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# **Project LINK Meeting**

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## **WORLD ECONOMIC OUTLOOK**

*Prepared by:*

*Development Policy Analysis Division*  
*Economic Assessment and Outlook Branch*

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## INTRODUCTION

The November 1999 Project LINK meeting is taking place in Athens, Greece, 1-5 November 1999, sponsored by the Centre of Planning and Economic Research of Greece. The agenda of the meeting includes: (1) presentations of the short- and medium-term outlook for the world economy, (2) discussions of current international economic-policy issues, and (3) topics on econometric modeling techniques and their application in forecasting and policy analysis.

With inputs from the national LINK centres and information from other sources, as of 25 October 1999, the staff of the Economic Assessment and Outlook Branch, Department of Economic and Social Affairs, at the United Nations prepared a pre-meeting world economic forecast, using the LINK econometric modeling system. This report summarizes the main features of that exercise. The outlook projected here is an interim exercise and will be updated by taking into account the discussions in Athens and the post-meeting forecast later in November. Most of the *LINK COUNTRY REPORTS*, which contain detailed forecasts and policy analyses submitted by the national LINK centres, are available on the websites at both the United Nations and the University of Toronto. Also the other papers submitted to the meeting can be accessed at these sites.

## GLOBAL OUTLOOK

The world economy has recently shown signs of strengthening and broadening the recovery identified at the time of the spring meeting in New York. Growth of gross world product (GWP) is now expected to be 2.6 per cent for 1999, a notable improvement over the 1.7 per cent of 1998 and about 0.7 per cent higher than the LINK forecast of May 1999 (table 1). Moreover, the outlook for 2000-2001 is moderately optimistic, as global growth is forecast to be above the pace earlier seen for 2000 and to fully resume its pre-crisis pace of above 3 per cent in 2001. However, this outlook remains subject to several weighty caveats.

First of all, as a legacy of the international financial crisis in the last two years, the global economy is now facing large current-account imbalances both

across countries and with the domestic economies of many countries. Normalization of these imbalances is inevitable in the process of economic recovery. But there is no guarantee that the adjustment process will evolve as smoothly as expected. Second, the world economy now appears to be highly asynchronized among major regions and economic groups, in terms of different phases in their growth cycles. While an asynchronized world economy in and of itself may be a dynamic and stabilizing force for sustaining the pace of global economic growth, it requires improved international policy coordination and cooperation to ensure a gradual compression of the imbalances. But it can also give rise to international protectionism. Third, the economic recovery in a range of countries remains fragile. Sustaining it depends on progressing with further major structural reforms that have so far proved to be formidable. Fourth, the rise in international integration, especially via international capital flows, and rapid technological innovation have posed new challenges to policy makers worldwide. Finally, reform of the international financial system, which was a hot topic at the height of the crisis, has since been relegated to second-stage, if not altogether taken off the policy agenda. This leaves the global economic framework ill-prepared for coping with any similar crisis that may arise in the years ahead.

## The Baseline Forecast

The general trend of the global economy since the LINK meeting in May 1999 has been in line with the May 1999 forecast: a gradual healing from the impact of the international financial turmoil. As expected, international financial markets have further stabilized and investor confidence has been substantially restored. Deflationary pressures on international prices of commodities have been largely alleviated, led by a strong rebound of oil prices. Meanwhile, monetary conditions in general have remained accommodative, as monetary policy has held interest rates down or lowered them, especially in many developing countries and transition economies. At the same time, most crisis-affected economies in Asia have achieved a notable recovery.

However, some developments over the past six months have been at variance with the May LINK

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

	November 1999 <sup>a</sup>			May 1999 <sup>b</sup>	
	1999	2000	2001	1999	2000
<b>Gross world product</b>	<b>2.6</b>	<b>2.8</b>	<b>3.1</b>	<b>1.9</b>	<b>2.5</b>
<b>Developed market economies</b>	2.5	2.2	2.5	1.8	2.0
Canada	3.6	2.9	3.3	3.1	3.2
France	2.4	2.9	3.0	2.2	2.6
Germany	1.7	2.4	2.1	1.8	2.6
Italy	1.1	2.0	2.6	1.6	2.5
Japan	0.9	1.0	1.7	1.4	0.9
United Kingdom	1.4	2.6	3.4	0.5	2.1
United States	3.9	2.4	2.8	3.5	2.0
<b>Developing countries</b>	3.3	5.1	5.3	2.5	4.5
Latin America	-0.4	3.5	4.5	-0.3	3.3
Argentina	-3.6	2.9	4.4	-1.0	3.0
Brazil	-0.2	3.3	5.1	3.2	3.0
Mexico	3.5	4.9	4.4	3.0	4.6
Africa	3.0	4.4	4.5	3.0	3.5
North Africa	3.4	5.6	5.1	3.4	4.5
SubSaharanAfrica (excluding South Africa)	3.2	4.4	4.6	2.8	3.1
Nigeria	3.7	3.3	3.3	3.4	3.4
South Africa	1.7	2.4	2.9	1.3	2.8
South and East Asia	5.1	5.6	5.6	2.9	4.5
India	6.2	6.3	6.4	6.1	6.4
Indonesia	1.3	4.1	4.6	-2.5	3.4
Korea, Republic of	9.0	6.7	6.2	3.4	4.6
Malaysia	4.3	7.0	7.2	1.5	3.3
Philippines	3.4	4.9	4.2	2.4	4.7
Singapore	5.7	6.7	6.8	1.0	2.1
Taiwan Province of China	5.3	6.4	6.2	4.8	6.0
Thailand	3.8	5.1	6.2	1.3	2.1
China	7.4	7.5	7.2	7.1	7.0
West Asia	3.8	4.3	4.0	-1.0	5.2
Economies in transition	1.6	2.2	3.0	-0.3	1.3
World export volume	3.4	5.7	5.9	2.5	3.6
Export prices					
All goods	-0.5	3.6	2.5	0.4	4.0
Agricultural commodities	-4.6	2.5	2.1	3.2	2.5
Raw materials and ores	1.8	4.7	4.3	-1.9	4.1
Oil	35.2	9.0	0.0	4.0	8.0
Manufactures	-2.1	3.2	2.7	0.7	2.9

<sup>a</sup> Pre-meeting forecasts.

<sup>b</sup> Post-meeting forecasts.

forecast by a perceptible margin. First, the recovery of economic growth in Asia, including Japan, has been faster and much stronger than expected. Second, oil prices have more than doubled from their early lows, thus rising much higher than the levels assumed in the last LINK baseline. Third, the Federal Reserve (Fed) of the United States raised interest rates twice since the summer of 1999, deviating markedly from the last LINK policy assumptions. These and other new developments in the global economy warrant a reassessment of the current world economic situation and a revision of the LINK baseline assumptions.

### *Improved outlook for world economic growth*

The new baseline forecast features a more optimistic outlook for global economic growth, with expected growth in many economies being upgraded.

The economic outlook for the developing economies as a group shows noticeable improvements. The aggregate growth rate for the group is estimated to be 3.3 per cent in 1999, a significant rise from the depressed 1.3 per cent of 1998. It is also 0.8 per cent better than seen in the May 1999 forecast. Whereas in 1998 per capita GDP declined, a modest gain is now anticipated for the year. More encouragingly, over 5 per cent growth is forecast for 2000-2001, marking a return to the high average growth rates recorded by the group in the early 1990s.

Among the developing economies, the recovery in South and East Asia has been stronger and faster than expected. Across the region, reflationary policies are fueling an expansion in domestic demand, while growing external trade is pulling industrial production. Except for Indonesia and Hong Kong Special Administrative Region of China (Hong Kong SAR), most crisis-hit Asian economies are expected to register a solid recovery in 1999, with the Republic of Korea outperforming the group as its growth is now expected to be near 9 per cent—more than double the 3.4 per cent forecast in May 1999. Meanwhile, China and India, two large economies in the region, are expected to continue their strong growth, which has been well above the average for the Asian developing countries, and of course for the developing countries as a whole. After an estimated 5.1 per cent for 1999, growth for the South and East Asian developing economies is

forecast to return to 5.6 per cent for 2000-2001. However, sustainability of such substantial growth for the region depends critically on continuation of the post-crisis structural reforms in many economies.

The economic outlook for other developing-country regions has also improved, albeit to varying degrees. While the strong rebound in oil prices has significantly strengthened growth for the oil-exporting countries in Africa, Latin America and West Asia, other developing economies have also benefited from the general improvement in the global economic conditions. *Africa* is expected to have 3.0 per cent growth in 1999, followed by acceleration to about 4.5 per cent in 2000-2001, with *North Africa* leading *Sub-Saharan Africa* by about one percentage point. But sluggish growth is forecast for South Africa. In *Latin America*, where several economies experienced severe economic contraction in the first half of 1999, a slow recovery is under way. Although the aggregate GDP for the region is still expected to register a mild recession of -0.4 per cent in 1999, dragged down by countries such as Argentina, Chile, Colombia, Ecuador and Venezuela, growth of 3.5-4.5 per cent is forecast for 2000-2001. After a recession in 1998, *West Asia* is expected to rebound to near 4 per cent in 1999, followed by stable growth above 4 per cent for 2000-2001, with the oil-exporting countries leading the recovery in the region.

The economies in transition continue to perform poorly, but very unevenly, although some marginal improvements in outlook have recently come to the fore. Growth in 1999 for the group as a whole is forecast at 1.6 per cent, which is far better than the contraction of 0.3 per cent seen in May 1999. Growth in 2000-2001 should be in the range of 2 to 3 per cent. The dispersion among the various countries of this group continues to be marked, however. The Russian economy has in fact been working better than expected for 1999 in the light of the early aftermath of the 1998 financial crisis. Driven by import substitution, as a result of the substantial rouble depreciation in 1998, especially by consumers but increasingly also by domestic producers, industrial production has sparked an upturn, and inflation has fallen markedly, thus underpinning a fairly stable exchange rate. But GDP growth is expected to be merely around 1 per cent for 1999-2001.

Performance in the Baltics and the other members of the Commonwealth of Independent States (CIS) in 1999 remains affected by Russia. Whereas growth is likely to return to most of the CIS countries, it is expected on the whole to remain low key. The Baltic countries, however, appear to be strongly recovering in the second half of 1999 with good prospects for the near term. The economic outlook for Central and Eastern Europe is mixed, with 3-4 per cent GDP growth for 2000-2001 for the group, with Hungary and Poland leading.

The economic prospect for developed economies in general is good. The estimate of GDP growth for 1999 has been upgraded to 2.5 per cent from the 1.8 per cent in the last LINK forecast, mainly because of the stronger than expected rebound in Japan. While the prolonged economic expansion in North America continues at a robust pace of near 4 per cent, the slowdown in Europe in early 1999 has turned out to be brief, if perhaps more protracted than earlier expected for core countries like Germany and Italy. Growth moderation in the United States is expected for 2000-2001 as the economy appears to be stretched in several respects. A tight labour market in particular is likely to make continuation of the 4 per cent growth difficult. In contrast, growth in Europe is expected to accelerate, while recovery in Japan will become more self-sustainable—though the forecast rate of growth for Japan remains mediocre. In sum, growth for the developed economies as a group is forecast to slow down to 2.2 per cent in 2000 and then to accelerate somewhat to 2.5 per cent in 2001.

#### *Recovering international trade but with large imbalances*

With a recovery in world output, growth of international trade has also shown signs of strengthening. However, the recovery in growth in trade volume appears to be lagging output growth, but not by as much as seen in May 1999. In fact, international trade grew very slowly in the first half of 1999, with significant declines in some regions as many economies, especially in Asia and Latin America as well as many transition economies, continued their post-crisis adjustment by cutting import demand. As more and more economies have begun to recover, however, international trade has started to rebound since the second half of 1999. World export volume

is estimated to grow by 3.4 per cent in 1999, slightly lower than the 3.8 per cent of 1998. But the ratio of trade growth to growth in GWP is now far lower than the average of 3 recorded for the period of the 1990s prior to the Asian crisis and even below the historical average of 2 for the 1970s and the 1980s. Faster growth in international trade is forecast for 2000-2001, with world export volume growing at about 6 per cent, bringing the ratio of growth in trade volume to that of GWP back to about 2, but not to the higher levels observed earlier in the 1990s.

The unevenly distribution of the impact of the international crisis in the last two years has led not only to a slowdown in total world trade, but also to uneven adjustment in external balances across countries. In general, the income effects and the relative price effects from the crisis, plus the change in the external-financing conditions, have been mostly unfavourable for import demand in many emerging economies, but mostly favourable for many developed economies, in particular the United States. As a result, the trade deficit in the United States has surged to a record high, near \$300 billion in 1999, while most developing economies and some other countries, including a number of transition economies, have been forced to turn their trade account into surplus. Now, as the growth recovery in the rest of the world broadens and the pace of economic expansion in the United States is expected to moderate, a reversal of these imbalances is inevitable. However, given their size, the re-equilibrating process is expected to take a few years, a rather desirable future in order to maintain world economic stability.

So far the large shift in the pattern of international trade across countries has not given rise to significant trade conflicts, in part because employment has continued to expand in the United States. However, a number of trade disputes, including between the European Union and the United States, have come to the fore. Nevertheless, along with the world economic recovery, trade liberalization is expected to continue. In fact, the Seattle Ministerial Conference of the World Trade Organization (WTO) (30 November to 3 December 1999) is likely to launch a new round of negotiations aiming at further liberalizing trade; however, the proposed agenda for that meeting remains controversial.

