IV

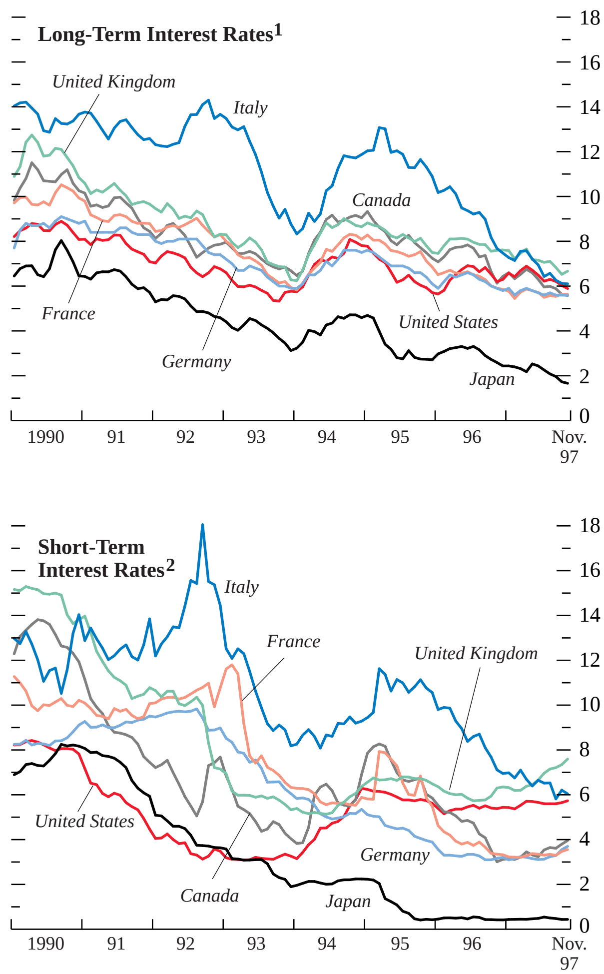
Economic Developments and Financial Conditions in the Advanced Economies

Experience shows that the level and terms of private financing for developing countries are sensitive not only to economic conditions in the recipient countries but also to the global business cycle and financial conditions in the advanced economies. Thus, the large capital flows to emerging market countries witnessed since the beginning of the 1990s and the compression of yields on emerging market debt instruments in recent years have been influenced by the very low level of interest rates in the major advanced economies. This, in turn, has partly been the result of progress in containing inflation. However, sluggish growth and structural deficiencies in continental Europe and Japan also have contributed to outflows of capital toward countries with more promising investment opportunities—in particular, the United States and the emerging market countries.

When the Mexican crisis erupted in late 1994, financial conditions had tightened considerably in world capital markets, with markedly higher bond yields worldwide, following increases in interest rates by the U.S. Federal Reserve beginning early in the year (Figure 18). Subsequently, with inflation remaining subdued, long-term interest rates eased during 1995 and 1996. Net capital flows to emerging market countries surged to record levels in the latter year, including to Latin America, where there had been a significant slowdown in 1994–95.

In the current episode, global financial conditions have remained quite favorable because inflation has remained low. Nevertheless, during the first half of 1997 there were some indications that the extended period of relatively low interest rates might be coming to an end. This prospect mainly reflected developments in the United States and the United Kingdom, where there were concerns about high rates of capacity utilization and tight labor markets. There were also signs that the Bundesbank would begin to raise interest rates as the recovery took hold in Germany and the European Union more broadly and also to counter the effects on inflation of the weakening of the deutsche mark. The perceived need for short-term interest rates in Europe to converge ahead of the start of EMU reinforced expectations that the Bundesbank would begin to raise interest rates (which it eventually did in October, albeit only modestly). In Canada also, as economic growth picked up strongly, it seemed clear that short-term interest rates would have to be raised. In

