocre growth of world GDP, which is barely above population growth, implies that personal incomes and living standards for a large proportion of the world's population are declining or stagnating.

World financial markets, which have experienced severe turmoil and led directly or indirectly to protracted and sharp economic and social crises in many economies since 1997 have finally been showing some signs of stabilization, with a restoration of confidence in many emerging markets. Most noticeably, the contagion effects of the Brazilian currency crisis at the beginning of 1999 have been contained. Meanwhile, led by the recent easing of monetary policy in major developed economies, as advocated by Project LINK since early 1998, monetary conditions in the world economy have become more accommodative to global economic expansion. Moreover, international prices of commodities, which experienced a sharp deflation in 1997-1998 and led to economic deterioration in many developing countries, have also stabilized, with a remarkable rebound in the price of oil since early 1999.

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

| | May 1999 [a] | | | November 1998 [b] | |
|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 1999 | 2000 |
| World GDP | 1.7 | 1.9 | 2.5 | 1.9 | 2.7 |
| Developed market economies | 1.9 | 1.8 | 2.0 | 1.5 | 2.2 |
| Canada | 3.0 | 3.1 | 3.2 | 2.2 | 2.0 |
| France | 3.4 | 2.2 | 2.6 | 2.8 | 3.1 |
| Germany | 2.8 | 1.8 | 2.6 | 2.2 | 2.8 |
| Italy | 1.4 | 1.6 | 2.5 | 2.3 | 2.9 |
| Japan | -2.8 | -1.4 | 0.9 | -0.9 | 1.6 |
| United Kingdom | 2.1 | 0.5 | 2.1 | 0.7 | 2.5 |
| United States | 3.9 | 3.5 | 2.0 | 2.1 | 2.0 |
| Developing countries | 1.2 | 2.5 | 4.5 | 3.4 | 4.7 |
| Latin America | 2.3 | -0.3 | 3.3 | 1.5 | 3.5 |
| Argentina | 4.5 | -1.0 | 3.0 | 3.0 | 4.5 |
| Brazil | 0.4 | -3.2 | 3.0 | -1.8 | 2.3 |
| Mexico | 4.8 | 3.0 | 4.6 | 3.6 | 4.0 |
| Africa | 2.5 | 3.0 | 3.5 | 3.0 | 4.1 |
| North Africa | 4.0 | 3.4 | 4.5 | 4.1 | 5.0 |
| Sub-Saharan Africa (excluding South Africa) | 2.5 | 2.8 | 3.1 | 3.0 | 3.8 |
| Nigeria | 2.8 | 3.4 | 3.4 | 3.0 | 3.3 |
| South Africa | 0.1 | 1.3 | 2.8 | 2.0 | 4.0 |
| South and East Asia | -2.0 | 2.9 | 4.5 | 2.7 | 4.6 |
| India | 5.6 | 6.1 | 6.4 | 5.8 | 6.3 |
| Indonesia | -13.1 | -2.5 | 3.4 | -2.5 | 0.5 |
| Korea, Republic of | -5.8 | 3.4 | 4.6 | 1.4 | 3.9 |
| Malaysia | -6.7 | 1.5 | 3.3 | -1.5 | 3.5 |
| Philippines | -0.5 | 2.4 | 4.7 | 3.3 | 4.5 |
| Singapore | 1.5 | 1.0 | 2.1 | 0.5 | 2.4 |
| Taiwan Province of China | 4.8 | 4.8 | 6.0 | 5.5 | 6.0 |
| Thailand | -8.0 | 1.3 | 2.1 | -0.7 | 3.5 |
| China | 7.8 | 7.1 | 7.0 | 8.0 | 7.5 |
| West Asia | -0.5 | -1.0 | 5.2 | 2.0 | 3.3 |
| Economies in transition | -1.5 | -0.3 | 1.3 | 0.7 | 1.5 |
| World exports, volume | 4.5 | 2.5 | 3.6 | 3.5 | 4.7 |
| Export prices (annual percentage change) | | | | | |
| All goods | -6.3 | 0.4 | 4.0 | 3.6 | 2.1 |
| Agricultural commodities | -10.4 | -3.2 | 2.5 | -1.7 | 1.8 |
| Raw materials and ores | -8.3 | -1.9 | 4.1 | 1.6 | 3.3 |
| Oil | -33.4 | 4.0 | 24.0 | 4.0 | 8.0 |

[a] Pre-meeting forecasts; weights used are in 1995 U.S. dollars.
[b] Post-meeting forecasts; weights used are in 1988 U.S. dollars.