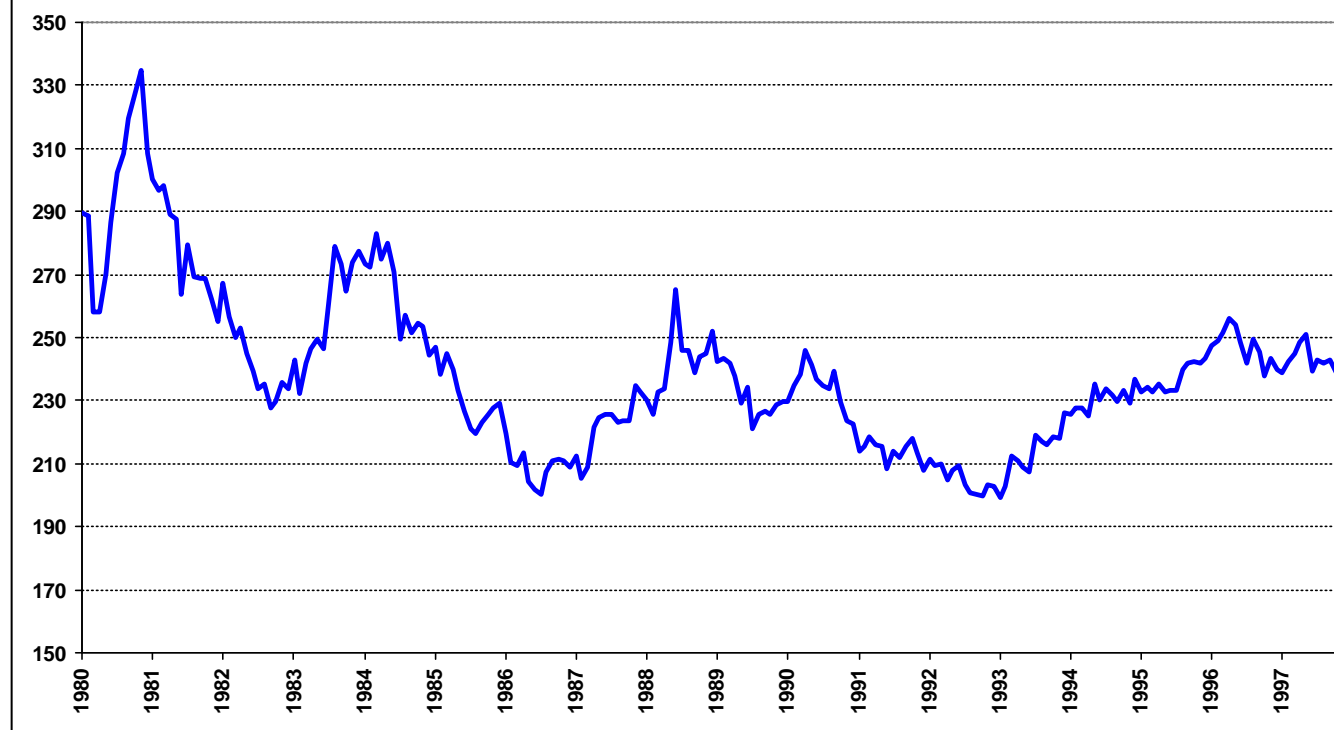
### Commodity prices strengthening

The 1997-1998 international financial crisis drove the prices of major commodities, expressed in U.S. dollar, to their lows in decades. Since the first quarter of 1999, the prices of many commodities have either stabilized or started to recover (see chart 1). However, except for oil (see chart 2) and a few metals, recovery for other commodity prices has so far not been significant and many prices remain below the average of 1998, especially for food and beverages. While the strong rebound in the prices of oil may continue in the near term, on a year-to-year basis the change in the next two years is likely to moderate markedly. But recovery in the prices of other commodities, especially industrial metals, is expected to continue in 2000-2001. The general level of aggregate commodity prices, however, will remain low, especially when placed in a longer-term perspective, which simply confirms the long price cycle for most primary commodities.

The prices of oil have doubled since March 1999, when an agreement was reached among the major oil-exporting countries to reduce their oil production by about 5 per cent. The successful supply restraint and expectations of recovery in world demand have pushed prices above their pre-crisis levels (chart 2). Although the major oil-exporting countries have most recently reiterated their commitment to sustaining the supply cut well into 2000, the LINK baseline forecast assumes that the current high prices will induce more oil supply in 2000-2001 and that this will not be neutralized by speculative inventory accumulation. On an annual basis, after a drop of 33 per cent in 1998, the prices of oil are estimated to rise by 35 per cent in 1999, followed by another 9 per cent annual increase in 2000, but to stay flat in 2001.

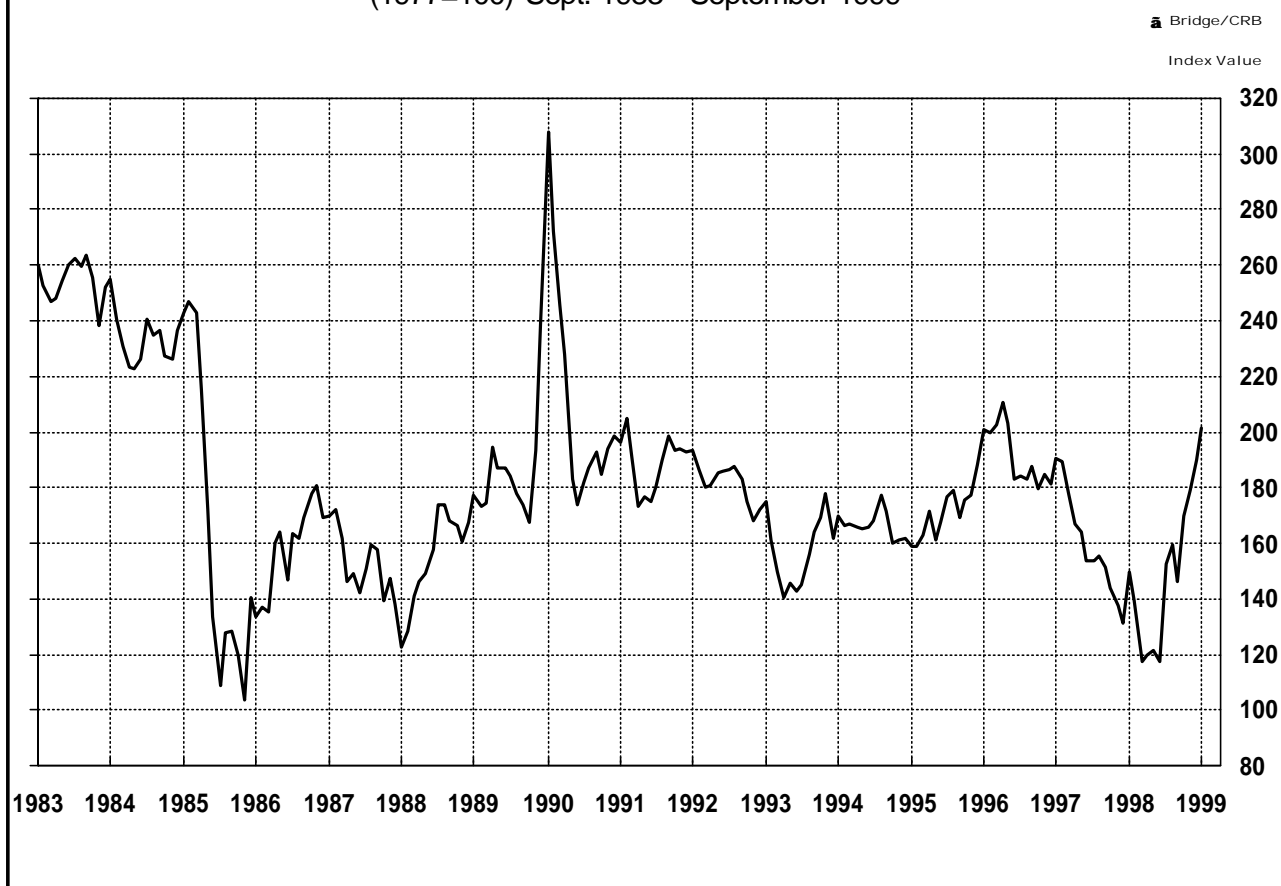
The prices of industrial materials, especially metals, such as copper, aluminium and nickel, have also rebounded notably since the summer of 1999.

**Chart 1: CRB Commodity Futures Index**  
(1947-1949=100) Jan. 1980- Sep. 1999





**Chart 2: CRB Energy Index**  
(1977=100) Sept. 1983 - September 1999



The situation of oversupply in some of these materials in the last few years is now ending. With the recovery of world industrial production, the price rebound of these commodities is likely to be sustained into 2000-2001.

In contrast, the prices of most agricultural commodities still remain at their lows, and they are estimated to register another annual decline in 1999, although a moderate recovery is expected in 2000-2001.

#### **External financing for emerging economies remaining constrained**

Capital flows to emerging economies dropped sharply during the 1997-1998 crisis, with net private capital flows contracting in 1998 to one third of their 1996 level, when a total of \$214 billion was recorded.<sup>1</sup> Although investor confidence has been

gradually restored after the Brazil crisis at the beginning of 1999, net private capital flows to emerging economies remain subdued, with no increase estimated for 1999. Since net official lending is expected to decline, total capital inflows in 1999 are likely to contract as well. While a moderate increase in private flows is expected for 2000-2001, net flows will only rebound to over half the 1996 level, leaving a restrained external-financing environment for most developing economies and economies in transition.

Foreign direct investment (FDI) in emerging economies remained fairly stable even at the peak of the crisis and is expected to continue to be the main stable source of external financing for these economies. Meanwhile, portfolio flows, which dropped significantly during the crisis, have recovered markedly. But credit flows from banks, from bond issues and from other lenders, which turned from net inflows into net outflows in 1998, are esti-

<sup>1</sup> According to the IMF definition.



mated to remain negative in 1999, in substantial contrast to lending prior to the crises.

Investors and private lenders appear to be more cautious and more risk averse than they were prior to the crisis, as shown by the movement of the interest-rate spreads between emerging sovereign bonds and United States treasuries (chart 3). The spreads narrowed substantially after the 1999 crisis in Brazil, but they are still 400-500 basis points higher than the historical normal level. Meanwhile, in comparison to sovereign borrowers, the corporate sector in emerging economies is finding it much more difficult to access international capital markets.

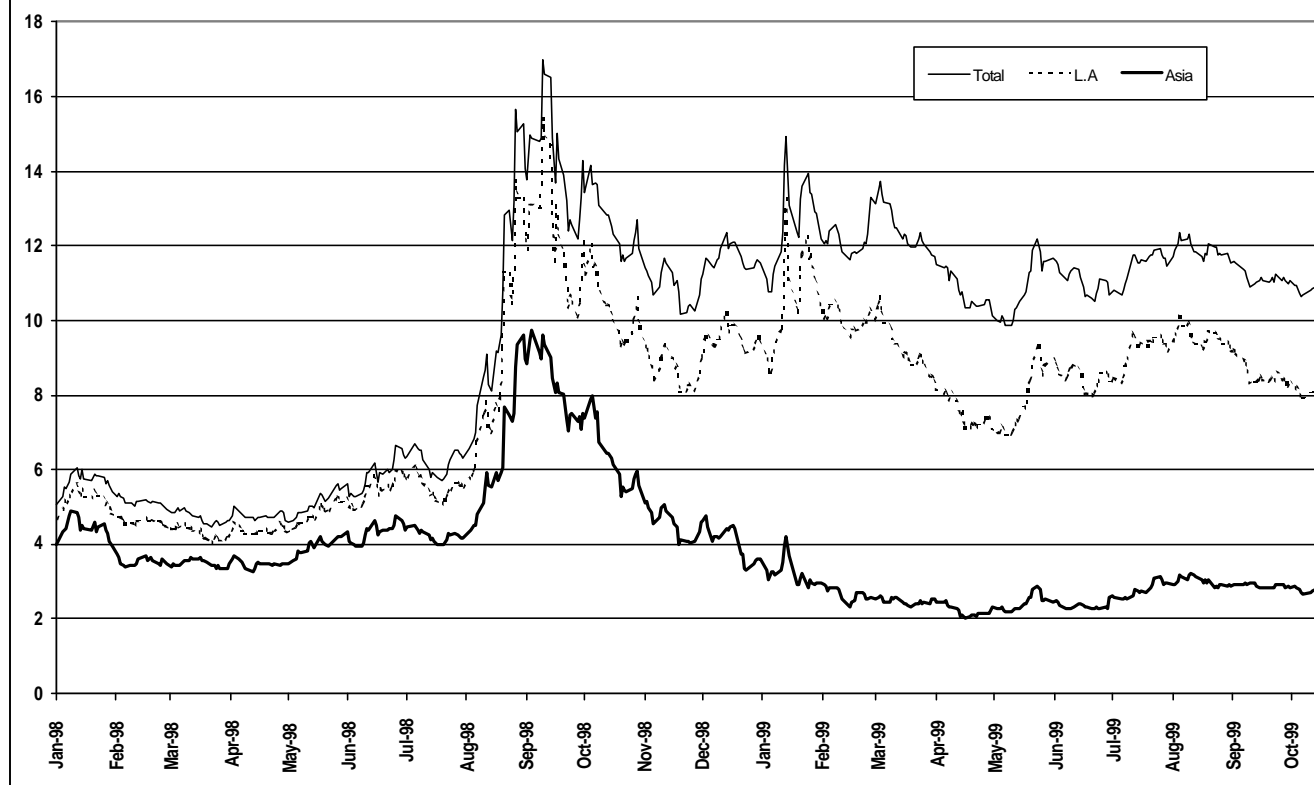
On the supply side, the widening external deficit of the United States in the last two years have absorbed a large share of world total savings—over 70 per cent. Meanwhile, benchmark long-term interest rates in global capital markets, such as the rate

on the 30-year bonds of the United States Government, have edged up by more than 100 basis points since the beginning of 1999, implying tightening supply, and may well rise slightly in 2000.