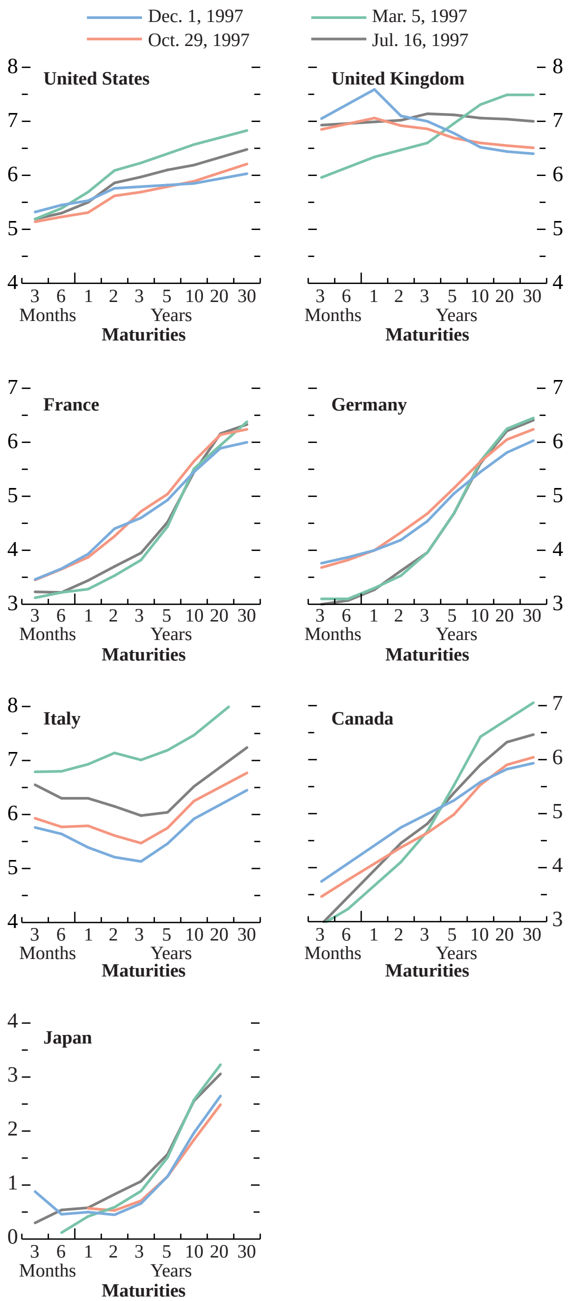
Figure 18. Major Industrial Countries: Nominal Interest Rates
(In percent a year)



Sources: WEFA, Inc.; and Bloomberg Financial Markets, LP.
[1]Yields on government bonds with residual maturities of ten years or nearest.
[2]Three-month maturities.

Figure 19. Major Industrial Countries: Yield Curves[1]

(In percent a year)



Source: Bloomberg Financial Markets, LP.

[1]Yields on treasury bills and government bonds of varying maturities.

Japan, signs of strengthening activity led to expectations in financial markets in the spring of 1997 that the monetary authorities would soon begin to lessen the degree of monetary stimulus. Subsequently, indications that output in Japan contracted sharply in the second quarter, with continuing weakness in indicators for the second half of the year, suggested that interest rates might remain low for an extended period.

Overall, however, while there were some reasons to expect global financial conditions to begin to tighten during the second half of 1997 and in 1998, the absence of serious inflation worries suggested that the prospective firming of interest rates would be gradual and moderate as implied by relatively flat yield curves for short maturities. Changes in world financial conditions therefore do not seem to have played a major role in triggering the Asian crisis, although international bank lending to the region fell significantly already in the second quarter of 1997. More recently, in part because of the effects of the crisis on near-term growth prospects, expectations of future interest rate increases have generally receded, and long-term rates have declined so that yield curves have flattened further. Indeed, yield curves have recently been downward sloping over part of the term structure in Japan, the United Kingdom, and Italy (Figure 19).