In spite of those improvements, there is no room for complacency. Adjustments in real economic sectors will take a much longer period of time than changes in financial and monetary indicators. But recovery in employment and real wages, and reversing the social setbacks, such as the recent deterioration in inequality and broader damage to human capital incurred in countries with economic crises, will lag well behind the resumption of output growth. Above all, changes in economic structures of many countries and reforms of the international financial system will be a protracted process. While there appears to be consensus on the need for reforming the international architecture, there is no agreement on how to go about it. Without successful systemic reforms, the global economy remains highly vulnerable to future international financial crises.

### *The baseline forecast*

Since the last LINK exercise in November 1998, several new developments in the world economy warrant a reassessment of the outlook with perceptible changes in the prospects of different economic groups and regions. But the outlook for aggregate global growth shows little difference as the broad global trend has been in line with the last LINK forecast. Meanwhile, the probability of a global recession for 1999-2000, which was not considered to be high in the last LINK baseline forecast, has declined further.

The Brazilian currency crisis at the beginning of 1999 was the latest financial shock to the world economy, following the Mexican crisis in 1994-1995, the Asian crisis in late 1997, and the Russian crisis since August 1998. Devaluation pressures on the Brazilian real had escalated since the Asian crisis in the summer of 1997, as Brazil’s large and increasing fiscal and external deficits had caused growing concerns in financial markets. In January 1999, when Brazil’s exchange reserves reached about $30 billion, down from the $70 billion before the Russian crisis in August 1998, the central bank decided to let the real float. As a result, the real lost about 50 percent of its value against the US dollar within two months, but it has since stabilized with some recovery since March 1999.

The potential for a Brazilian currency crisis had been studied by Project LINK in the past few years and attention drawn to it repeatedly. A devaluation of the real by 20-30 per cent was in fact built into a downside scenario for the world economy last November. Although the devaluation was not assumed in the last LINK baseline forecast, a mild recession was expected in Brazil for 1999, given the expected fiscal adjustments. In the current LINK forecast, the short-term outlook for Brazil, as well as for the region of Latin America, has been further downgraded moderately. But the impact of the Brazilian crisis on other regions is not expected to be significant.

The latest Brazilian crisis is a reminder of the fragility in besetting the international monetary and financial system. But the relatively mild ripple effects of the crisis might signal improved stability in world financial markets and rebuilding of confidence in emerging markets. The yield spreads between the sovereign debts of the emerging economies and the Treasury bonds of the United States, which surged with a high cross-country correlation during the Asian and Russian crises, have recently moved in directions that reflect the fact that international investors are more likely to differentiate the risk premiums in these countries based on differences in their macroeconomic fundamentals. For example, the spreads for Argentina and Mexico have been much smaller and less volatile in comparison with that for Brazil. Meanwhile, access to primary-market issues has also improved. Within days of the real's devaluation, Argentina and Mexico were able to raise more than $1 billion in bond issue. This contrasts with the more than four months that elapsed after the 1994 Mexican crisis before international investors bought 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. By the end of April 1999, the spreads for several emerging economies with sound economic fundamentals had returned to pre-Asian-crisis levels, thus lowering the cost of external financing for these countries.

Other notable improvements in world financial markets since the beginning of 1999 include a substantial rebound of equity prices and a further stabilization of depreciated currencies in many emerging economies. Meanwhile, the financial strains that were evident in developed economies last fall have also evaporated.

During the Asian and Russian crises, prices of equity markets in many emerging economies plummeted by 50 to 80 per cent and stock markets in developed economies also experienced a correction by about 20 per cent. After a temporary weakening caused by the Brazilian crisis, equity prices for most economies have rebounded significantly, with some emerging markets now being close to their all-time highs.

Many emerging economies experienced large currency depreciation in 1997-1998, ranging from 20 to 80 per cent. Now, most of these currencies have stabilized at their low nominal party levels, but a few have recovered some of their value against the US dollar.