### *Benign inflation outlook*

Except for a few countries, the global economy has been on a steady disinflation trend for the last few years, as policy makers in many economies managed to compress inflation rates to historical lows. In fact, during the recent international financial crisis the large devaluation in many economies pushed up the inflation rates only for a brief period of time, unlike what happened in earlier crises. Many factors have contributed to the successful control of global inflation such as disciplined monetary policies, fiscal consolidation, and increased global market competition. These factors may have not only reduced the

**Chart 3: Yield spreads on emerging market bonds**  
1 Jan. 1998-15 Oct. 1999 (Percentage points)



inflation rates, but also inflation expectations in many economies, breaking the potential for setting off the conventional inflation spiral.

However, deflation in a few economies in the last two years, such as China and Japan, has caused some policy concern. The main cause of deflation in these economies has been weak effective aggregate demand as a result of a sudden shift in the behaviour of consumers and investors, due to cyclical and/or structural changes in the economy. Therefore, deflation in these countries cannot be addressed in a simple monetary framework that would, for example, lead monetary authorities to push nominal interest rates to near or below zero. Deflation in these economies is more than a monetary phenomenon.

Generally stable inflation for the global economy is expected to continue for 2000-2001. For most developed economies, where inflation rates have reached near zero, a slight rise in inflation is expected, given the recovery of commodity prices and/or tight labour market in some countries. But the rate of inflation will likely be under 3 per cent—within the inflation target range of many central banks of developed economies. But Japan will continue to experience a slight deflation. For most emerging economies, disinflation is likely to continue, especially for countries with double-digit inflation rates, such as Indonesia, Russia, Turkey and several economies in Latin America as well as from among the other economies in transition.

### *Mixed employment prognosis*

The current situation of employment in the world economy is mixed and will remain so in the short-run outlook. While the United States and a few other economies have been able to achieve near-full employment, as their unemployment rates dropped to record lows, the recent international financial crisis has pushed up unemployment significantly in many emerging economies and in Japan. Improvement in employment usually lags economic recovery in the business cycle. Unemployment in some countries is mainly cyclical and will be mitigated eventually when the economy fully recovers, but in other countries, unemployment is more a structural problem, whose resolution requires reforms in labour markets and in related institutions.

Among the emerging economies, a notable improvement in unemployment is under way for

many Asian economies that suffered the most during the crisis. However, unemployment continues to exceed by a broad margin the pre-crisis levels. The large number of laid-off workers from the state sector remains an urgent concern for China. Meanwhile, unemployment rates have continued to rise for many Latin American economies. No significant improvement is likely in the short run.

In the group of developed economies, the low unemployment rate in the United States is likely to be maintained, while a decline in unemployment is expected to accelerate somewhat in Europe along with the anticipated economic expansion and more structural reforms of labour markets. But the unemployment rate in Japan, which rose significantly in the last two years, is not expected to revert by 2001 to the levels observed prior to the financial crisis.

### *Policy Issues*

Many factors have contributed to the current economic recovery in many crisis-affected economies. Crucial are the combination of the global accommodative monetary conditions since mid-1998 and the specific reflationary policies adopted in these countries. If these policies had been embraced earlier once the crisis began to unfold, the recession in these economies could have been less severe and the recovery started much earlier.<sup>2</sup> With the global economy now strengthening, a reversal of monetary easing is likely to be under way. Meanwhile, more and more economies are expected to implement fiscal consolidation in order to reduce the large budget imbalances accumulated during the crisis.

### *Major monetary policy assumptions*

An easing of monetary policy prevailed in the global economy at least during the first half of 1999. Led by the United States Federal Reserve (Fed) with three consecutive cuts of interest rates in late 1998, almost all countries worldwide reduced their policy interest rates. Many emerging economies, whose interest rates were pushed to extreme heights during the crisis, were able to reduce the rates substantially—with some of them lowered to pre-crisis levels. The last round of global monetary easing, notably in the United States in 1998 and by the European Central Bank (ECB) in early 1999, was very crucial

<sup>2</sup> See the LINK Reports of September 1998 and May 1999.

in containing the international financial turmoil and in preventing the world economy from falling into a global deflationary spiral.

However, the Fed has raised interest rates twice since June 1999. This could mark a turning point for global monetary conditions. So far, only a few central banks, such as the Bank of England (BoE) and the Hong Kong SAR monetary authority, have followed suit, although for varying reasons—Hong Kong SAR because its currency is pegged to the U.S. dollar and the United Kingdom in part because of concerns about an asset-price bubble. But more central banks, especially in developed economies, are expected to raise their rates in the next few months.<sup>3</sup> Several reasons are at play, including narrowing interest-rate differentials and moving from an accommodative to a more neutral monetary stance, given the slight uptake in inflation.

In the outlook, the Fed is assumed to keep both the federal fund rate and the discount rate at the current level for 2000–2001. There is a high possibility that the Fed will raise rates by another 25 to 50 points in the next six months, if more inflationary signs were to emerge in the United States economy than those now in the baseline. This would not be helpful for, from a global perspective, economic recovery in many economies still needs an accommodative monetary stance. Even from a domestic perspective, the inflation outlook in the United States remains benign. While asset-price inflation and the tight labour market may pose an inflationary threat to the economy of the United States, there is no proof that the use of a preemptive monetary policy could effectively eliminate the equity-price bubble in an orderly manner.

On the other hand, the ECB is assumed to raise interest rates for the euro area in 2000, reverting monetary policy to a more neutral stance.<sup>4</sup> Meanwhile, BoE is also expected to raise interest rates further in 2000, after the last rise of 25 basis points in September 1999. However, the Bank of

Japan (BoJ), which has kept the overnight interest rate at near zero since early 1999, is assumed to remain accommodative.

Historically, when central banks in major developed economies tighten their monetary policy, interest rates in emerging economies rise above those in developed economies. But if the Fed holds the current rates, as assumed in the baseline, there is still some leeway for many emerging economies not to raise their interest rates immediately or even to lower their rates further. Nominal interest rates in many of these economies are still at high levels, compared with developed economies. If inflation rates could be further reduced in some of these economies, nominal interest rates could be brought down. Meanwhile, the emerging economies that have recently moved from a fixed exchange-rate regime to a floating system have regained more independence of monetary policy. Therefore, interest rates in these countries do not have to follow every move of the central banks in major countries, at least within a certain range. However, how these countries will define a new monetary anchor under the new floating regime remains an important issue, including the appropriateness of inflation-targeting, but one that falls outside the present discussion.

Two additional remarks on global monetary conditions are in order. First, given the low inflation rates worldwide, real interest rates in many economies remain high, so the stance of monetary policy is not as lax as it appears at first sight. Second, as noted earlier, market forces have already raised long-term interest rates in global capital markets by more than 100 basis points since the beginning of 1999, thus tightening credit conditions. The monetary authorities can therefore remain more relaxed with regard to their policy rates.

### *Major fiscal policy assumptions*

The international financial crises of the 1997–1999 have not only left the world economy with large trade imbalances across countries, but also large fiscal imbalances especially in countries that experienced recession. Moreover, there is a sharp divergence among different regions. Most developed economies in Europe and North America have managed to improve their fiscal position considerably in the last few years, with some turning a large budget deficit into a sizeable surplus. Japan and many

<sup>3</sup> During the Link meetings, the ECB and the Bank of England raised their policy rate by 50 basis points and 25 basis points, respectively. Also Australia raised its policy rate by 25 basis points.

<sup>4</sup> The scenario assumption for 2000 was brought forward by about a quarter as a result of the action taken by the ECB on 4 November.

emerging economies, however, have faced a drastic deterioration in their fiscal positions.

In contrast to the trend of a more globally correlated monetary policy across countries, largely due to increased international capital mobility, national fiscal policy remains to some extent independent. Most developed economies, except Japan, have restrained their fiscal policy, even during the international financial crises. The outstanding case is the United States, which turned a deficit performance during three decades into a surplus in 1998; the surplus for 1999 is estimated to reach \$140 billion. However, in order to stimulate their economies out of recession, Japan and many Asian developing economies accumulated large deficits into debt and now have almost reached the limits of fiscal expansion. The budget deficit of Japan is estimated to reach 10 per cent of GDP in 1999, and many Asian emerging economies are currently in fiscal deficit.

In the baseline forecast, a neutral to moderately relaxed fiscal policy is assumed for most developed economies in Europe and North America for 2000-2001. For Japan, after another expected fiscal injection in late 1999, fiscal policy will be tightened in 2000-2001. Fiscal consolidation is also expected for most emerging economies in the future, albeit at varying points in time.

More detailed assumptions about monetary and fiscal policies in individual economies can be found in the *LINK Country Reports*.

### ***Exchange rates: flexibility versus stability***

Currencies of many countries, the emerging economies in particular, were devalued significantly against the U.S. dollar during the recent international financial crises. Most have stabilized since then. While some currencies such as those of Indonesia, the Republic of Korea, Mexico and Thailand, have gradually appreciated from their lows, in both real and nominal terms, others, such as the currencies of Brazil, Russia and South Africa, have been drifting around their new low parities.

As a result of the crises two polarized exchange-rate systems for the emerging economies are now prevalent. Many economies adopted, or were forced to adopt, a floating exchange-rate regime. But there are still several countries that stick to a rigid fixed exchange-rate system. In the LINK baseline fore-

cast, countries with fixed exchange rates are assumed to keep the current parity to the major pegging currencies. For countries with a floating regime, a relatively stable real parity is assumed so that the nominal exchange rate will fluctuate in line with the expected international inflation differentials. Nevertheless, other factors, such as domestic policies and market sentiment, may well drive their nominal exchange rates well away from the assumed real parity.

Speculations about devaluation of the Chinese yuan has been rife. In the baseline forecast, the yuan is still assumed to keep at the current peg with the U.S. dollar, although it might be devalued in 2000-2001, especially after China enters the WTO. However, given the fact that the yuan has already devalued by about 8-10 per cent in real terms against the U.S. dollar in the last two years, as a result of the continued domestic deflation in China, the need for a further devaluation is limited. More importantly, the ripple effects on other currencies will also be much smaller than they would have been had the yuan been devalued two years ago.

Exchange-rate movements among the major currencies of the developed economies in the last few years have to some extent reflected the differentials of economic growth in these economies. The strong U.S. dollar vis-à-vis the yen and the euro has been in line with the robust growth in the United States in comparison with the stagnation in Japan and the relatively weak growth in Europe. More recently, with strengthening sentiment about an impending slowdown in the United States and further recovery in Europe and Japan, the U.S. dollar has been weakening. In the baseline forecast, the U.S. dollar is expected to stay at the current exchange rate with the yen, but to devalue slightly against the euro in 2000-2001.

### **Uncertainties and Risks of the Forecast**

Large and interrelated imbalances in the global economy have accumulated in the wake of the disturbances provoked by the international financial crises in the last two years. For example, fiscal deficits in Japan and in many emerging economies have increased significantly, and both the widening current-account deficit and the rapidly growing private-sector debt in the United States have reached record highs. Since these imbalances are unsustain-



able, compressing them at some future point is inevitable. Corresponding to the international imbalances, the growth cycles among many economies have become significantly asynchronized. The outlook of the world economy therefore depends critically on how these imbalances will prospectively be resolved. The fairly optimistic LINK baseline discussed earlier assumes smooth adjustment, basically a gradual slowdown in North America accompanied by strengthening recovery in Europe and sustained recovery in Asia. But other scenarios for working off these imbalances cannot be ruled out.

On the downside, there are some uncertainties and risks that may trigger an abrupt adjustment of these imbalances rather than a smooth one, leading the global economy to a much lower growth path, if not a recession, than the baseline projection. Many studies, including by Project LINK have in the past couple of years sought to identify the downside risks and to analyze the possible consequences for the world economy. A popular downside scenario revolves around another turmoil in world financial markets, but this time centred in developed markets, such as Europe and the United States, rather than in emerging markets.

As reported to the May 1999 LINK meeting, a simulation based on the LINK modeling system shows that the negative wealth effects and the international repercussions of a collapse in equity markets in major developed countries for global economic growth are considerable. A 40 per cent decline in the value of equity markets in the United States and a few major European economies in combination with a credit crunch in corporate borrowing would lead to a loss of 1.5 per cent of world GDP over two years. While growth in Europe and the United States would drop to barely above zero, recovery in Japan and developing Asia would be aborted. The impact on many emerging economies would be considerable, especially for those economies with strong international linkages of trade and capital flows.<sup>5</sup>

Other studies have drawn a similar picture. However, questions arise regarding the relevance of such a downside scenario. First, what is the probability of such a collapse in equity markets in the major developed economies, such as the United

States? Second, will the wealth effects be as significant as shown by the model simulations? None of the available studies has come up with conclusive answers to these questions. There are many good reasons for this lack of solid backup, if only because there is no precedent for the recent changes in international linkages, notably through capital flows; for the sharp rise in the number of households now keeping some share of their wealth portfolio in the form of equity; or for the precise shape of the cycle, given the technological revolution and the way in which information technology in particular has been affecting productivity in non-traditional economic activities.