Since the middle of 1997, the most significant change in the economic situation and short-term outlook for the major advanced economies has been for *Japan*, where the economic recovery has essentially stalled following promising signs during 1996 and early 1997 that the protracted slowdown was finally over. In the second quarter of 1997, real GDP dropped by 2¾ percent, as domestic demand contracted in the wake of the April hike in the consumption tax. Economic indicators for the second half of the year have so far been mixed, with continuing weakness suggested by sluggish employment growth and a renewed weakening of business confidence. In the third quarter, although consumer spending picked up from depressed levels and the foreign sector remained strong, there was only a partial reversal of the drop in GDP in the previous quarter, so that activity overall was no higher than in the final quarter of 1996. The deterioration in economic performance, concerns about the impact on Japan of financial turmoil elsewhere in Asia, and doubts about the health of Japan's financial system have led to a marked drop in equity prices, and government bond yields have reached the lowest levels observed in the postwar period in any major country. Compared with a projection in the May 1997 *World Economic Outlook* that real GDP would expand by about 2¼ percent this year, the October 1997 *World Economic Outlook* projected growth of about 1 percent; this estimate still appears reasonable in the light of subsequent data. However, as discussed below, the growth projection for 1998 has now also been marked down in this Interim Assessment.

The faltering of Japan's recovery can be attributed to several factors, including the lingering effects of the collapse of asset prices in the early 1990s and the persistence of serious loan problems in the financial system. Against the background of continued fragilities in business and consumer confidence, however, an important factor in the renewed weakening of activity appears to have been the substantial reversal of the earlier stimulative fiscal stance. On a structural basis, the fiscal contraction in 1997 is now estimated to amount to 2 percent of GDP, above earlier estimates, reflecting a sharper than expected cutback in public investment. Although needed from a medium-term perspective, in retrospect this withdrawal of fiscal stimulus was clearly too abrupt in view of the fragile recovery.

Concerns have recently reemerged about fragilities in Japan's financial sector. These problems have their roots in asset price bubbles of the late 1980s that left financial institutions with a large volume of problem loans. Despite quite accommodative monetary conditions, the generally weak performance of the Japanese economy in recent years has limited the capacity of the financial system to work its way out of these earlier difficulties under the policy of regulatory forbearance adopted by the authorities. Recent strains have reflected the renewed weakness of the economy, the downturn in equity prices (see Box 2), and the events in other Asian economies. Moreover, pressures on financial institutions have been accentuated by anticipation of the "big bang" financial reforms next year, especially the more competitive environment and the tightening of regulatory standards implied by them.[10] As a result of the concerns about the health of the financial system, the premium being charged to Japanese banks in international money markets widened sharply in early December but subsequently moderated. Most Japanese banks are solvent and profitable, and they should be expected to remain quite profitable in a continuing environment of accommodative monetary policy, provided that they are not saddled either with the costs of bailing out insolvent and very weak institutions or with continued competition from institutions that cannot be run on an economically sound basis. Indeed, there is an urgent need to ensure that insolvent institutions do not jeopardize the health of solvent ones and to reduce the risk of a continuing credit crunch as banks seek to strengthen their balance sheets. This will require decisive actions to write off problem loans and restructure and consolidate the banking sector. In the absence of a sustained rebound in equity prices, well-targeted additional public funds may well be needed to deal with insolvent and undercapitalized banks, although it would be imperative to provide such funds in a transparent manner that involves a full writing down of existing equity claims on insolvent institutions. The announcement on November 17 that one of the major banks would be closed was well received by financial markets, since it appeared to reflect a recognition by the authorities of the need for a new strategy to deal with bad-loan problems. However, this was followed by considerable volatility in the stock market stemming partly from uncertainties about the use of public funds for financial sector restructuring. The failure of a major securities firm on November 24 further contributed to concerns about the health of the financial system, especially because it was revealed that this firm had hidden substantial losses from regulators and shareholders.

