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Interim Assessment

December 1997

**A Survey by the Staff of the
International Monetary Fund**



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Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during October 9–November 5, 1997 except for the bilateral rates among the European exchange rate mechanism (ERM) currencies, which are assumed to remain constant in nominal terms; that established policies of national authorities will be maintained; that the average price of oil will be \$19.39 a barrel in 1997 and \$19.03 a barrel in 1998, and remain unchanged in real terms over the medium term; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 5.9 percent in 1997 and 6.4 percent in 1998. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available in mid-December 1997.

The following conventions have been used throughout the *World Economic Outlook*:

- . . . to indicate that data are not available or not applicable;
- to indicate that the figure is zero or negligible;
- between years or months (for example, 1996–97 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years or months (for example, 1996/97) to indicate a fiscal or financial year.

“Billion” means a thousand million; “trillion” means a thousand billion.

“Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to $\frac{1}{4}$ of 1 percentage point).

In figures and tables, shaded areas indicate IMF staff projections.

Minor discrepancies between sums of constituent figures and totals shown are due to rounding.

* * *

As used in this report, the term “country” does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.



Preface

This Interim Assessment was undertaken in November–December 1997 to evaluate prospects and policies in the wake of the prolonged turmoil in financial markets, particularly in Asia, that began in mid-1997. The focus is primarily on those Asian countries that have been most affected by the recent difficulties. A more complete assessment of prospects for this region and the world economy more broadly will be provided in the next regular update of the *World Economic Outlook*, to be published in May 1998.

The projections and analysis contained in the *World Economic Outlook* are an integral element of the IMF's ongoing surveillance of economic developments and policies in its member countries and of the global economic system. The IMF has published the *World Economic Outlook* annually from 1980 through 1983 and biannually since 1984.

The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department and the Fiscal Affairs Department.

The country projections are prepared by the IMF's area departments on the basis of internationally consistent assumptions about world activity, exchange rates, and conditions in international financial and commodity markets. For approximately 50 of the largest economies—accounting for 90 percent of world output—the projections are updated for each *World Economic Outlook* exercise. For smaller countries, the projections are based on those prepared at the time of the IMF's regular Article IV consultations with member countries or in connection with the use of IMF resources; for these countries, the projections used in the *World Economic Outlook* are incrementally adjusted to reflect changes in assumptions and global economic conditions.

The analysis in the *World Economic Outlook* draws extensively on the ongoing work of the IMF's area and specialized departments, and is coordinated in the Research Department under the general direction of Michael Mussa, Economic Counsellor and Director of Research. The *World Economic Outlook* project is directed by Flemming Larsen, Deputy Director of the Research Department, together with Graham Hacche, Assistant Director for the World Economic Studies Division.

Other primary contributors to the current issue include Guy Meredith, Andrew Tweedie, Thomas Krueger, Staffan Gorne, Jahangir Aziz, John Montgomery, and Cathy Wright. Francesco Caramazza, Paula De Masi, Ranil Salgado, and Bart Turtelboom also contributed. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget measures. Sungcha Hong Cha, Jeffrey Gable, Gretchen Gallik, Mandy Hemmati, and Anthony G. Turner provided research assistance. Allen Cobler, Nicholas Dopuch, Isabella Dymarskaia, Yasoma Liyanarachchi, and Olga Plagie processed the data and managed the computer systems. Susan Duff, Caroline Bagworth, and Margaret Dapaah were responsible for word processing. James McEuen of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the *World Economic Outlook* on December 16, 1997. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.



I

Overview

The economic and financial crisis that erupted in southeast Asia in July 1997 has continued to deepen and broaden since the October 1997 *World Economic Outlook* was written. As investor sentiment toward the emerging market countries has deteriorated, not only has the crisis spread to several other economies in Asia, but spillover effects have been felt throughout the global financial system.

The crisis has brought downward pressures on the currencies of countries perceived as vulnerable—typically those countries whose competitive positions have deteriorated as a result of the large currency depreciations in southeast Asia, those that exhibit potentially unsustainable current account deficits, and especially those that have relied heavily on short-term borrowing. In addition, many emerging market economies have witnessed sharp declines in stock market prices, with generally smaller stock market reverberations experienced in the advanced economies. Large exchange rate depreciations and falling equity prices in turn have exposed and exacerbated financial sector fragilities in many countries, including most recently in Korea.

Banking sector problems have also intensified in Japan, where the fragile economic recovery, which had already suffered a setback following the withdrawal of fiscal stimulus in the first half of 1997, will be further undermined by spillovers from the crisis affecting many of Japan's Asian trading partners.

The repercussions in regional and global financial markets of what began as an adverse shift in market sentiment toward Thailand and several other members of the Association of South-East Asian Nations (ASEAN) have proven much deeper and more extensive than seemed likely only a few months ago. The economic implications also can now be expected to be more serious. As a result of sharply reduced capital inflows and the need for strong measures to correct domestic and external imbalances and to help restore and maintain confidence, many emerging market countries are likely to experience a slowdown in domestic demand and activity during the period ahead, with significant declines in imports and reductions in external deficits. This slowdown will adversely affect activity in other economies. Among the advanced economies,

Japan will be particularly affected, although North America and Europe are also likely to experience a dampening of foreign demand.

At the time of writing, it is far from clear that market turbulence has ended, and more uncertainty than usual applies to any assessment of the most likely future course of developments. The staff's revised baseline projections assume that investor sentiment toward the emerging market countries will begin to turn around in the course of 1998 and that the countries most affected, after a significant slowdown in growth in 1998, will witness a gradual pickup during 1999, even though the upturn may not be quite as rapid as the V-shaped recovery experienced by Mexico and Argentina following the 1994–95 "tequila crisis." Provided that macroeconomic adjustment, financial sector restructuring, and other reform efforts are implemented without undue delay, such an outcome is clearly possible—and indeed seems most likely—not least in light of the strength of the medium-term macroeconomic fundamentals of the Asian economies. In this scenario, the economic slowdown in Asia and the spillovers to the rest of the world would be relatively moderate and temporary. If policy and reform efforts are inadequate, however, the crisis of confidence may persist and continue to spread to other emerging market countries. In that case, there would be more serious implications for financial flows to these countries for a more extended period, their economic slowdown would be deeper and more protracted, and the adverse spillovers to the advanced economies would be more serious.

This Interim Assessment contains a preliminary analysis of the Asian crisis. It first examines the background to the present difficulties and analyzes the various stages of the growing contagion within Asia and to other emerging market countries. It then discusses economic developments and financial conditions in the major advanced economies, highlighting changes in the assessment relative to the October 1997 *World Economic Outlook*. This is followed by a review of revisions to the staff's global projections and a discussion of alternative scenarios for the depth of the crisis. The concluding section considers policy responses to help contain the crisis.