If measured by price-earnings (P/E) ratios, stock-yield or other traditional equity-valuation models, the United States stock market is overvalued. An immediate return to the historical levels of these traditional measures would imply a 20 to 40 per cent drop in the value of equity markets. However, observers have argued that the rapid innovation in information technology has permanently lowered equity premiums—the margin by which the implied rate of discount on stocks exceeds the rate of interest on riskless assets. If this were to be borne out, the current valuation of the stock market in the United States would be undervalued. In-between these polar cases many other gauges for what might happen to asset prices can be readily applied.

None the less, there are other signs of unwarranted excesses in the United States economy. Consumers and the corporate sector have been borrowing well beyond historical levels, leading to record private-sector debt. While the household saving rate, as measured, has dropped to below zero, household debt as a share of disposable income is now approximately 100 per cent. As reflected in the widening current-account deficit of the United States, the soaring private-sector debt has been financed by large capital inflows, attracted by the recent strong appreciation of the stock market. A sharp reversal in confidence as a self-fulfilling process could be triggered by any shock, such as a tightening in interest rates. It could set off financial turmoil in the United States. Foreign capital flows could be reversed, leading to a drop in stock-market values and a credit crunch for the private sector, which in turn would lead to a decline in business investment and a contraction in household demand.

<sup>5</sup> See Link Report of May 1999 for details.

These will reinforce the slowdown in economic growth. Of course, the U.S. dollar would weaken, leading to reduced import demand and export growth so that eventually the large trade deficit will be compressed.

There are other uncertainties and downside risks in the global economy. For example, if the yen continues to appreciate considerably, the current recovery in Japan could be in jeopardy. A further surge in oil prices could rekindle inflation expectations. Since post-crisis restructuring in many emerging economies has proved to be difficult and slow, recovery in these economies could be interrupted and the reform process stalled. Moreover, there are also political uncertainties about fiscal consolidation to reduce budget deficits in many countries. Failure to do so could induce another default crisis. Last, but not the least, uncertainties about the scale and magnitude of the Y2K problem will remain at least until the beginning of 2000, but the economic impact of the problem, if it materializes, would extend beyond the first quarter of 2000.

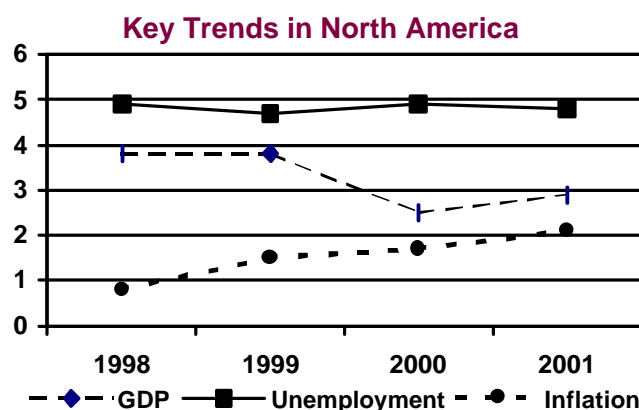
On the upside, it is possible that the reduction of the cited imbalances could have a smaller impact on the world economy than in the projected baseline. For example, the economy of the United States could continue to expand at the robust rate for some time, supported by continued technological innovation, hence substantial productivity gains. In this case, world economic growth would be 0.5 per cent higher than forecasted in the baseline.

## REGIONAL OUTLOOK

### Developed countries

#### North America

The economies of North America continued to expand rapidly in 1999, with the combined output of the region increasing at an estimated pace of nearly 4 per cent for the year. While the United States may have reached some supply constraints, especially a tight labour market, Canada still has underutilized capacity. A moderation of growth in the region is expected in the LINK baseline forecast, with North America's gross region product rising between 2.5 to 3 per cent in 2000-2001, but risks especially on the downside remain.



The strength and the duration of the current economic expansion in the United States have surprised many economists and policy makers. After solid and sustained growth for more than 100 months, the economy is still running at a robust pace of about 4 per cent. Private consumption expenditure has been the driving force behind the expansion, fueled by real wage gains, high consumer confidence, considerable borrowing, and a sharp appreciation in equity markets. Strong business investment, particularly of information-processing equipment, has been another important factor. It has not only added to effective demand, but also contributed to rapid capacity creation and a rise in productivity.

Notwithstanding this notable performance, some trends are not sustainable. First, the labour market is very tight, as the unemployment rate has fallen below to just over 4 per cent, the lowest in decades. Second, the current-account deficit reached a record high of nearly \$300 billion in 1999. Third, the household propensity to save out of current income has been declining to a rate below zero. Fourth, valuations in equity markets have risen much faster than the improvement in conventional economic fundamentals to levels that are exceptionally high by traditional benchmarks. These trends, and other signs, indicate that the pace of economic growth in the United States is close to, or already beyond, the potential warranted by its resource constraints and its need for external and internal balances. The challenge before policy makers is to avoid an immediate and sharp downturn in economic activity as the economy adjusts.

In spite of the tight labour market and a drastic rebound in the price of oil, overall inflation has been benign, with consumer prices rising at a 2 per cent

annual rate. However, the Federal Reserve (Fed) has recently adopted a preemptive approach to inflation and raised interest rates twice during the summer of 1999, reversing two of the three interest-rate reductions made in the fall of 1998 in response to the international financial crisis. It is assumed in the baseline forecasts that the Fed will continue its current stance. But a further rise in interest rates by another 25-50 basis points in the next two quarters is possible should inflationary signs appear.

Fiscal policy in the United States has in general been restrained, as government spending has been increasing slower than the growth of GDP and government revenue. As a result, the surplus in government accounts is expected to reach \$140 billion in 1999, up from \$58 billion in 1998. The current debate on the federal government budget surplus is not expected to lead to any significant policy change in the short run. For this reason, continued fiscal restraint is assumed in the baseline outlook.

There are several downside risks that could markedly affect trends expected under the baseline. A large and sudden decline in equity markets, for example, could depress consumer confidence and lead to much lower growth or even a recession. There is also a risk of overtightening by the Fed, which would trigger a downturn in spending and production. Uncertainties surrounding the Y2K problem will at a minimum cause some fluctuation in the economy through large inventory changes. On the other hand, it cannot be ruled out that the United States economy will quickly overcome any difficulty and continue to grow at its current robust pace for the foreseeable future.

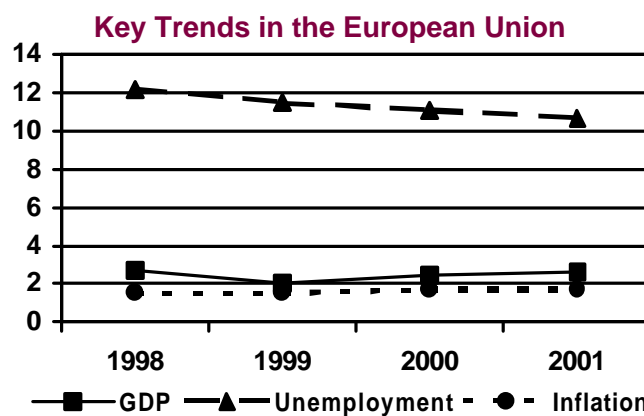
In Canada, the central bank (Bank of Canada) has not followed the Fed in its last two increases in interest rates, leading to an interest rate spread of about 75 basis points, a fairly large difference by historical standards. To date, inflation, which is the focus of monetary policy, is running at an annual rate of 2 per cent, and the outlook for expected inflation is within the same range as recent experience. However, at a rate of growth of over 3 per cent, spare capacity is likely to be reduced in the next year or two. At the same time, the recent rebound of international prices of main commodities produced and exported by Canada is both a source of stimulus to Canada's economic activity and its general price level. Therefore, inflationary pressures could build

up. In the baseline outlook, it is assumed that these pressures will be manageable and that the current stance of monetary policy remains unchanged.

### Western Europe

Western Europe's economies on the whole strengthened during the year, as the effects of the slowdown induced by the world financial crisis dissipated. The weakening in world demand, which was particularly hard in the fourth quarter of 1998 and lasted through the first quarter of 1999, resulted in a substantial drop in the region's exports. Manufacturing suffered badly due to its dependence on foreign sales and the strong investment growth seen in 1998 slowed. During the second quarter of 1999, economic activity began to pick up, boosted by a strong rebound in exports while consumption expenditure remained robust, inventory destocking ended, and investment picked up with the revival of manufacturing output. These trends coupled with a number of positive factors for growth such as the low inflationary environment, a highly stimulative monetary policy and the increased competitiveness of the euro, points to accelerating activity in the second half of 1999 and into 2000 and 2001. For western Europe as a whole, GDP is expected to increase by 2 per cent in 1999, and then expand at a faster pace of about 2.5 per cent the next two years.

At the beginning of 1999, consumer confidence was at a near record high across western Europe, while industrial confidence was low. Since then, the two measures have narrowed, with a strong rebound in industrial confidence and some mellowing of consumer sentiment, although in the last few months consumer surveys have indicated some strengthening once again. Consumption, while cooling in the





second quarter, remained strong in the first half of the year, and with very positive readings from consumer surveys, looks set to maintain its strength throughout the rest of the year and into 2000. Steady employment growth, moderate wage gains, and low inflation should maintain the growth in purchasing power, while high levels of consumer confidence argues for stable saving rates.

After many months of decline, industrial production stabilized in Europe during the summer months, with increases in the production of intermediate and consumer goods. Order books for manufacturing, particularly foreign orders, turned up strongly in these months, which, in line with the improvement in business sentiment, points to a substantial improvement in the second half of the year, particularly for capital goods. The environment is currently positive, with low rates of interest, low and stable inflation, a competitive exchange rate, and strong internal and external demand. To this should be added that the elimination of exchange risk among the eleven member states of the euro zone has resulted in substantial crossborder mergers and acquisitions, propelled by the increase in competitive pressures. In addition, companies have access to a much wider source of funds by issuing euro-denominated bonds.

The revival in production saw investment picking up in the first half of the year. Cautious tightening of monetary policy envisaged in the near term, together with low rates of inflation and continued strong demand, should generate strong investment spending over the next few years. Much of this improvement came from the rebound in exports, which began in the second quarter of the year, propelled by the strengthening of external demand and by the gain in competitiveness resulting from the substantial depreciation of the euro. While the euro has rebounded somewhat from its lows, it is still highly competitive. Foreign order books suggest strong export growth in the second half of the year.

The major surprise in the outlook is the mix of performances. The United Kingdom and France are much stronger than previously anticipated and especially Italy much weaker. France has seen a rapid rise in consumption expenditure, boosted by continued strong job creation, while data on industrial production show clear signs of continuing acceleration. The United Kingdom has seen unexpected strength

in consumption expenditure fueled in part by a strong rise in house prices, while, surprisingly, exports have started to pick up despite the strength of the pound, bringing a turnaround in manufacturing. Germany has had very positive indications in manufacturing from orders received and business sentiment, but data for industrial production have not yet registered positive growth. Consumption expenditure weakened in the second quarter, but is expected to rebound from the impact of higher wage bargains agreed to earlier in the year. Nevertheless, stagnant job growth will be a restraining factor. Italy still suffers from the effects of fiscal consolidation. Consumption was also dampened by negative wealth effects from low interest rates. However, there are recent positive signs in both countries. And just as they suffered the most from the collapse of external demand, as their export and industrial structures were particularly vulnerable to the crisis, these two countries should benefit the most as exports pick up. For this reason, a much stronger second half is expected. The fast growing smaller economies that are catching up to euro area levels of income per capita and levels of productivity have slowed but still continue to register strong growth.

Inflation in Europe has picked up moderately due to the strong rise in oil prices and some other non-oil commodity prices, and, for the euro zone, the sizeable depreciation of the euro against the U.S. dollar in the first half of 1999. Although there are worries concerning the effects of higher economic growth coupled with rising commodity prices, there is no sign of an acceleration in inflation. Moreover, in most countries wage growth has remained moderate. Consumer prices are expected to rise to an average of 1.5 per cent in 1999 and 1.7 per cent in 2000. There are, however, some concerns over inflation in some of the fast-growing economies. Nominal wage growth is expected to continue its moderate upward trend.

The labour market in Europe continues to improve, but slowly. Employment grew moderately in the first quarter of 1999, but national sources indicate a deceleration in the second quarter probably caused by lagged effects from the economic slowdown. The deceleration was concentrated mainly in manufacturing, while the service sector fared much better. The generally positive performance, however, was not evenly distributed geographically.

For the year as a whole, rates of growth of employment similar to those experienced in 1998 are expected for 1999, with some acceleration in 2000. But aggregate European unemployment remains stuck in the 10 per cent range.

The euro started strongly with an early high in January of \$1.1903 but weakened significantly during the year, reaching lows of \$1.0105 during the summer. It recovered moderately in early October, but thereafter sagged again. The weakness, however, was mostly a matter of the relative cyclical positions vis-à-vis the United States, as well as unfavourable yield differentials. There were also some confidence problems, such as questions about the independence of the ECB and the risk of fiscal deficits. But there were also signs of confidence as euro-denominated bond issuances were substantial. As euro-zone growth picks up, and interest differentials narrow further, the euro is expected to strengthen and it is assumed that it will rise to \$1.13 in 2000. The British Pound has remained strong, in contrast to expectations, but is relatively high historically and is expected to weaken in the medium term.