In contrast to the setback in Japan, economic performance in the *United States* has continued to be remarkably favorable. Growth has remained stronger than generally expected—the latest assessment by the staff shows a small upward revision to real GDP growth in 1997 to 3¾ percent; consumer price inflation has moderated slightly; and the federal budget deficit is projected to be almost eliminated in the current fiscal year. Signs of overheating have nevertheless been emerging, including a further decline in the unemployment rate to 4.6 percent in November, a widening external deficit, and the continued buoyancy of the stock market. The stock market correction in late October in response to developments in Asia was largely erased by the end of November.

For some time, the key issue facing U.S. policymakers has been the appropriate timing of any tightening of monetary policy. Recent developments in output and labor markets would, in themselves, call for further tightening at this time. In particular, data for the third quarter of 1997 indicate a sharp surge in domestic final demand by more than 6 percent at an annual rate, a clearly unsustainable pace of expansion. Offsetting considerations include the restraining impact of the strong dollar and its impact on U.S. exports, and weaker growth in Asia and perhaps other regions as a result of the financial crisis. At this stage, financial markets seem to hold the view that these dampening factors will allow growth in the U.S. economy to slow to a more sustainable pace during the period ahead and that monetary policy is unlikely to be tightened much, if at all, in the near term.

Canada has also recorded strong growth thus far in 1997, which has been accompanied by declines in inflation to below the midpoint of the authorities' target range of 1 to 3 percent. Fiscal policy is on track, and the overall budget position (general government) is expected to be broadly balanced in 1997. Near-term inflation risks remain modest given the still sizable output gap. Nevertheless, the move in October to make monetary conditions somewhat less accommodative was appropriate in light of the momentum

[10] A number of financially stronger banks have begun a more aggressive strategy of provisioning for bad loans in an effort to prepare for the more competitive environment that will follow the "big bang."

Box 2. Japan: Financial Sector Fragilities and the Stock Market

The further decline in the Japanese stock market, which began in August 1997 and intensified in late October and early November, has renewed concerns about the general condition of Japan's financial system and, in particular, about Japanese banks. These concerns reflect both the potential for a further deterioration in asset quality, owing to the economic slowdown in Japan and in other Asian markets, and the direct effect of equity price declines on the capital position of Japanese banks.

The most immediate problem that surfaced in October and November was the ability of Japanese banks to meet international standards of capital adequacy. At end-March, 19 of the top 20 banks had Basle ratios of capital to risk-weighted assets that were above the required 8 percent level. Capital ratios at the larger regional banks were generally higher than this. However, the capital counted in these ratios included "hidden reserves" from unrealized gains on equity holdings, which were vulnerable to equity market declines. Regulations permit banks to count 45 percent of the unrealized gains on listed equities toward the "Tier 2" part of their capital.

At the end of the past fiscal year (March 1997), when the Nikkei 225 index closed at 18,003, hidden reserves contributed ¥3.8 trillion toward the aggregate capital of the top 20 banks. This was down from ¥6.5 trillion the previous year, when the Nikkei had closed at 21,407, but hidden reserves in March 1997 still amounted to 19 percent of aggregate Tier 2 capital and 9 percent of total capital. The exposure of banks varied considerably. Some banks have reduced their reliance on these hidden reserves by selling other capital, including subordinated debt and preferred stock. The estimated levels for the Nikkei at which banks' hidden reserves disappeared ranged from about 12,500 to about 17,500, with the median large bank losing its hidden reserves at about 14,700.

In addition, because banks have sold equities in recent years in order to book profits and often repurchased the same securities, the value of existing equities on their books has risen. This trend makes the reported value of bank assets (excluding hidden reserves) more sensitive to declines in the stock market.[1] In 1996/97, the stock market declined by 16 percent, and banks reported ¥2.4 trillion in losses on equities. So far in 1997/98 (as of November 26), the stock market is down an additional 11 percent, which makes it likely that banks will have to report further losses on equity holdings.