Capital markets in developed economies were also affected significantly by the Asian and Russian crises, but much less by the Brazilian crisis. Although the effects of "flight to quality" had for a while diverted massive capital flows from emerging to developed markets, such as the United States, the latter nonetheless also experienced a broad rise in risk aversion, experiencing a severe credit crunch for a while in the Fall of 1998. This entailed rising spreads on the entire range of bond instruments, from high-quality corporate bonds to junk bonds; a shrinkage in new bond issues in developed countries; and a tightening of lending standards by many commercial banks, including in the United States. By now, however, these financial strains have been lifted, partly in response to the easing of monetary policy in major developed economies since the last quarter of 1998.

Monetary conditions for the world economy have improved remarkably since the last LINK exercise and are now much more accommodative than six months ago. In fact, Project LINK has long been advocating monetary easing in major economies to stimulate global economic expansion, especially to help recovery in the countries in economic crisis. Until the fall of 1998, monetary policies worldwide were restrictive. While policy makers in the United States were focusing on the inflationary potential from the stronger-than-expected growth momentum over a protracted period of time, European central banks were concentrating on the convergence criteria for entry into the monetary union. In the same period, interest rates in many emerging economies surged to extreme highs in an attempt to maintain, and possibly attract more, foreign capital in order to stabilize their currencies. Facing the growing threat of a global deflationary spiral, major central banks started to ease monetary policy in the fall of 1998. Led by the United States Fed, which made three interest-rate cuts in two months, most developed economies reduced interest rates substantially, including the most recent cut of 50 basis points by the new European Central Bank (ECB) in April 1999. Meanwhile, interest rates in many emerging economies have also been lowered noticeably, with some returning to the pre-crisis levels.

Signs of stabilization have also appeared in international commodity prices during the first quarter of 1999. In fact, international prices of oil have rebounded by about 40 per cent from their lows at the end of 1998, in response to the recent agreement among world oil producers to reduce their output by about 2 million barrels per day, or about 3 per cent of the total world production. Although prices of other commodities have not followed the rebound, most have stabilized.

Dollar prices of several major commodities, such as oil and metals, dropped by about one third in 1998, with some prices reaching record lows in decades. These sharp declines have led directly to a severe deterioration in external and fiscal balances in many developing economies. It has also made significant changes in the terms of trade across nations, resulting in large welfare gains for net-commodity importers and losses for net commodity exporters. For example, the drop in oil prices alone may have yielded a gain of at least $70 billion for the net oil-importing developed counties.

While weaker world demand because of recession in many dynamic Asian economies has been blamed for the commodity-price deflation, other factors were at work as well. Among long-time factors, technological innovation in commodity production and in input substitution has reduced both production costs and aggregate demand for commodities. Other factors include oversupply in many markets caused by over-investment in some countries in recent years and export push by some countries in economic crisis in order to meet their liquidity needs. Recovery in world demand is expected to lift these prices onto the ascending part of their cycle, but full recovery for most prices is not expected, certainly not before the end of 2000.

Other new developments in the world economy, while they may not have a significant impact on global growth, are bound to affect the outlook for some regions. For example, the current conflict over Kosovo will have a significant impact on Yugoslavia as the nation directly involved in the armed conflict, but also on the adjacent economies as well as countries farther away whose land and river trade with Yugoslavia’s neighbours is being impeded.

Taking these latest developments in the world economy into account, along with the policy assumptions discussed below, Project LINK forecasts a gradual recovery in global growth for 1999-2000, although the pace of expansion is far from satisfactory and some serious downside risks remain.

Growth for developing economies as a group is expected to recover gradually from the sharp deceleration in 1998, when the growth rate for the group registered a mere 1.3 per cent with a decline of 0.5 per cent in per capita GDP. However, the 2.6 and 4.6 per cent rates of GDP growth forecast for the developing group for 1999 and 2000, respectively, are still below the 5 per cent average annual growth rate recorded in the first half of 1990s.

Asian developing economies are expected to recover from the impact of the regional crisis. Most economies in Southeast and East Asia, which have been at the centre of the crisis and experienced severe recession in 1998, are striving to recover with the Republic of Korea, Malaysia and Thailand improving rapidly. None is expected to return to the pre-crisis high growth pace in 1999-2000, however. In fact, post-crisis restructuring in these countries will require several more years. Meanwhile, China's growth is expected to slow down further in 1999-2000 to about 7 per cent, from 7.8 per cent in 1998. Accumulated pressure on its export sectors and weak consumption demand related to problems in public enterprises will remain a drag on China's growth. At the same time, countries in South Asia, which were less affected by the financial crisis, are expected to continue their growth at about 4-5 per cent.