The year began with the ECB setting its main refinancing rate at 3 per cent, which represented a substantial loosening of policy for the high interest-rate members of the newly created monetary union, but on average a moderate loosening of policy. It was hoped that this overall easing would provide a sufficient stimulus to the euro area as a whole to combat the deflationary pressures coming from the world financial crisis. But as the downside risks became increasingly evident, particularly to Germany and Italy, the ECB lowered rates by 50 basis points in April, where they stand at present at end October 1999. While the Bank of England continued lowering its repurchase rate gradually from 6.25 per cent at the beginning of the year to 5 per cent in June, interest rates have been on hold until recently.

With the strengthening of the recovery, central banks have become more hawkish in tone. Growth has been very strong in France and some of the smaller economies, bringing forth the classic dilemma for the ECB whether to gear its policy towards aggregate euro area performance or worry about the situation in individual countries. With every piece of positive evidence for German manufacturing, there has been speculation for a rate increase. High mon-

etary growth, strong credit growth, and worries over the next round of wage bargaining, especially in Germany, are also cited by the ECB as a cause for concern. But there are as yet no signs of substantial inflationary pressures. Consequently, the ECB is expected to maintain its current stance for the rest of 1999 and then to begin to bring policy to a more neutral stance in 2000.<sup>6</sup> The BoE, in a surprise move, raised its repurchase rate by 25 basis points to 5.25 per cent in September, citing the strength of consumption and asset markets, particularly the housing market. Policy is expected to be tightened over the next year, bringing short-term rates to 6 per cent.<sup>7</sup>

Fiscal policy has generally been neutral to mildly expansionary over the year. However, low interest rates and more rapid growth have led to improved budgetary positions. Not much progress was made on reducing structural budget deficits, however. So future fiscal policy is assumed to be fairly restricted for most countries.

The present outlook sees most risks to the upside. Both consumption and investment could be stronger than anticipated, given the favourable monetary environment and potential for strong export growth. Also, strong employment growth could surprise, raising incomes and fueling consumption expenditure. These may exacerbate price risks especially if higher wage increases were to materialize. But it is still unclear how the wage-bargaining process in key countries will unfold. Finally, the possibility of policy mistakes should not be overlooked given the new institutional environment.

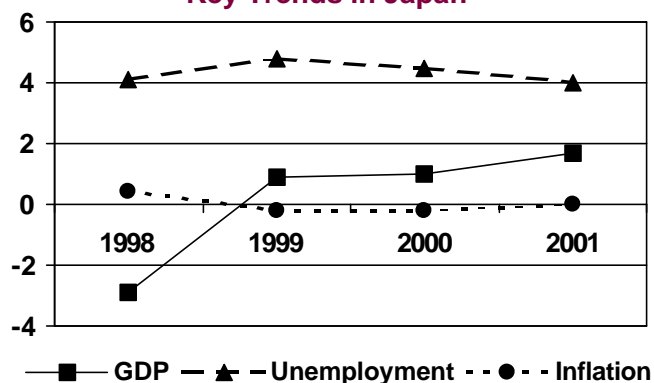
### *Japan*

After five consecutive quarters of decline, the economy of Japan showed signs of recovery during the first half of 1999, as GDP rebounded by an annual 8.1 per cent in the first quarter and continued to increase by 0.9 per cent in the second quarter. For the year as a whole, GDP is expected to grow by 1 per cent, reversing a contraction of 2.8 per cent in 1998. However, the near-term economic outlook is still cautious, with a forecast of 1-1.7 per cent in

<sup>6</sup> Note that the ECB did raise its policy rates by 50 basis points on 4 November 1999.

<sup>7</sup> It raised its policy rate to 5.5 per cent when the ECB acted on 4 November 1999.

## Key Trends in Japan



economic growth for 2000-2001. Japan's recovery is still fragile with many weaknesses remaining in banking and corporate sectors. Meanwhile, as the yen strengthened during the summer, it raised concerns about the country's export prospects.

The recent recovery has been supported by strengthened domestic private demand, especially consumption. In contrast, business investment continued to fall in the second quarter due to corporate restructuring. Inventory adjustment has also taken place and industrial production has started to increase. Despite an improvement in business sentiment, investment is expected to decline through early 2000 as firms scale back on widespread excess capacity. Exports have turned around, supported by growing external demand, particularly from emerging economies in Asia. Given the slack in the economy and strong yen, inflation should remain flat in the short term despite rising oil prices.

With regard to monetary and fiscal policies, the BoJ has held the overnight interest rate to near zero since early 1999 to promote the recovery. Moreover, the government has extended credit lines, particularly to small- and medium-size firms, in order to further relax tight credit conditions. In the baseline forecast, this accommodative monetary policy is assumed to continue. Fiscal policy has also played an important role in stimulating the economy. Initially, there was a front-loading of a massive fiscal injection in the first quarter of the year, but spending slowed down in the second quarter. As the unemployment rate rose to 4.9 per cent in July, however, the government introduced an extra-budgetary package of \$4.5 billion aimed at creating 700,000 jobs. It is recognized that there are limits to the cur-

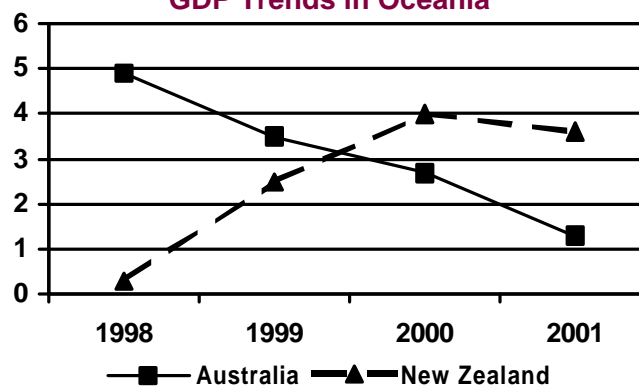
rent fiscal stimulus as the current fiscal deficit is expected to reach near 10 per cent of GDP in 1999 (excluding social security). Accordingly, the public debt has increased rapidly and is already putting pressure on long-term interest rates. Given the fragility of the recovery, the fiscal momentum is assumed to be maintained.

There are still downside risks to this outlook. First, the recent sharp appreciation of yen—from 145 yen per U.S. dollar in August 1999 to 103 in October—raises concerns about its effect on exports and the recovery. While Japan's exports are considered competitive up to 100 yen per dollar, a strong yen could lower external demand and reduce profits. To date, however, the negative price effect of the strong yen has been more than offset by the positive income effect from an upturn in demand in Asia, Europe and the United States and by transnational industrial linkages between parent firms in Japan and their overseas subsidiaries. Second, there is high uncertainty about the short-term effects of ongoing corporate restructuring on production capacity and employment and therefore on effective demand. Resumption of normal bank lending through the implementation of bank reforms will be crucial to a revival of business investment. Finally, if an additional fiscal stimulus is not introduced and/or private demand does not pick up further, the recovery may stall.

## Oceania

The two major economies in Oceania, Australia and New Zealand, are presently in very different phases of their economic cycle. While Australia sustained above-trend growth in the first half of 1999, New Zealand, which had been recovering from a short-

## GDP Trends in Oceania



lived recession in the first half of 1998, recorded a modest decline in economic activity for the second quarter of 1999. The contrast in growth trends between the two countries is expected to persist at least until 2000. However, the economy of Australia is expected to slow significantly in 2001 when the stimulus effects related to the Olympics fade, while the recovery in New Zealand is expected to continue.

The economy of Australia is in a situation similar to that of the United States. Having weathered the Asian financial crisis remarkably well, the economy is expected to register its eighth year of expansion with output increasing about 3.5 per cent in 1999. Spurring the strong pace of growth is private consumption expenditure, supported in turn by employment gains, low interest rates, and rising consumer confidence. Construction projects related to the Olympics in 2000 have also contributed to growth. The housing sector and equity markets remain buoyant. However, the growth of business investment, after a long expansion, may have begun to wane recently, and weak exports, a low saving rate and a widening current-account deficit are key policy concerns. Inflation has remained very low, however, and the unemployment rate has continued to fall to its lowest level in a decade.

Low interest rates maintained by the Reserve Bank of Australia (RBA) since the Asian crisis have played a critical role in offsetting deflationary forces. Given subdued inflation, the RBA is assumed in the baseline forecast to keep interest rates low.<sup>8</sup> With regard to fiscal policy, because the fiscal budget is in surplus, there is less pressure for fiscal consolidation.

In contrast to Australia, New Zealand's economy has exhibited considerable volatility during the past two years. Its modest recovery was interrupted by a dip of 0.3 per cent in its GDP in the second quarter of 1999. This downturn was mainly attributed to two temporary factors: a delay in the pre-winter slaughter of livestock and weak sales of winter items due to mild weather. A decline in exports, combined with rising imports, also contributed to the downturn.

Monetary policy in New Zealand was eased sub-

stantially during 1998, and this accommodative stance was held into 1999. A continuation of this policy is expected to support domestic demand in the near term. With low interest rates and an improved external environment, the economy is expected to resume growth from the third quarter of 1999 and regain momentum thereafter. Exports are seen as increasingly leading the recovery, although agricultural exports are likely to remain constrained by the drought-damaged agricultural sector. Tourism exports have been growing rapidly in recent months and manufacturing exports are also expected to recover. Despite the large currency depreciation and food-price increase, inflation has remained low in New Zealand, due to excess capacity and competitive forces. In summary, real GDP is expected to increase 2.5 per cent in 1999, followed by 4 per cent in 2000-2001. Inflation in the first half of 1999 was 1.2 per cent, below the mid-point of the target range of 0 to 3 per cent, but is expected to pick up to the upper-end of the target range in 2000.

These two economies share some downside risks. First, low saving ratios and widening current-account deficits present major risks to the current outlook. Second, the extent of the expected slowdown in the United States, especially if a major correction in its stock market were to occur, and the sustainability and strength of the recovery in Asian economies are still uncertain. Finally, in the case of Australia, once its economic cycle has peaked and a slowdown sets in, bad debts in the banking system could rise and threaten its outlook.

## Economies in transition

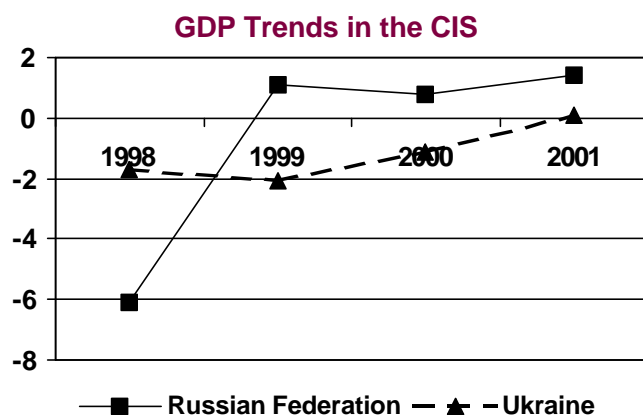
### *Commonwealth of Independent States (CIS)*

In the wake of the Russian financial crisis in August 1998, exports of other CIS countries to Russia collapsed and intra-CIS trade disruptions multiplied, owing to the overwhelming size and importance of Russia, both as a source of the region's aggregate production and of its demand for imports from other CIS countries.

The Russian economy on the whole remains weak with sharp contrasts in trends and conditions in different sectors of the national economy. Domestic demand is anemic, reflecting the sharp decline in real incomes following the currency devaluation and the collapse of the banking system. Real consumption

<sup>8</sup> Following the interest-rate hikes by the ECB and the United Kingdom, Australia also raised its policy rates by 25 basis points in early November 1999.





and retail sales are at 80 and 85 per cent of last year's levels and have not picked up in 1999. The share of investment fell to 12 per cent of GDP in the first quarter of the year from 17 per cent in 1998, and capital expenditures have remained sluggish. The other large economies of the region, Kazakhstan and Ukraine, are also in deep recession. In the first half of 1999, GDP contracted by 3.3 per cent in Kazakhstan and by 3 per cent in Ukraine compared to the same period in 1998, with strong ripple effects on the smaller economies of the CIS.

Although the economies of the CIS region remain deeply depressed, a gradual recovery now appears to be under way. In Russia, the improvement in performance has been narrowly based on import substitution in selected sectors such as consumer goods, food processing, machinery and textiles, whose output rose on average by 8 per cent between January and July 1999. Macroeconomic policies have been tight in 1999, and this halted the fall of the rouble in early May and helped bring inflation down to a monthly rate of 1-2 per cent. Increased efforts at tax collection and higher oil prices have raised government revenues, and the primary budget balance has swung into surplus. Helped by this macroeconomic stability and by the sizeable real depreciation of the rouble, industrial output in Russia stopped declining in March-April, and grew by 3.1 per cent year-on-year during the first half of 1999, although GDP as a whole still declined by about 1 per cent. Despite the massive devaluation of the rouble, there has not been any significant increase in exports, except in the energy sector. For 1999 as a whole, Russia might end the year with a slight increase in real GDP over 1998.

Ukraine's economy, on the other hand, is likely

to contract in 1999 by at least 2 per cent and Kazakhstan's by 2.5 per cent. Prospects are somewhat better for the resource-rich commodity exporters, given the gradual firming of world prices. So far, only Azerbaijan, Tajikistan and Turkmenistan have managed to increase their exports when compared to the same period in 1998. These two economies and Armenia, Belarus, Georgia and Uzbekistan have recorded modest year-on-year increases in real GDP over the first half of 1999.

