IV

Implications for the World Economy: Revisions and Risks to the Projections

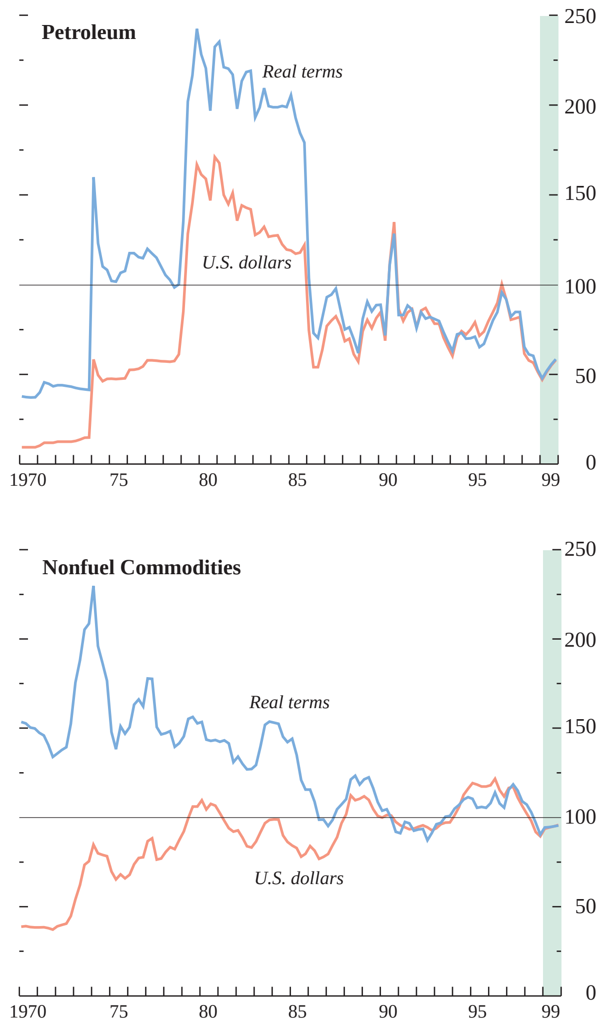
Global growth in 1999 seems likely to be in the range of 2–2¼ percent for the second consecutive year, well below the historical average of nearly 4 percent. This underscores the continuing costs of the Asian crisis, its repercussions, and the crises that have afflicted financial markets more broadly in 1998. However, the most serious downside risks to the global economy that emerged as a result of the turbulence in global financial markets in the wake of the Russian crisis in August now seem to have subsided, and the relatively modest scale of the further downward revisions to the global growth outlook since early September suggests that the situation may have begun to stabilize. At the same time, the balance of risks still seems to be predominantly on the downside. The consequences of some of these risks materializing are explored in an alternative scenario below.

Key Revisions to the Projections

Projected growth in the world economy in 1999 has been lowered only modestly from the October 1998 *World Economic Outlook* to 2.2 percent, about the same growth rate as estimated for 1998 (Table 4.1). Nevertheless, there are significant downward revisions to projected growth in particular countries and regions, notably in Japan, where the recession now appears deeper and longer than previously projected, and in other countries reflecting the crisis in Russia and the subsequent contagion to other emerging markets, including Brazil. Recent changes in exchange rates, interest rates, and commodity prices, which affect assumptions underlying the projections, have also contributed to forecast revisions. Chief among these are a stronger yen (which, in real effective terms, is now assumed to be 12½ percent more appreciated in 1999 compared to the October 1998 *World Economic Outlook*), lower short-term interest rates in the United States and Europe, and lower real oil and nonfuel commodity prices (see Table 4.1 and Figure 4.1). Net private capital flows into emerging market economies are projected to increase by about one-third in 1999 to about $90 billion, but this represents a downward revision of about $40 billion compared with the October projection, and it would still be well below the levels seen in 1990–97. The timing

Figure 4.1. Prices of Crude Petroleum and Nonfuel Commodities[1]
(Quarterly averages, 1990 = 100)

Prices of oil and nonfuel commodities have declined further in 1998, in both nominal (U.S. dollar) and real terms. Petroleum prices are assumed to recover somewhat in 1999.



[1]Shaded areas indicate IMF staff projections.