In contrast to the upturn in the Asian developing economies, growth for Latin America and Caribbean is expected to slow down in 1999. A mild recession of -0.3 per cent in GDP growth is expected for the region, mainly on account of the expected recession of -3.2 per cent in Brazil. While Argentina and Venezuela are also expected to experience recession in 1999, other countries in the region will have to contend with a deceleration, as these economies continue to make adjustment to the external financial constraints and low commodity prices. Natural damages from last year's El Niño effects and from hurricanes will also hold growth down in some economies in Central America and the Caribbean. A moderate recovery of 3.3 per cent for the region's GDP is forecast for 2000, still lower than the 3.5 per cent average in 1991-1997.

Growth in Africa is expected to move up slightly for 1999-2000, with GDP growing at about 3.0 per cent, compared with the 2.5 per cent in 1998. Per capita GDP will further decline on average. The drop in commodity prices affected all African economies. South Africa in addition suffered from the international financial crises because of its integration into the global trade and financial systems. Meanwhile, economies in West Asia are also expected to recover for the year 2000 from the deflationary oil-price shocks, which sent the group in recession in 1998 and 1999.

Growth for developed economies as a group is expected to stagnate at about 1.9 per cent for 1999-2000, virtually no change from the growth rate of 1998. Leading the group is the United States, whose economy is expected to register another robust growth of 3.5 per cent in 1999, after nearly 4 per cent growth per year in 1996-1998. But that pace is forecast to slow down to 2 per cent in 2000, partly due to adjustment to the Y2K-related inventory cycle. The key policy task is how best to avoid a hard landing for the taut economy, where labour markets are stretched, stock prices have appreciated tremendously, and the value of the external deficit has reached record highs. Meanwhile, Canada is also expected to perform well in part because it has more slack in labour markets than the United States.

Economies of the European Union are expected to have a noticeable deceleration, a combination of weakening growth in the euro-zone countries in the first half of 1999 and a soft landing in the United Kingdom. Economic activity in the region's major economies has experienced a significant slowdown since the last quarter of 1998, as a result of weakened or shrinking exports and domestic investment. Nevertheless, the recent bold cut in interest rates by the ECB, plus fairly buoyant consumer spending, will likely lead to recovery in the second half of 1999. Meanwhile, a relatively weak euro vis-à-vis the US dollar will help to support exports. GDP for the European Union as a whole is expected to be 1.9 per cent for 1999, down from the 2.8 per cent in 1998, but a rebound to 2.5 per cent growth is forecast for 2000.

In Japan, in spite of substantial government stimulus, GDP is still expected to drop by another 1.4 per cent in 1999, following the decline of 2.6 per cent in 1998. Although there were some signs of recovery in early 1999, such as slightly rising household expenditure and a comparatively sharp increase in stock prices, orders in manufacturing continued their slide. A slight recovery of 0.9 per cent in GDP growth is forecast for 2000, based on assumptions of further government efforts to stimulate the economy and progress with alleviating the overhang of bad loans.

The growth outlook for transition economies remains discouraging. While Russia is expected to remain in recession for 1999-2000, growth for economies in Central and Eastern Europe (CEE) is expected to slow, with recession continuing in Czech Republic and Romania and the growth momentum in the Baltic States, Hungary, Poland and Slovakia losing steam. Russia's GDP is expected to decline by 3 per cent and 1 per cent for 1999 and 2000, respectively, and GDP for CEE is expected to grow at 3 per cent per year for 1999-2000. But the armed conflict in Yugoslavia, if protracted, will have a devastating impact on its economy and that of the neighbouring countries and beyond.

While global growth is expected to be slow, the short-term outlook for growth in world trade is also far from rosy. World export volume is expected to grow by 3-4 per cent in 1999-2000, lower than the 4.5 per cent registered in 1998 and far down from the 10 per cent in 1997.