For the region as a whole, industrial production increased on average by 2.3 per cent in the first half of 1999 compared with the same period in 1998. Investment, exports, imports, retail trade turnover and freight carried slightly improved in the second quarter.

The outcome for the rest of 1999 and for 2000 will depend critically on what happens in Russia. If the Russian recovery leads to sustained growth and increased import demand from its CIS partners, the region's prospects for emerging from the current stagnation will significantly improve. However, such a scenario hinges on significant policy changes to be enacted in the first instance in Russia.

### **Baltic Countries**

The economies of the Baltic region too were strongly affected in 1999 by the recession in Russia because a substantial share of their exports to the CIS cannot readily be reoriented. The recession was especially steep in the first quarter of 1999, when GDP contracted at an annual rate of nearly 6 per cent in Estonia and Lithuania and by 2.3 per cent in Latvia.

Although the extent of decline may be exaggerated when measured against the strong growth recorded a year earlier, it nevertheless reflects the vulnerability of these small economies to their external environment. Despite the successful diversification of their trade away from Russia and an advanced stage of transformation that has improved the flexibility of their economies in recent years, they remain highly dependent on a narrow base of exports and the Russian market. Even at the much-reduced level of trade at end 1998, Russia still accounted for 13-16 per cent of exports and 7 to 20 per cent of their imports. The limited prospects for Russia point to a strong dampening effect on the performance of these economies in the near future. Moreover, the depressed level of economic activity

has adversely affected government budget balances, and all three countries have been in the process of cutting back on expenditures. Unlike Latvia, Estonia revised down its growth forecast for 1999 to 0.4 per cent and Lithuania to 1-1.5 per cent.

Even these reduced rates are achievable only with a strong recovery in the second half of 1999. Signs of gradual recovery in the region have appeared in the last few months. Investment is still rising and retail sales have picked up. More important, FDI flows are rising, after suffering a temporary drop due to investor uncertainty and delays in privatization. Inflation has been very low, which has supported the currency board or quasi-currency board exchange-rate regimes of these countries. Consumer-price inflation rate is now around 2 per cent and producer prices have declined in recent months. The current-account deficit of these countries has shrunk, mostly because of a fall in imports.

Given these improved conditions, any incipient recovery is likely to be strengthened by the expected upturn in Western Europe, the main trading partner for the Baltic countries. Prospects for growth in 2000 would be further enhanced by continued domestic economic reforms, including large-scale infrastructure privatization and accompanying FDI flows into these countries. Aspirations of early EU entry, shared by all political parties, serve as a strong additional stimulus for and guarantee of responsible policies over the medium-term.

### Central and Eastern Europe

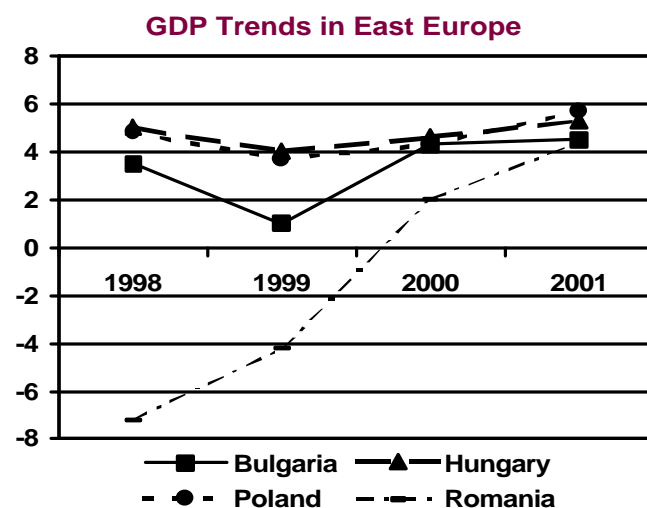
The economic performance of countries in Central and Eastern Europe during the first two quarters of

1999 was rather disappointing. In Central Europe, output and exports grew very slowly and in most cases GDP declined in Eastern Europe. In most of the countries, but not Hungary, industrial output declined in the first half of the year.

Among the principal reasons for this slowdown were weakened global demand and the external trade shocks that occurred in 1998, namely slow growth in Western Europe and the loss of the Russian market after the devaluation of the rouble in August 1998. The latter had a substantial impact on the region, given the limited options for policy response and trade reorientation these countries really have. The conflict in Kosovo also affected the region, especially, countries of South-eastern Europe, disrupting trade, contracting tourism revenues, delaying foreign direct and portfolio investment and structural reforms, as well as increasing costs of borrowing in international capital markets. The economic consequences for individual countries have varied, with the estimates of GDP loss ranging from 2 per cent for Albania to 50 per cent for Yugoslavia.

In addition to external shocks, weaker domestic demand also played a crucial role in the economic downturn. This slowdown was, in many cases, due to tight fiscal and monetary policies implemented in response to overheating followed by the high current-account deficits recorded in 1998. As an example, policy makers in Poland forced the economy to cool down after the rate of growth of domestic absorption in 1998 exceeded the rate of production by almost 4 per cent. Many countries tightened fiscal policy following lower-than-projected revenues, since the budgets of almost all countries overestimated growth prospects for 1999. Given the acute twin-deficit problem in Romania and Slovakia, austerity measures were taken that cut expenditures and increased revenues.

Trade volumes fell in the first half of 1999, because of weaker demand in western Europe, tight competition on world markets, and weakened intraregional trade (attributed both to Kosovo crisis and changes in mutual exchange rates). Despite curbed imports and a temporary depreciation of real exchange rates for some economies, external balances deteriorated in 1999—the fall in exports being the primary cause. The depreciation of the exchange rate and the gains in terms of trade early in 1999 did not exert a favourable impetus on the pace of eco-



economic activity in these countries. Since borrowing prospects are uncertain, except for Hungary and Poland, FDI as a source of financing the current-account gap became more important in 1999.

Inflation continued to fall in most of Central Europe in the first half of 1999. However, in contrast to 1998, when low international commodity prices led to low domestic inflation, this year's disinflation owes most to weakened domestic and export demand. Deceleration of inflation should have created a more favourable environment for investment. However, the region failed to benefit from disinflation, since, although interest rates were cut and supply conditions gradually relaxed during the first half of 1999 in the Czech Republic, Hungary and Poland, real interest rates remained high, thus dampening investment in particular. The cautious approach to the reduction of interest rates is explained by the importance of external-financing constraints and by problems in the banking sector. Inflation has remained relatively high in Romania and, with the rise in international commodity prices, especially those for fuels, began to rise in the third quarter in most of the region. Some countries (for example, Hungary) have been forced to revise their inflation forecast upwards. In Poland, interest rates were raised in September to prevent an upsurge in inflation. Any further relaxation of monetary policy depends on the fiscal situation, especially in Hungary and Poland.

The repercussions of the 1998 Russian financial crisis seem to be over for the most stable economies in the region, namely, Hungary and Poland, who have since restored their access to international capital markets and do not now experience pressures on their currencies. Some countries, like Croatia and Slovenia, which had strict controls on shortterm capital flows, were sheltered from the 1998 financial turbulence. However, for other countries the cost of borrowing in international capital markets remains high.

Growth is expected to continue in most of Central Europe. Some countries will benefit from the economic upturn in the European Union (including Czech Republic, where an export-led recovery and the government's revitalization programme should pull the country out of recession; however, austerity measures and restructuring in Slovakia may result in negative growth in the second half of

1999). The expected recovery in the EU will benefit Hungary, with its exports to Austria and Germany already rising and boosting industrial production. For Poland, given the relatively large size of its economy, domestic demand is of higher importance for boosting growth of production. The situation is more difficult for South-eastern Europe. Given the wide range of structural problems in many sectors, restructuring in Bulgaria and Romania will imply contraction of output in the last quarter of 1999.

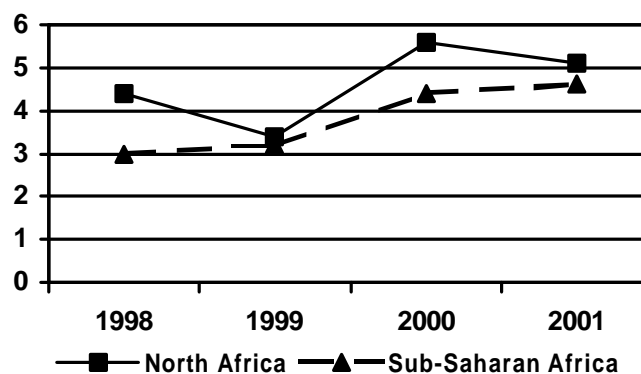
For Albania and the successor States of the former Yugoslavia (except Slovenia), growth prospects depend strongly on EU activities and the commitment of developed economies of Western Europe to assist in overcoming the economic fallout of the Kosovo conflict. To date, the prospects for reconstruction and for EU enlargement policy towards the region remain vague.

## Developing countries

### Africa

Available information up to the end of the third quarter indicates that GDP growth in the African region will average 3 per cent in 1999. This represents an improvement over two consecutive years of slowed-down performance in 1997 and 1998, and the decline in per capita GDP registered in the latter year. The turnaround is attributable to substantial terms-of-trade gains for the region's oil-exporting countries as a result of increases in oil prices, but also to strong macroeconomic policies in most countries of the continent. The combined GDP of the eight major oil-exporting countries (Algeria, Angola, Cameroon, Congo Republic, Egypt, Gabon, Libya and Nigeria) jumped by more than a full per-

GDP Trends in Africa





centage point to 3.9 per cent from earlier estimates of 2.8 per cent. GDP growth was also positive overall for non-oil-exporting countries and for Sub-Saharan Africa.<sup>9</sup>

Africa's export revenues increased by 4 per cent in 1999, a significant improvement over earlier estimates of a 6 per cent decline and a substantial recovery from the 16 per cent decline in 1998. Export earnings of all oil-exporting countries taken together improved substantially during the course of the year as oil prices rose, but voluntary production and export restraints under OPEC agreements lowered export-revenue growth in Algeria, Libya and Nigeria. Angola, among the other major oil-exporting countries, benefited from large increases in crude oil exports and significant inflows of FDI into the country's oil sector. Equatorial Guinea and Sudan recently joined the ranks of major oil-producing countries in Africa. Substantial investment in the petroleum sectors of both countries, together with the increase in oil prices, contributed to significant economic gains in 1999.

Improvements in other areas of the international economic environment contributed to stronger demand for African commodity exports in Europe, Japan and the United States. Demand for Africa's export commodities also picked up in some of the recovering Asian crisis countries and in Japan. However, steep declines in non-oil commodity prices limited the growth of export revenues in Sub-Saharan African countries that are heavily dependent on commodity exports as their principal source of export earnings. Some countries, on the other hand, were able to increase export volumes to offset the decline in prices. Higher oil prices also contributed to the deterioration in the terms of trade and a decline in imports of Sub-Saharan African countries, although imports for Africa as a whole rose by 2 per cent in 1999.

Domestic factors also contributed to the turnaround in Africa's economic performance in 1999. Agricultural output increased in most countries as a result of improved weather and growing conditions. However, in Ethiopia, Mauritius, Morocco and several other countries drought led to a decline in agricultural production and food shortages. Continuing

armed conflicts in Eritrea, Ethiopia, Somalia, Sudan and other countries also contributed to their poor performance. The civil war in the Democratic Republic of the Congo abated during the year, which left some room for the return to normal economic activity in that country.

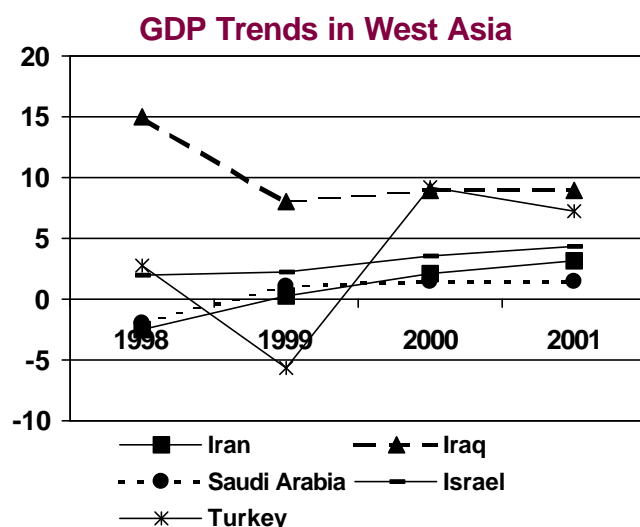
Increases in foreign and domestic investment contributed to economic growth in Côte d'Ivoire, Mozambique and elsewhere in Sub-Saharan Africa. In several other countries, low inflation, manageable fiscal deficits, stable money-supply growth (generally viewed as indicators of domestic macroeconomic stability) and political stability boosted investor confidence. South Africa's economy regained its growth momentum after a brief period of decline, capital flight, depletion of the country's gold and foreign-exchange reserves, high domestic interest rates and escalating inflation caused by the turbulence of the Asian financial crisis. FDI and portfolio capital inflows increased as international investors responded positively to what was regarded as sound management of the economy.