Table 4.1. Overview of the *World Economic Outlook* Projections

(Annual percent change unless otherwise noted)

			Current Projections		Differences from October 1998 Projections	
	1996	1997	1998	1999	1998	1999
World output	**4.3**	**4.2**	**2.2**	**2.2**	**0.2**	**–0.3**
Advanced economies	3.2	3.2	2.0	1.6	—	–0.3
Major industrial countries	3.0	3.0	2.1	1.5	—	–0.4
United States	3.4	3.9	3.6	1.8	0.1	–0.2
Japan	5.0	1.4	–2.8	–0.5	–0.3	–1.0
Germany	1.3	2.2	2.7	2.0	0.1	–0.5
France	1.6	2.3	3.0	2.6	–0.1	–0.2
Italy	0.7	1.5	1.3	1.9	–0.8	–0.6
United Kingdom	2.6	3.5	2.6	0.9	0.3	–0.3
Canada	1.2	3.8	2.8	2.2	–0.2	–0.3
Other advanced economies	3.8	4.2	1.5	2.0	0.1	–0.3
Memorandum						
Industrial countries	3.0	3.0	2.3	1.7	—	–0.3
Euro area	1.6	2.5	2.8	2.4	–0.2	–0.4
Newly industrialized Asian economies	6.3	6.0	–2.6	0.5	0.3	–0.2
Developing countries	6.5	5.7	2.8	3.5	0.5	–0.1
Africa	5.8	3.2	3.6	3.8	–0.1	–0.9
Asia	8.2	6.6	2.6	4.3	0.8	0.4
China	9.6	8.8	7.2	6.6	1.7	1.1
India	7.4	5.7	4.7	4.8	–0.1	–0.1
ASEAN–4[1]	7.1	3.7	–10.6	–1.4	–0.2	–1.3
Middle East and Europe	4.7	4.5	3.3	2.9	1.0	0.2
Western Hemisphere	3.5	5.1	2.5	1.5	–0.3	–1.2
Brazil	2.8	3.2	0.5	–1.0	–1.0	–3.0
Countries in transition	–1.0	1.9	–0.8	–1.9	–0.6	–1.7
Central and eastern Europe	1.6	2.8	2.5	2.2	–0.9	–1.4
Excluding Belarus and Ukraine	3.7	3.2	2.9	3.2	–0.8	–0.9
Russia	–5.0	0.7	–5.7	–8.3	0.3	–2.3
Transcaucasus and central Asia	1.6	2.2	2.1	3.0	–2.0	–0.8
World trade volume (goods and services)	**7.0**	**9.9**	**3.3**	**4.4**	**–0.4**	**–0.2**
Imports						
Advanced economies	6.5	9.2	4.6	4.6	0.1	–0.1
Developing countries	9.5	10.4	–0.7	5.7	–1.7	1.1
Countries in transition	10.0	8.2	1.0	1.3	–2.5	–2.2
Exports						
Advanced economies	6.3	10.4	3.3	3.7	–0.3	–0.5
Developing countries	8.7	11.3	2.9	5.4	–1.0	–0.1
Countries in transition	7.0	6.9	3.5	5.1	–1.8	–0.8
Commodity prices						
Oil[2]						
In SDRs	23.7	–0.2	–29.7	5.6	–0.5	–4.8
In U.S. dollars	18.4	–5.4	–30.5	8.4	0.6	–0.9
Nonfuel[3]						
In SDRs	3.3	2.0	–14.5	–3.2	–2.9	–4.6
In U.S. dollars	–1.2	–3.3	–15.6	–0.6	–1.7	–1.0
Consumer prices						
Advanced economies	2.4	2.1	1.6	1.6	–0.1	–0.1
Developing countries	14.1	9.2	10.2	8.4	–0.1	0.1
Countries in transition	41.4	27.9	21.0	30.2	–8.5	–4.4
Six-month LIBOR (in percent)[4]						
On U.S. dollar deposits	5.6	5.9	5.5	5.1	–0.2	–0.8
On Japanese yen deposits	0.7	0.7	0.7	0.5	0.1	—
On deutsche mark deposits	3.3	3.4	3.7	. . .	—	. . .
On Euro deposits	. . .	. . .	. . .	3.3	. . .	–0.4

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during October 19–November 4, 1998 except for the bilateral rates among ERM currencies, which are assumed to remain constant in nominal terms.

[1]Indonesia, Malaysia, Philippines, and Thailand.

[2]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $19.27 in 1997; the assumed price is $13.39 in 1998 and $14.51 in 1999.

[3]Average, based on world commodity export weights.

[4]London interbank offered rate.