Other Japanese financial institutions are vulnerable to stock market declines as well. Life insurance companies also depend partly on hidden reserves, and securities companies have also been vulnerable to drops in the market, partly owing to their own holdings of equity. In early November, Sanyo Securities, the seventh-largest brokerage firm, became the first Japanese brokerage to file for bankruptcy in the postwar era. Financial pressure then mounted on Yamaichi Securities, the fourth-largest brokerage, which announced its closure on November 24. A particularly troubling aspect of Yamaichi's failure was the more than ¥200 billion in undisclosed, hidden losses (known as *tobashi)*. The firm reportedly used offshore companies to conceal these losses from regulators.

As bank capital declines with the stock market, banks may attempt to reduce their risk-weighted assets in order to meet capital adequacy requirements. This could reduce the supply of bank loans to the economy, and it may lead to a reduction in the availability of credit to finance economic recovery in Japan and elsewhere in Asia.

Because banks have generally been reluctant to report net losses, the lack of profits to offset losses on problem loans has limited their ability to make loan-loss provisions and to write off bad loans.[2] The profits that may be used to offset loan losses include realized gains on securities holdings. Over 1996/97, when 18 major banks reported positive net profits, gains on selling securities provided much of banks' profit cushion for writing off nonperforming loans. Banks booked ¥3.5 trillion in realized gains on equities and ¥380 billion in gains from selling bonds held for investment purposes. Along with net operating income of ¥4.2 trillion, these profits were used to offset the ¥2.4 trillion in losses on equities mentioned above and ¥5.5 trillion in loan-loss provisions and charge-offs. Sustained weakness in the Japanese stock market would limit the ability of Japanese banks to book equity profits to offset loan-loss provisions.

Full accounting of loan losses would enhance the transparency of banks' balance sheets, which would increase creditors' ability to differentiate between healthy and unhealthy banks. New rules due to come into effect in April 1998 are designed to tighten reporting standards on loans and should increase transparency by decreasing the discretion banks have to postpone reporting loan losses. The closing of Hokkaido Takushoku Bank, announced on November 17, was a harbinger of this new regime. This is the first closure of a major Japanese bank, and it appears to indicate a departure from previous policies of forbearance with respect to asset quality problems at major banks.

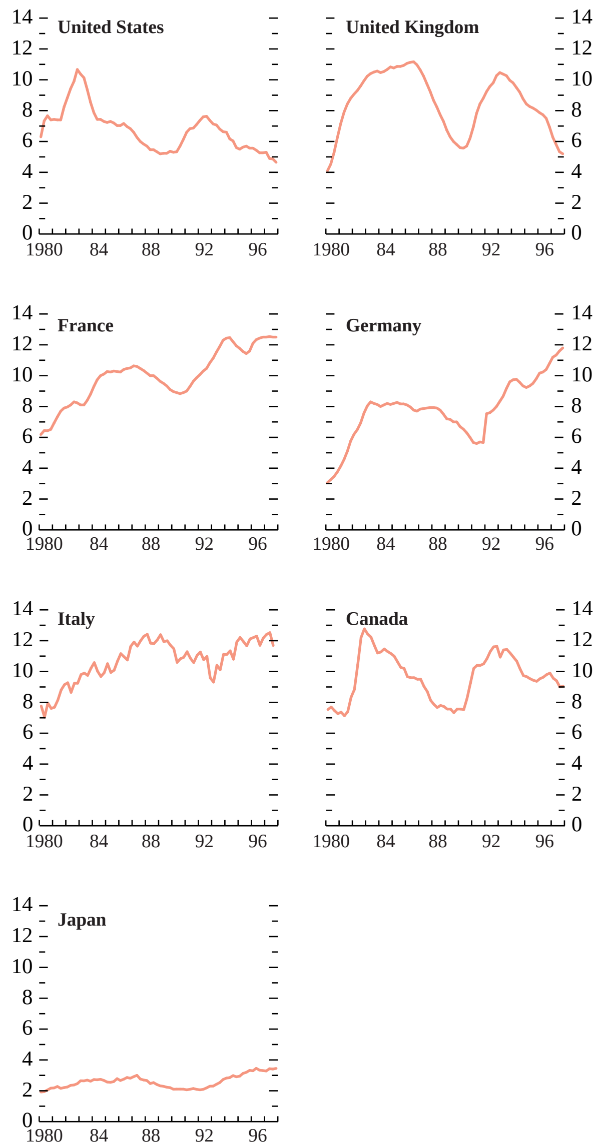
[1]Japanese accounting rules require losses to be recognized on equity holdings when market value falls below purchase cost. Gains are recognized only upon sale.