The uneven impact of the international financial crises on different economies has caused not only a general slowdown in world trade but also a change in the structure of international trade flows. As many economies in Asia, Latin America and other regions adjust their external imbalances downward, mainly by cutting imports, trade flows into these economies have declined. For example, total imports for the group of South and East Asia dropped by more than 20 per cent in 1998. In the meantime, trade flows to the United States have been increasing, partly because of the robust domestic growth and the lower international prices that pushed up United States import demand by about 10 per cent in volume in 1998. In addition to the income (or output) effects, there were relative-price effects that have also led to changes in the pattern of trade flows across countries. Realignment in exchange rates across economies, due to the currency devaluation in many economies, and drops in commodity prices have been the main sources of the relative-price effects.

The overall effects from the crisis-related adjustments have led to a more inward-oriented production and consumption pattern across countries relative to the pre-crisis. So far, the slowdown in aggregate trade has not yet given rise to significant trade conflicts. Should both world output and world trade continue to be on a sharp and prolonged downturn, however, more tensions in international trade are bound to come to the surface.

Notwithstanding improved international financing conditions, net private capital flows to emerging economies are likely to be constrained for 1999-2000. After peaking at over $200 billion in 1996 and declining to $70 billion in 1998, net capital flows are expected to stabilize at the same level for 1999 and then double to about $140 billion in 2000. While foreign direct investment will remain relatively stable, as during the recent crises, portfolio investment and bank loans will continue to be volatile. An increasing investment-saving gap in the United States, as indicated by its high current-account deficit, has been filled by absorbing a large proportion of world savings and putting a limit on the flow of savings to emerging economies. Meanwhile, competition among developing economies for capital inflows is expected to rise, as Asian economies recover. Benchmark interest rates in international capital market are assumed to remain at their April 1999 levels. The risk premiums, as measured by the spreads, for emerging economies are expected to decrease further towards the non-crisis normal levels, although some differentials will remain across countries, reflecting different economic fundamentals.

Inflation will in general remain benign for most economies in the world. Most developed economies are expected to continue their low inflation trend. While some developing countries with large currency devaluations are expected to have higher inflation (in adjustment to the overshooting in the real exchange rates, depending on the monetary policy adopted), a mild deflationary pressure will remain in others.

The recent rebound in oil prices has probably discounted the agreed production cuts among oil producers by too wide a margin, so that this price can be expected to retreat slightly in the second half of 1999 from the current levels in April. The recovery will continue in 2000 as world demand continues to grow. But the level by 2000 will still be 1-2 dollars lower than in 1997. Prices of other commodities are also expected to rebound slightly in 1999-2000.

The outlook for employment in the world economy shows quite a diverging picture. The United States continues to record low unemployment, although some signs of a tight labour market have appeared recently. High unemployment in the European Union is under a cyclical improvement, but a large part of it remains as a long-run structural issue, rooted in the rigidity of labour markets. Unemployment in a number of developing and transition economies is worsening as a result of the recession or slowdown in these economies. Since recovery in labour demand always lags the recovery of output growth, the unemployment problem in these countries will linger for the next few years.

## POLICY ISSUES

### *Major policy assumptions for the baseline forecast*

In the baseline forecast, monetary policy of major central banks is assumed to stay at the present stance of April 1999. With the low inflation prospects, room remains for further monetary easing in the large developed economies, such as several European Union economies and the United States. There is also a need for more accommodative monetary policy to rise above the protracted anemic world growth, especially to stimulate more robust recovery for economies in recession. However, given the most recent cut of interest rates by 50 basis points by the ECB and the stretched United States economy, the baseline outlook assumes that the target interest rates in both the euro zone and the United States will stay at the current level for 1999-2000. Meanwhile, there is virtually no room for a further cut of interest rates in Japan. Monetary policy for most developing economies is expected to be accommodative, with more interest-rate reductions in those economies where interest rates were pushed up to extreme highs during the financial crises.

Fiscal policy in major developed economies will continue to be under restraint, although many have attained significant improvements in budget balances after a decade-long fiscal consolidation. One exception is Japan, where the Government is expected to continue its stimulus policy in spite of the large government deficit (10 per cent of GDP) and the large public debts (120 per cent of GDP). Fiscal policy among developing economies will vary, depending on the specific economic conditions. For example, while fiscal stimulus is expected to be the major policy in China, most economies in Latin America will continue with their fiscal austerity.