GDP growth is expected to accelerate further in 2000 and match or exceed the 4.5 per cent rate recorded in 1996, the peak rate of increase attained in the 1990s. This optimistic assessment of the prospects for a sustained recovery and more rapid growth momentum hinges on oil prices remaining at high levels and some strengthening in the international prices of nonoil commodities as global demand for Africa's exports strengthens. Increases in the value of exports are expected to accelerate to 11.5 per cent in 2000, which would provide a firm basis for a broad-based expansion of African economies.

### *West Asia*

In response to the OPEC agreement in March 1999 to cut production, oil prices increased sharply in 1999 as most oil-exporting countries in West Asia reduced their production. The resulting terms-of-trade gain improved their internal and external balances and their prospects for growth, with all oil-exporting countries recovering in 1999 from the economic recession of 1998. Iraq is the only oil-exporting country where economic growth is likely to be strong in the next few years—albeit an expansion from a small base. In the case of the oil-importing countries of the region, economic growth is also expected to be weak. Drought has devastated Jordan and Syria, and

<sup>9</sup> References to Sub-Saharan Africa exclude Nigeria and South Africa.



tourism activity remains depressed as uncertainties over the Middle East peace process persist.

Given the stronger growth expected in Iraq, the region's average economic growth may well increase to about 4 per cent in 1999 and accelerate to over 4 per cent in 2000; if Iraq is excluded when calculating the average, however, the outlook for the region is far much lower growth. Export earnings in West Asia as a whole are estimated to recover this year from the steep fall recorded in 1998 and, when combined with a slight increase in import demand, may well lead to a reduction of the current-account deficit in most countries. Similarly, fiscal deficits are likely to be reduced as well. Because most countries framed their budgets assuming low oil prices, the oil-price recovery has brought an unexpected windfall. As most countries maintained their tight fiscal policy, budget deficits are expected to be reduced significantly in 1999.

In the case of Israel, the economic outlook remains subdued. Economic activity in 1999 is likely to be weak due to reduced exports and stagnating domestic demand. Israel's terms of trade deteriorated in 1999, which could lead to an increase in the current-account deficit at a time of slowing export growth and rising imports largely owing to the rise in import prices, particularly for oil. Nevertheless, GDP growth in Israel is expected to be around 2.2 per cent in 1999 and may rise to 3.5 per cent in 2000.

In another important development, an earthquake devastated Turkey in August 1999. Prior to the earthquake, the Turkish economy had been hit hard by the Asian and Russian financial crises. GDP

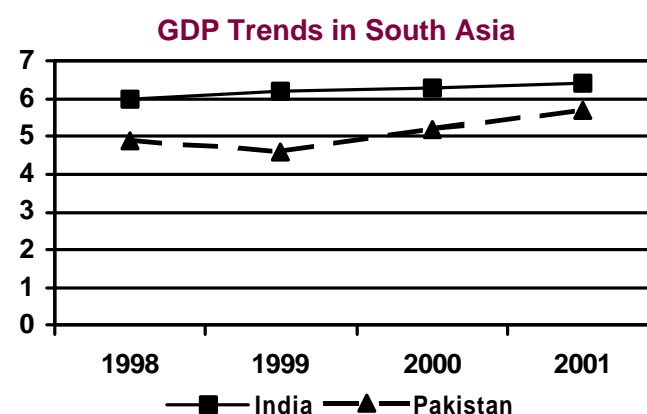
growth had decelerated sharply from a 7.3 per cent in 1997 to 3 per cent in 1998, in the process slowing inflation, though it remained at a double-digit level. To boost economic growth and address the problem of inflation, Turkey introduced reforms early in 1999, and GDP growth was expected to increase to an average rate of 3.5 per cent for the year.

But a major earthquake struck north-western Turkey on 17 August 1999 with over 15,000 lives lost and extensive damage to Turkey's industrial base as the quake occurred in the provinces of Istanbul and Kocaeli, where an estimated 70 per cent of Turkish industry is located. Instead of the expected 3.5 per cent increase in real GDP, it is now estimated that the country's output will fall by 5 per cent in 1999. The fiscal deficit, which had been substantially reduced earlier in the year, is expected to rise to 15 per cent of GDP this year, inflation is likely to accelerate, and the current-account deficit may widen to 2 per cent of GDP.

In addition to the major economic setback, the earthquake has had a huge social impact. Employment losses in the affected areas are estimated to range from 20 to 50 per cent. Addressing these social costs will impose a heavy burden on Turkey's social protection system. While an immediate international relief effort was mobilized, Turkey faces many challenges in the reconstruction and rehabilitation of its economy. Towards this end, substantial international financing is needed.

### South Asia

Despite a somewhat improved international economic environment, the economies of South Asia exhibited great contrasts in their performance during the first half of 1999 due to differences in domestic



factors affecting their economic growth. Externally, the negative effects of the financial crises and, in the case of India and Pakistan, of sanctions for the most part faded and stronger global demand began to support their exports. Domestically, however, differences in weather conditions, political developments, and policy and structural problems resulted in divergent performances across the subregion.

Output in some countries has grown rapidly. Real GDP growth in Bangladesh, despite severe flood damage during the summer of 1998, has been recovering in 1999 at a better than expected pace of about 5 per cent due to a bumper rice crop. India, after two years of sluggish growth, also began to recover gradually, supported by a favourable crop, relaxed monetary conditions, and improving confidence. On the other hand, the economic performance of Nepal, Pakistan and Sri Lanka has been poor. Output in each of these latter countries has grown at a rate below 4 per cent mainly as a result of poor agricultural harvests and, in the case of Pakistan, an acute balance-of-payments constraint. In Nepal, growth was hampered by structural factors in spite of an improvement in its agricultural production.

In view of subdued inflation and to stimulate sagging domestic demand and/or offset the deflationary effect of budget consolidations, monetary policy has been eased in a number of countries in the region. The Reserve Bank of India, for example, recently cut its bank rate to 10 per cent and lowered the cash reserve ratio to 9 per cent. Sri Lanka also lowered the statutory reserve requirement and bank rates by one percentage point. Pakistan, after a rescheduling of its external debt, was able to lower interest rates by four points to 14 per cent.

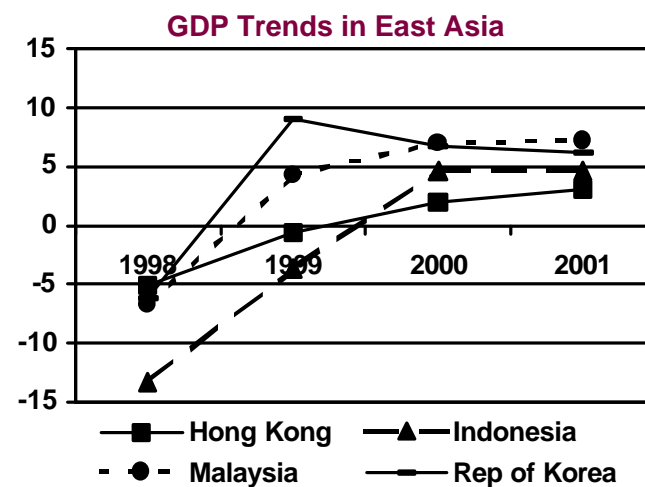
Fiscal deficits have widened or remained above 5 per cent of GDP in most countries. Fiscal consolidation consequently remains a critical policy issue in the region. In the case of India and Pakistan, the recent military conflict further exacerbated their fiscal problems, which could continue to be a source of inflation and an impediment to private investment and growth. Despite large and widening fiscal deficits, inflation fell substantially in the first half of this year, especially in India and Nepal, as a result of a strong recovery in food production, low commodity prices, weak domestic demand, and, in a number of countries, tightened policies.

The current prospects for South Asia have improved somewhat in recent months. Most countries in the region, except Pakistan, are expected to record somewhat higher growth in the near term, although the pace of this growth is likely to be below that of recent years and divergent among countries. A return to normal weather, improved external conditions, and a relaxed monetary policy—key assumptions in the baseline forecast—are seen as main factors supporting a further expansion of the region's economic activity and international trade.

In the baseline forecast, barring bad weather and political disturbances, the countries of South Asia, except Pakistan, are expected to exhibit a modest recovery but the pattern of their growth will range widely from 4 per cent in Nepal to about 6.5 per cent in India. In the case of Pakistan, as now assessed, real GDP growth could decelerate to about 3 per cent. Exports from the region are also expected to rise in response to a strong upturn forecast for East Asia and rising demand from Europe and Japan. By mid-2000, the expected slowdown in the United States, if it materializes, could moderate this upward momentum. Inflation in the region, except for Nepal, is expected to edge up in line with rising domestic demand, higher oil prices, and in some countries, such as Bangladesh and Pakistan, a one-off increase in utility rates and new taxes. In Nepal, it is expected to continue to decline gradually.

### East Asia

The economies of East Asia began to show increasingly clear signs of recovery during the first half of 1999, after nearly two years of setback caused by



the sequence of financial crises. Output is increasing more rapidly, inflation has continued to fall sharply or has remained subdued in most countries, and the unemployment rate has begun to decline in the region, but still remains high.

In four crisis-hit Asian emerging economies, the recovery from their deep recessions was markedly stronger than had been expected and would appear to be strengthening. In this regard, the Republic of Korea is a star performer, with its real GDP increasing remarkably at a rate of 4.6 and 9.8 per cent in the first two quarters with respect to the low base of the previous year. Recovery in 1999 is expected to be significantly higher than earlier anticipated, with an increase in real GDP of about 9 per cent. Even Indonesia, which has lagged in its recovery, unexpectedly exhibited some growth in the second quarter. In other areas, exchange rates have regained much of their lost ground and, in the case of the Republic of Korea, the possibility of a credit crunch has been considerably reduced. Current-account surpluses, albeit somewhat reduced with rising imports, have remained sizeable.

The recovery in these countries, however, is still not broad-based. Supported by expansionary policies, it has been led by an upturn in private consumption, inventory adjustment, and rising exports. Despite high unemployment and reduced real wages, private consumption began to pick up in response to policy stimuli, wealth effects from sharp asset-price increases, and improved consumer confidence. On the other hand, except for the Republic of Korea, business investment has remained on a downtrend due to excess capacity, cautious lending by banks, and weak business confidence; but the decline appears to have slowed. Exports in these countries have risen in response to a surge in regional trade, sustained demand expansion in the United States and Europe, and favourable global demand for certain lines of electronics related to Y2K compliance. In combination with good growth in services, this has bolstered industrial output (except for Indonesia). Imports have rebounded rapidly from last year's dramatic contraction. In Indonesia, rising oil prices increased export earnings and government revenues, but industrial output has remained rather weak, while agricultural output recovered rapidly from last year's setback as weather returned to normal. Increased foreign portfolio inflows have also

raised the capacity to import, build foreign reserves, and prop up stock prices in the region.

Other economies in the region also recovered from mild recessions during the first half of 1999, led by strengthening domestic and foreign demand. Growth in Singapore, after a feeble upturn in the first quarter, accelerated strongly to a rate of 6.7 per cent in the second quarter, spurred by increases in output of the manufacturing and service sectors. In the Philippines, as in Indonesia, agricultural output recovered strongly with a return of normal weather but industrial production, particularly construction-related output, remained weak. China, Hong Kong S.A.R., which fell into a deep recession in the first quarter of 1998, finally resumed growth in the second quarter of this year, supported by rising regional demand, sustained exports to the United States, and higher private consumption expenditures. In China, Hong Kong S.A.R. and Singapore, the financial service and tourism sectors have been recovering rapidly, supported by increasing demand from neighbouring countries. Damage from the recent earthquake in Taiwan Province of China is expected to be overcome relatively quickly. Together with active recovery efforts, this could lead to somewhat more rapid growth than last year.

In the near term, the recovery in East Asia is expected to continue. Driven by such factors as expansionary domestic policies, rising stock prices, improving market sentiment, and rising intraregional and global trade, buoyant private-consumption expenditure and growing exports should sustain the current upturn in economic activity. In the case of private consumption, income increases and improving consumer confidence should maintain aggregate demand as the current inventory and electronics' cycles fade. Business investment in the region is likely to be stimulated by a number of factors: a rise in private consumption and exports, low interest rates and relaxed credit condition, a need for upgrading production facilities, and improved business confidence. This upturn in domestic demand would also set off a virtuous cycle of multiplier effects through trade in goods and services, particularly within the region. Similarly, with an upswing in trade within the region and continuing demand expansion in the United States, Europe and Japan, exports should be more conducive to growth than last year. Services exports, particularly tourism and



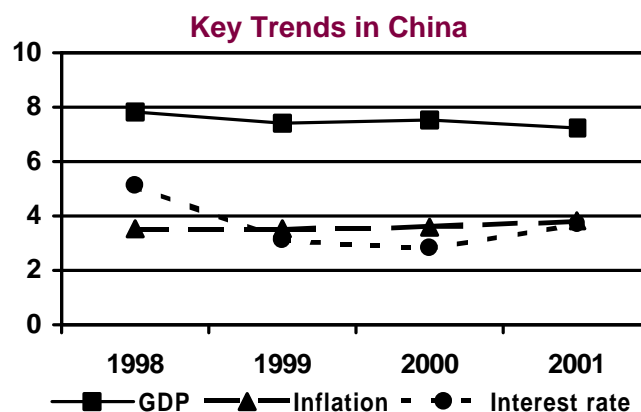
financial services, are also expected to be favourable in the future.