[2]The exception occurred in 1995/96, when 17 of the 20 major banks reported net losses. The major banks took aggregate loan-loss provisions and charge-offs of ¥10.8 trillion and declared net losses of ¥3.6 trillion.

of the recovery; the increases in official rates in November and December were intended to roughly maintain monetary conditions given the depreciation of the Canadian dollar linked to concerns about the effects of the Asian crisis on commodity prices. Financial markets expect further gradual steps toward a more restrained monetary stance as the expansion continues.

In the *United Kingdom,* the momentum of expansion has also been stronger than expected, despite the firming of official interest rates during the summer, the appreciation of the pound since mid-1996, and the restraining impact of significant fiscal consolidation. While retail price inflation (excluding the effects of mortgage interest rates) has remained moderately above target, the unemployment rate has fallen markedly (Figure 20) and is below most estimates of the structural unemployment rate. A slowdown in growth is widely anticipated as the lagged effects of the dampening forces already in the pipeline start taking hold, and financial markets appear to expect little further tightening of monetary conditions following the latest increase in official interest rates in early November.

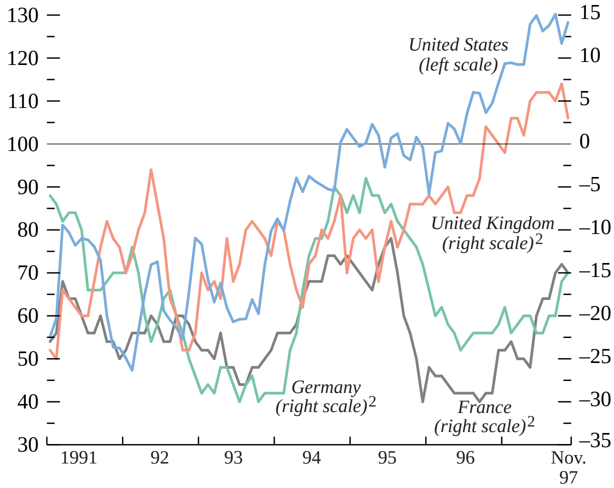
Figure 20. Major Industrial Countries: Unemployment Rates
(In percent of labor force)



The recovery in the major continental European countries has been gathering momentum and would have led to small upward revisions to GDP growth in 1998 had it not been for the likely effects of the crisis in Asia. Activity in *Germany* and *France* rebounded in the second and third quarters of 1997, and consumer confidence and the business climate have improved noticeably in both countries (Figures 21 and 22). Strong commitments to satisfy the Maastricht criteria for EMU have contributed to further declines in interest risk premiums across the prospective euro area. This is helping to underpin generally robust upswings in many of the smaller European Union countries, which in turn are supporting activity in the larger countries. The move by the Bundesbank toward tighter monetary conditions in early October, which was followed by broadly similar adjustments in France and several other countries, was widely expected in financial markets in light of the depreciation of the deutsche mark vis-à-vis the dollar, associated upward pressures on import prices, and a brighter near-term outlook. Nevertheless, the recoveries in Germany and France remain overly dependent on exports, and a self-reinforcing recovery of domestic demand is not yet in place. Subdued underlying inflation, significant margins of cyclical unemployment in both countries, and the likelihood that foreign demand could weaken during the period ahead all seem to justify market expectations that relatively easy monetary conditions will be maintained until the pickup in domestic demand is more firmly established. As emphasized in past issues of the *World Economic Outlook,* the strength and durability of the recovery depend critically on the determination with which structural fiscal and labor market problems are tackled.