Consistent with the assumptions of monetary policy and the outlook across countries, the yen/dollar exchange rate is likely to fluctuate around the annual average projected by the last LINK forecast (120 yen/dollar). While the euro has been weakening against the US dollar since shortly after its debut, it is expected to stay around the current parity of 1.1 dollar per euro. No big devaluation is assumed for developing economies in the baseline outlook, especially for China, in spite of pressures from a weakening external sector. Meanwhile, more stability is assumed for those currencies that devalued recently, such as the Brazilian real.

Other country-specific policy assumptions, including tax reforms, trade policies, and economic restructuring measures, can be found in the regional outlook section and in *The LINK Country Reports*.

### *Economic policy for recovery*

As mentioned, several recent signs have signaled abatement of the global financial crises that haunted the world economy in 1997-1998. Economies in Southeast and East Asia, which were devastated the most by the crises, have started to recover. The probability for the world economy to fall into a global deflationary spiral seems now much less significant than this was the case a few months ago thanks to the relaxed monetary conditions worldwide. However, many questions remain unsolved regarding the true causes of the crises, the policies in response to the crises, and the reform of international financial architecture to reduce the probability and degree of a recurrence of the crisis. In particular, debate on the effectiveness and efficiency of the policies implemented in the Southeast and East Asian countries has drawn growing attention from, among others, policy makers and the academic community.

Specific questions that have been raised include whether these economies really had to pass through such a deep and protracted recession, given their fairly sound pre-crisis economic fundamentals; the nature of the overall effect of the economic policies carried out during the crisis on the real economy of these countries, especially the effects of austere fiscal adjustment and of raising interest rates to extremely high level; the appropriate time path and magnitude for restructuring the ailing bank and financial sectors in these economies; and the measures that the international community could have embraced in addition to the rescue programme through IMF to speed up the recovery in these economies.

Like many other debates on economic policy, a consensus on these issues may well fail to crystallize, partly because of the complexity of the economic system and the different political positions underlying economic policies, but also because the appropriate counterfactual is by definition not known. Nevertheless, there seems to be some consensus that the fiscal austerity pursued by these economies at the initial stage of the crisis was inappropriate. Fiscal balances in these economies were sound as all were in surplus and, in any case, the crisis was caused by financial problems in the private, rather than the public, sector. In effect, fiscal austerity was lifted in these economies when the recession became more serious.

But, there has been no agreement on the desirability of raising interest rates to extreme highs. In general, monetary policy in these crisis economies faced a dilemma. When exchange rates initially depreciated with overshooting, monetary tightening could avoid a depreciation-inflation spiral. However, excessive monetary tightening would severely weaken economic activity. In the policies chosen, there seemed to have been a bias towards inflation prevention as interest rates were raised to very high levels and kept there for long. Advocates of that policy insist that high interest rates were necessary to restore market confidence in order to stabilize the exchange rates. Opponents argue that this policy was not based on sound theory or evidence. They have shown that circumstances exist, and indeed that these may have affected the situation in the Asian economies, when raising interest rates weakens the economy and leads to a further currency depreciation. As such, this policy may have caused an avoidable recession while it fueled to stabilize the currencies.

While the debate continues, the LINK Centre has recently explored the possibility of alternative policies to boost economic recovery in the Asian crisis economies. One of the alternatives is a combination of an internationally coordinated cut of interest rates in major developed economies with official transfers to the crisis economies. The policy design is based on four arguments.

First, the global economy is a closed system, and so one country’s external deficit is another country’s surplus. The ability of economies to reduce their external deficit depends partly on the willingness of the rest of the world to lower their surplus. It would be counterproductive for the global economy as a whole if the entire adjustment burden had to be borne by the crisis economies' tightening their demand via austerity. Instead, it would be better if some of the adjustment were to be enacted by countries stimulating domestic consumption in the rest of the world, thus permitting crisis countries to run a surplus. In this way, the deficit- cutting efforts of the latter economies would be more likely to succeed and less burdensome, while global demand would remain high. If adjustment is left to the market, most of the adjustment burden is placed on the weaker crisis economies. Surplus countries, or large countries enjoying seigniorage from acting as suppliers of international money and thus not depending on external funding, by definition do not face similar adjustment pressures.