Given the slack in the economy, the current acceleration in the region's growth should not be supply constrained. Next year, economic growth in East Asia is expected to settle down to a sustainable pace of 5 to 7 per cent a year, a pace below its previous high growth path. Several factors, however, could offset the current growth momentum in 2000 and beyond. One upside factor is that existing excess capacity could be eliminated more rapidly than assumed here. This would depend on progress in banking and corporate restructuring, stronger stimulatory policies, greater external demand, and increases in foreign private capital inflows than currently anticipated.

On the other hand, major downside risks also exist. First, large public-debt burdens could restrain growth in some countries. Second, a major correction in equity prices in world financial centres would result in negative wealth effects and a possible credit crunch, with a consequent abrupt slowdown in major developed countries, particularly the United States. Third, should the implementation of structural reforms be postponed, notably in Indonesia and Thailand, normal bank lending will be less buoyant, with negative implications for economic activity; similarly, political uncertainties could affect the economic environment. Fourth, exchange-rate changes could markedly affect the prospects for exports of the region. Fifth, there is high degree of uncertainty on how serious the Y2K problem will be and what impact it might have on financial markets and the production and export of electronics. Finally, the recent surge in oil prices, should it continue, could have significant implications on inflation and the balance of payments of these countries.

### China

Following the noticeable slowdown in the pace of economic growth in the last few years as a result of weakening domestic demand due to difficulties in restructuring its state-owned enterprises (SOEs) and the impact of the Asian financial crisis, China's economic situation in the first half of 1999 worsened as its exports dropped by about 10 per cent from the same period a year earlier and private consumption demand stagnated. Since mid-1999, however, there



have been signs of improvement, including a significant turnaround of exports, which rose at an annual rate of 15 per cent in the third quarter as the recovery in Asia and elsewhere broadened. Industrial production has also been improving as investment has expanded fairly strongly, supported by increased government spending on infrastructure.

Underpinning the recovery is a considerably relaxed fiscal and monetary policy. Government spending has accelerated since the beginning of 1999, with increased spending on infrastructure and, in an attempt to stimulate private consumption directly, higher wage, pension and unemployment benefits. As a result, the budget deficit in 1999 is expected to widen to about 180 billion yuan, still below 2 per cent of GDP. In addition, a new bill has been passed to tax interest income from saving deposits in order to encourage consumption. Monetary policy has also become more accommodative. In mid-1999, the central bank of China made its seventh and most aggressive cut in interest rates in three years, with the rate on one-year deposits now standing at 2.25 per cent, substantially below the 11 per cent rate of 1996.

The still-unfolding effects from these policy measures are expected to strengthen overall demand, especially private-consumption expenditure. Their effectiveness, however, will depend, among other developments, on progress in reforming SOEs, which remains a major challenge. It has recently become clear that some issues associated with SOEs can no longer be sidestepped, including problems of redundant employees, high indebtedness, and a heavy burden of social-service provisioning. In September 1999, the authorities issued guidelines for

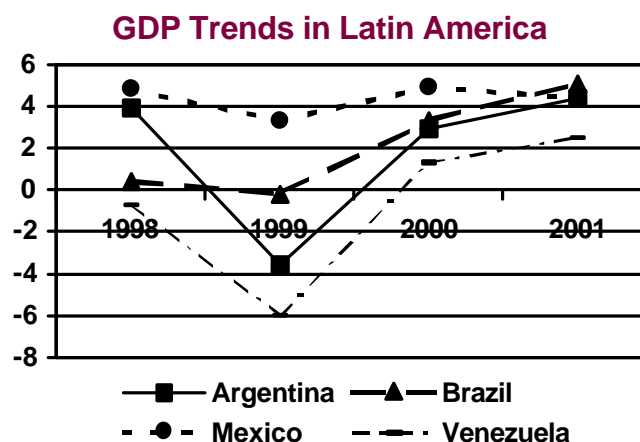
SOE reform and laid down principles and strategies for solving the sector's problems in the next 10 years. One component is maintaining state ownership in industries related to the "lifeline of the national economy," while reducing the role of the state in other areas. At present, however, the main challenge facing policy makers is the large number of workers laid off from SOEs undergoing reform, estimated at about 6 million in 1998 alone. These layoffs have directly contributed to a depressed level of consumption demand, which has led to a deflation in retail prices for more than 20 months in a row.

In comparison with many other Asian economies the impact of recent international financial crises on China has been limited, owing mainly to its sound external balance and its control of the capital account. Nevertheless, given the close economic linkage of China with other Asian economies, the country's export sector has suffered markedly, as the growth of China's exports turned from an increase of 21 per cent in 1997 to a decline of about 10 per cent in the first half of 1999. Although China's policy of not devaluing its currency (renminbi) has helped stabilize the financial situation in the region, the policy has none the less imposed large costs on its export sector. As noted above, some recovery has been observed in its exports since the second half of 1999, but foreign investment is expected to register a noticeable decline in 1999. Meanwhile, China has continued to carry out a policy towards gradually opening up its economy, and its determined effort to join the WTO is likely to succeed in 1999 or soon thereafter.

Despite the problems and difficulties confronting the economy, assuming a continuation of present macroeconomic policies, economic growth is forecast to stabilize at around 7.4 per cent in 1999, slightly below the 7.8 per cent increase registered in 1998. Afterwards, China's growth is expected to stabilize at around 7.5 per cent a year. Key forecasting assumptions in this outlook are further improvements in China's external sector and more success in reforming SOEs.

### *Latin America and the Caribbean*

Following the poor economic performance in 1998, economic growth in Latin America and the Caribbean worsened in 1999, and the economy of the region is now expected to contract by -0.4 per cent this year before picking up in 2000. The overall



average rate of growth for 1999, however, masks contrasts among countries in the region and reflects changes in expectations from those prevailing earlier in the year.

For the region taken as a whole, the current forecast for all of 1999 is practically the same as the assessment made at the beginning of the year. However, substantial revisions of individual country forecasts have been made. In the case of Brazil, which is recovering much faster than expected after the devaluation of the real in January, the forecast for economic growth this year has been revised upwards, although it remains negative. Offsetting this gain is a deterioration in the outlook for other South American economies. Moreover, the forecast for average growth in the region hides significant divergences in the growth performance of individual countries. In this regard, given that some major Latin American countries remain in recession, Mexico and many Caribbean and Central American countries have been performing relatively well in 1999.

Initial 1999 forecasts for Brazil in the aftermath of the real's devaluation were very pessimistic. However, following an initial overshooting, the exchange rate stabilized in the second quarter of 1999 and Brazil succeeded in adjusting to the new flexible exchange-rate regime, while keeping inflation subdued. Interest rates have been gradually and substantially reduced, providing some relief to the economy. The first half of 1999 was also much better than anticipated in part due to an exceptional harvest, raising agricultural output significantly. Brazil is now expected to experience only a mild recession in 1999 (about -0.2 per cent) rather than the deep decline feared earlier in the year.

Nevertheless, the spillovers of the Brazilian recession have seriously affected the country's main trading partners through a contraction of intraregional trade. Moreover, international prices for some commodities remain depressed, financial conditions in the region are constrained, and political uncertainties continue to influence the performance of many South American economies. Argentina has been particularly hard hit, with its GDP contracting by 4 per cent during the first half of 1999. Uncertainties in both Colombia (internal armed conflict) and Venezuela (constitutional reform) have aggravated economic conditions by delaying investment decisions and provoking capital flight. Both countries also suffer from severe recessions by historical standards in spite of higher prices for petroleum, which is a key export commodity. At around 8 per cent, the contraction in Ecuador's GDP in 1999 is likely to be the highest in the region. Even Chile is expected to experience zero growth in 1999 after having expanded at an annual rate of 7 per cent in 1991-1998.

In contrast to the adverse economic situation in South America, Mexico has continued to benefit from the buoyancy of the United States economy, its major export market. Although growth is expected to be slower in 1999 than in 1998, Mexico is likely to register an increase in GDP of 3.5 per cent, owing to the strength of services and manufacturing (in particular the maquiladora sector). Similarly, economies in the Caribbean and Central America have benefited from strong import demand by the United States and have been shielded from recent episodes of financial instability due to their limited exposure to international financial markets. However, these relatively small economies continue to be vulnerable to external shocks and natural disasters. Honduras, for example, is still struggling to overcome damage caused by Hurricane Mitch, and economic activity in many Central American countries (along with Mexico) have been negatively affected by torrential rains in late September 1999.

The external sector has been the main mechanism of adjustment in Latin America. Despite the poor performance of exports, the regional trade deficit narrowed significantly as a consequence of the reduction in imports, especially in the countries

experiencing recession. Moreover, private flows to the region became scarce and more expensive in 1999, further constraining the availability of import finance and the formation of fixed capital. In this regard, the Institute for International Finance estimates that private flows to Latin America will fall to \$60 billion in 1999 from \$84 billion in 1998 and \$105 billion in 1997. As a result, the region's current-account balance is expected to narrow from around 4.5 per cent of its GDP in 1998 to around 3.5 per cent in 1999.

Macroeconomic policies have been prudent in Latin America after the shock of the international financial crisis in 1998. In general, fiscal policies have remained tight. Budget imbalances none the less deteriorated in many countries as a result of higher debt-servicing costs and lower receipts. Monetary policy has generally been cautiously accommodative during the first half of 1999. One exception has been Colombia, which increased interest rates several times in an attempt to maintain the value of its currency before abandoning its currency band in September. Monetary policy has been eased considerably in Chile and Venezuela as well as in Brazil, where benchmark interest rates were gradually cut to 19 per cent in late September 1999 from 45 per cent in March.

Weak domestic demand and economic recession have kept inflation under control in the region. The recession has even brought deflationary pressures to countries such as Argentina, El Salvador and Paraguay. In contrast to Brazil, Ecuador was not able to control prices after the devaluation of its currency in early 1999, and consequently inflation could accelerate. Another consequence of the recession has been a worsening of labour conditions in many countries. For example, in Colombia unemployment has reached a record high of 20 per cent of the economically active population, while in Chile the unemployment rate surpassed 11 per cent by mid-1999, rising from 7.2 per cent at the end of 1998.

The short-term outlook for Latin America is for a fairly widespread, though uneven, economic recovery. In 2000, negative growth rates are forecast to disappear in all major economies, except Ecuador. The region's gross product is expected to increase by 3.5 per cent in 2000, led by Mexico and, to a lesser degree, by Brazil. The sources of the recovery in



the region are difficult to generalize due to the heterogeneity of the economic situation in different country. An acceleration of economic growth in Mexico is likely to be based mostly on strengthening domestic demand as exports are expected to be negatively affected by a slowdown in United States economy. However, in Brazil exports are expected to expand in 2000 after a disappointing performance in 1999. Higher export prices of those commodities produced by Latin America and stronger world demand will contribute to an expansion of export revenues in all countries. Additionally, improved international financing conditions are likely to boost fixed investment.

The forecast for 2000 is subject to a number of downside risks. First, the evolution of international financial-market sentiment towards the region will be crucial for any recovery, as foreign capital flows are required to finance external deficits. International financial markets reacted nervously during the summer of 1999 to doubts about the sustainability of Argentina's foreign debt and the default by Ecuador on its Brady bonds. Unfavourable developments in individual countries, even in those of relatively minor economic weight, could spill over into the rest of the region, in spite of the fact that markets are more discriminating than they have been in the past. Second, although Brazil's recovery would improve the prospects of other South American economies, that upturn depends crucially on further progress on fiscal consolidation to permit additional cuts in domestic interest rates. While Brazil has been meeting the fiscal targets of its revised agreement with the IMF, new revenue and spending measures are required to secure a higher primary budget surplus in 2000. In this regard, the Brazilian currency, the real, will remain exposed not only because of large current-account deficits and external financial requirements, but also because of the difficulties in carrying out fiscal reforms necessary to sustain its recovery. Third, there is the potential for a sharp asset-price correction in the United States followed by a sharp slowdown in its economy. This would not only worsen prospects for Latin American countries, especially those with close economic links to the United States such as Mexico, but it could also result in another severance of credit lines to all countries in the region.

## CONCLUSIONS

The pace and comparative strength of the recovery in many developing countries, the brief slowdown in Western Europe with strengthening recovery in the second half of 1999, and the continuing strength of the economies of North America have fostered a more buoyant state of the world economy than was anticipated earlier in 1999, given the lingering effects of the various financial crises and the ominous developments in Brazil at the time. While growth itself is important for ensuring stability in the global economy, this can only be brought about as a durable basis through appropriate macroeconomic policies. Given the substantial current-account and fiscal imbalances hanging over the outlook for sustaining the recovery in many countries and for ensuring a 'soft landing' in North America, international policy coordination and collaborative stances on monetary policies in particular remain crucial.

Developments in late 1999 and the outlook for 2000-2001 are such that a moderate return to pre-crisis growth in the world economy by 2001 seems the most likely scenario for the near future. This moderately optimistic assessment does not, however, leave room for complacency. Several downside risks to the most likely course of events need to be borne in mind and these could usefully be factored into policy formulation, especially in major economies. Most important remains ensuring the gradual compression of the imbalances through cooperative strategies. However, the urgency to continue with structural reforms in the countries that were most exposed to the crises deserves to be emphasized as well. Likewise, reinforcing market institutions in the broad sense throughout the economies in transition, but especially in the countries that have not yet recovered from the protracted transitional recession, a veritable depression in some cases, should command prime attention on the part of policy makers. At the international level, part and parcel of policy coordination is making headway with reforming the international monetary system in particular so that the international community will prospectively be better prepared to cope with any further financial crisis than it was in those experienced from mid-1997 through early 1999.