In *Italy,* inflation appears to have stabilized at a low level, activity has strengthened since the weak first quarter, and unemployment has declined from peaks earlier in the year. Further steps have also been taken to help Italy meet the Maastricht fiscal deficit criterion, although the recent pension reform fell short of the authorities' own objectives and does not seem to go far enough to help ensure the long-run sustainabil-

Figure 21. Selected European Union Countries and the United States: Indicators of Consumer Confidence[1]

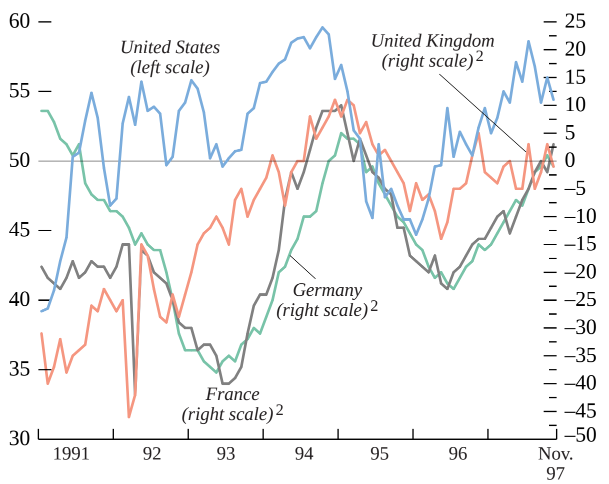


Sources: For the United States, the Conference Board; and for European Union countries, the European Commission.

[1]Indicators are not comparable across countries.

[2]Percent of respondents expecting an improvement in their situation minus percent expecting a deterioration.

Figure 22. Selected European Union Countries and the United States: Indicators of Business Confidence[1]



Sources: For the United States, the U.S. Department of Commerce, Purchasing Managers Composite Diffusion Index; and for European Union countries, the European Commission.

[1]Indicators are not comparable across countries.

[2]Percent of respondents expecting an improvement in their situation minus percent expecting a deterioration.

ity of public finances. The large output gap and progress in fiscal consolidation point to continued gradual convergence of Italy's short-term interest rates toward those of Germany and France.

Most of the smaller and medium-sized advanced economies continue to experience relatively rapid economic growth. This is notably the case in *Denmark, Ireland,* and the *Netherlands,* which have all reached high levels of resource use. Because of exchange rate constraints and in view of the more accommodating monetary stance that is warranted in the major countries of the European exchange rate mechanism (ERM), fiscal policy in these economies will need to bear the brunt of the policy tightening that is needed to contain potential inflationary pressures; Denmark, for instance, has recently introduced measures to tighten the fiscal stance. In *Spain* and *Portugal,* growth is also robust, with inflation remaining subdued; short-term interest rates in the two countries are likely to converge further toward those of Germany and France in the run-up to EMU. There are now stronger signs of recovery also in *Austria, Belgium,* and *Switzerland,* but the pickups in activity remain dependent on a continued upswing in Germany and France.

Activity has picked up in *Australia* during 1997 but has remained subdued in *New Zealand*. Growth is expected to accelerate in both countries as the recent easing in monetary policy stimulates demand, although both are expected to be more adversely affected by the Asian crisis than the industrial countries of North America and Europe, given their closer trade links with Asia. Monetary policy will need to strike a balance between limiting potential inflationary pressures from recent exchange rate weakness, and cushioning any adverse effects on domestic activity from the likely deterioration in external positions. The Asian crisis underscores the need for prudent fiscal policy over the medium term, given the already large stock of external liabilities in both countries. In both Australia and New Zealand the authorities' fiscal consolidation efforts, and improvements in recent years on the inflation front, should help the economies to withstand the short-term adverse effects of the crisis.