Second, while major developed countries have cut interest rates since the last quarter of 1998, these came late and they were introduced mainly in view of domestic requirements. And these cuts were not coordinated at the global level, though they were in the euro zon*e.* A coordinated interest-rate reduction would be more efficient to and have less side effects for the world economy, as it would stabilize the differentials in interest rates across the economies joining the coordination.

Third, an official transfer from the developed economies to the crisis countries would not only stimulate the latter economies, but also feed back to the developed economies through trade and other links. Putting it more technically, if the international multiplier is larger than the domestic multiplier in developed economies, the effects of a transfer from developed to developing countries on boosting global growth would be larger than if the same amount were spent within the developed economies.

Fourth, given the relatively large export-oriented production capacity in the Asian economies, an external demand stimulus would be more effective than a domestic demand stimulus for economic recovery in these countries.

By design, this alternative policy assumes a coordinated interest-rate cut in the major developed economies, with 150 basis points in North America and 100 basis points in Europe (before the latest cut by the ECB in April 1999). It also assumes a $30 billion ODA transfer from Japan to the five Asian economies (Indonesia, Republic of Korea, Malaysia, Philippines and Thailand) to provide more liquidity to these economies over two years.

With these assumptions, the LINK model simulation shows that world GDP would be boosted by 0.8 per cent over two years (all numbers in the discussion are relative to the baseline), with an increase of world trade by 2.5 per cent in the same period. While such an expansionary policy would improve employment in the developed economies, it would generate slightly higher inflation. There would be a gain in GDP for the developed economies of about 0.8 per cent through increases in their domestic investment and consumption. The gain for developing group would also be about 0.8 per cent, with most gains for the five Asian countries. Due to the expansionary effects from both ODA and increased external demand, the recovery in those crisis countries would be speeded up. The gain in GDP for these economies would range from 1.7 to 3.5 per cent.

As an extension of the policy, the model simulation shows that a triple stimulus for the five Asian crisis countries, that is, the policy above plus a fiscal stimulus within these economies, would generate an even stronger recovery.

### *Debate on exchange regime in developing economies*

During the recent international financial crises, more and more developing countries have shifted (or have been forced to by the market) to more floating exchange regimes. However, there still seems to be strong support for fixed exchange regimes in the current policy debate. For example, some suggestions have been made for countries in Latin America to fix their exchange rate to the US dollar through a currency board, as in Argentina, or simply by replacing their national currencies with US dollars, as in Panama.

A floating exchange regime may allow a country to have more monetary policy autonomy, better cyclical management of the macroeconomy, and flexible control of the real exchange rate. But a fixed exchange-rate regime can also have many advantages. The central bank of a country with a history of persistent inflation lacks credibility with the public; so it may fix the exchange rate to a currency under the management of a more disciplined central bank. A fixed exchange rate can also muffle some extraneous disturbances, such as speculative financial bubbles, to insulate the real economy against them.

More importantly, increased global integration of capital markets, as witnessed in the past few years, has placed more limitations on a nation's choice of exchange-rate regime and monetary policy. Theoretically, a country cannot simultaneously maintain fixed exchange rates and an open-capital market, while pursuing a monetary policy oriented toward domestic goals--the so-called "open-economy trilemma." Countries may choose only two of them. If domestic economic activity is the main consideration for monetary policy, either capital flows should be under control or the exchange rate should be freely floating. If a fixed exchange rate and integration into the global capital market are the main goals, monetary policy cannot be independent.

In Latin America, Argentina's currency board, which was established in 1991, has survived the international financial crises in the 1990s. Therefore, this exchange arrangement has drawn growing attention in the region. A strict currency board, which takes the central bank's place, cannot fulfil a central bank's domestic functions, for example, as macroeconomic stabilizer or lender of last resort. Argentina has been very successful in stabilizing the economy from its earlier hyperinflation. However, the true test of a successful policy is not merely conquering inflation by sacrificing prosperity, but conquering inflation while achieving full employment and reasonable growth. Argentina's high unemployment rate has always been the subject of criticism in the debate around the merits of the country's currency board.

Furthermore, Argentina and some other economies in the region are giving serious thought to full dollarization, that is, replacing the national currencies with the US dollar. In fact, many economies in the Latin America are partially dollarized as a certain proportion of domestic transactions and household deposits are already in US dollars. Advocates of dollarization believe that by giving up currency independence and by sacrificing the loss of seigniorage from issuing a national currency, these countries can defend themselves better against financial speculation, thus securing access to global capital markets. Opponents, by contrast, argue that in addition to the obvious political cost of losing that part of national sovereignty, without an exchange-rate buffer, external shocks would directly lead to higher unemployment and larger falls in real wages in the domestic economy. Moreover, the US Fed would most likely not include in its monetary -policy configuration the economic conditions and interests in the dollarized countries.

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

## UNCERTAINTIES AND RISKS OF THE FORECAST

The LINK baseline forecast presented here is based on many policy and exogenous assumptions that are deemed to be most likely to prevail under normal conditions. However, the probability that these assumptions may turn out to be wrong and the outcome of the world economy will be different from the forecast is by no means nil.

There are many uncertainties and downside risks, as well as some upside opportunities for the world economy. In developing and transition economies, for example, the Russian economy is still in chaos and the risk for a further sharp decline in output remains; Brazil's task to address the large public imbalances is formidable; and China's export sector is declining faster than expected, thereby exacerbating pressure on the currency. Among developed economies, Japan continues to fail in stimulating the economy from the recession, directly limiting the pace of recovery for the Asian developing countries; euro-zone countries may remain sluggish; and, the worst downside risk is a hard landing for the United States, either because of a stock-market crash, or surge in inflation. Should one or more of these risks eventuate, the world economy would experience another large shock.

To evaluate the possible impact of these downside risks on the world economy, the LINK Centre has recently simulated such a downside scenario. It assumes another international financial shock, this time originating from the developed countries. Equity markets in the US and Europe are assumed to decline by 40 per cent from their peaks (this would bring the price-earnings ratio to about its historical average), twice as large as the decline in the summer of 1998. Meanwhile, the credit crunch is assumed to worsen, as additional financial institutions like Long-Term Capital Management would fail, leading to a surge in corporate interest rates. At the same time, the meltdown of equity markets in developed economies would trigger a decrease of net capital inflows to emerging economies as a result of reduced foreign investment.

The impact of a collapse in the developed economies on the emerging economies would occur through changes in international trade and capital flows. For example, China is assumed to face a drop of $30 billion in foreign investment, which is about two thirds of the foreign investment it received in 1998. It is also assumed that, in Japan, the public rescue fund for banking reform will not have been fully successful in restoring the banks' lending capacities and that the fiscal stimuli already assumed in the baseline therefore become less effective.

In this scenario, no assumption of any discretionary monetary policies in major developed economies in response to the collapse of equity markets is made. However, endogenously within the logic of models reflecting existing monetary rules, there would be a cut of interest rates by the central banks ranging from 50 to 100 basis points. But as shown by the simulation results discussed below, this kind of policy reaction would be both too little and too late to offset the effects of the assumed financial panic on the real economy.

With the assumptions above, the LINK model simulation shows there would be a loss of world output of 1.5 per cent over two years, relative to the baseline, and world trade would slow by 5 per cent in the same period.

The loss for the developed economies as a whole would be 1.6 per cent of their total GDP over two years. The impact of the assumed asset-price decline and credit crunch on the real economy in the developed countries would emerge through several channels. First, accompanying the equity-market meltdown would be a drop in business confidence and in consumer sentiment, which in turn, through a self-fulfilling expectation process, would reduce both business investment and private consumption (particularly of durable goods). Next, a credit crunch would imply a higher user cost of capital, and thus impose another adverse impact on business investment. Furthermore, as the credit crunch spreads from corporate credit markets to consumer loans, private consumption would also be repressed. Finally, the wealth effect when private consumption is determined not only by current income but also by accumulated wealth, would not be negligible, given the assumed scale of the drop in asset prices. Along with a decline in domestic economic activity, import demand in these economies would also drop significantly, by about 6.0 per cent over two years compared with the baseline.

For the group of developing economies, a loss of 2 per cent of GDP over two years could be anticipated. Meanwhile, it would make the recovery in Latin America and Asia more difficult, if not impossible. With the specific assumptions of a decline in foreign capital inflows into China and a mild devaluation of the yuan by 15 per cent (with the exchange rate of yuan/dollar reaching the rate in unofficial markets that prevailed last summer), China's GDP growth would drop to just above 3 per cent.