Table 4.2. Advanced Economies: Real GDP, Consumer Prices, and Unemployment Rates

(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment Rate			
	1996	1997	1998	1999	1996	1997	1998	1999	1996	1997	1998	1999
Advanced economies	**3.2**	**3.2**	**2.0**	**1.6**	**2.4**	**2.1**	**1.6**	**1.6**	**7.3**	**7.0**	**6.9**	**7.0**
Major industrial countries	3.0	3.0	2.1	1.5	2.2	2.0	1.3	1.5	6.9	6.7	6.5	6.7
United States	3.4	3.9	3.6	1.8	2.9	2.3	1.6	2.2	5.4	4.9	4.5	4.8
Japan	5.0	1.4	–2.8	–0.5	0.1	1.7	0.4	–0.7	3.3	3.4	4.2	4.9
Germany	1.3	2.2	2.7	2.0	1.5	1.8	1.0	1.2	10.4	11.5	10.9	10.5
France	1.6	2.3	3.0	2.6	2.0	1.2	0.7	0.9	12.4	12.7	11.7	11.3
Italy	0.7	1.5	1.3	1.9	3.9	1.7	1.7	1.6	12.1	12.3	12.2	12.0
United Kingdom[1]	2.6	3.5	2.6	0.9	2.9	2.8	2.6	2.5	7.3	5.5	4.7	5.1
Canada	1.2	3.8	2.8	2.2	1.6	1.4	1.2	1.8	9.7	9.2	8.4	8.4
Other advanced economies	3.8	4.2	1.5	2.0	3.2	2.5	2.7	2.2	8.3	8.0	8.3	8.2
Spain	2.4	3.5	3.8	3.4	3.6	2.0	1.9	2.0	22.2	20.8	18.9	17.7
Netherlands	3.1	3.6	3.8	2.5	2.1	2.2	1.8	1.6	7.6	6.6	5.3	5.3
Belgium	1.3	3.0	2.9	2.2	2.1	1.6	1.0	1.2	9.8	9.3	8.8	8.4
Sweden	1.3	1.8	2.9	3.0	0.5	0.5	0.5	0.7	8.0	8.0	6.6	5.7
Austria	1.6	2.5	2.9	2.5	1.9	1.3	1.1	1.3	6.3	6.4	6.4	6.3
Denmark	3.5	3.5	2.5	1.9	2.1	2.2	1.9	2.1	8.6	7.6	6.4	6.2
Finland	3.6	6.0	4.9	3.3	0.6	1.2	1.5	1.7	14.6	12.6	11.3	10.2
Greece	2.7	3.5	3.3	3.6	8.2	5.5	4.8	2.6	10.3	10.3	10.2	10.0
Portugal	3.6	4.0	4.2	3.5	3.1	2.2	2.7	2.5	7.3	6.7	5.1	5.0
Ireland	7.4	9.8	9.1	6.8	1.6	1.5	2.8	2.8	11.5	10.2	8.9	8.2
Luxembourg	3.5	4.8	4.1	3.9	1.4	1.4	1.6	1.7	3.3	3.7	4.1	4.5
Switzerland	—	1.7	2.1	1.4	0.8	0.5	0.1	0.9	4.7	5.2	3.9	3.5
Norway	5.5	3.4	2.5	2.6	1.3	2.6	2.3	3.5	4.8	4.1	3.2	3.6
Israel	4.6	2.2	1.5	2.0	11.3	9.0	5.5	9.1	6.7	7.7	9.0	9.5
Iceland	5.5	5.0	5.0	4.0	2.3	1.8	2.2	3.0	4.5	3.9	3.3	3.0
Korea	7.1	5.5	–7.0	–1.0	4.9	4.4	7.8	3.8	2.0	2.7	7.0	8.0
Australia[2]	3.7	3.3	3.5	2.0	2.7	1.7	1.7	2.3	8.6	8.6	8.1	7.7
Taiwan Province of China	5.7	6.8	4.9	3.9	3.1	0.9	1.5	2.0	2.6	2.7	2.7	2.4
Hong Kong SAR	4.6	5.3	–5.0	–1.0	6.0	5.7	3.0	–1.8	2.8	2.2	5.0	6.4
Singapore	6.9	7.8	0.7	–0.8	1.4	2.0	–0.2	0.3	2.0	1.8	3.4	3.9
New Zealand[2]	3.2	2.4	–0.7	1.6	2.3	1.7	1.6	1.4	6.1	6.6	7.5	8.4
Memorandum												
European Union	1.8	2.7	2.8	2.2	2.5	1.9	1.5	1.6	11.2	11.0	10.2	9.9
Euro area	1.6	2.5	2.8	2.4	2.4	1.7	1.3	1.4	12.3	12.4	11.6	11.2

[1]Consumer prices are based on the retail price index excluding mortgage interest.
[2]Consumer prices excluding interest rate components; for Australia, also excluding other volatile items.

and strength of the recovery in capital flows to emerging markets is one of the key uncertainties in the outlook.

Apart from Japan, the largest downward revisions to projected growth in 1999 are for various emerging market countries across all regions. These downward revisions are slightly offset by an upward revision for China. The major industrial countries, excluding Japan, have been affected relatively little so far by the crisis, in part because of the limited importance, relative to overall activity, of trade with emerging market economies, and also because of generally robust domestic demand, especially in the United States. In 1999, output growth is expected to slow somewhat in the euro area and to a greater extent in the United States, but the risk of more pronounced slowdowns has been reduced by recent monetary policy actions.

Japan and Emerging Market Economies in Asia: When Will the Recessions End?

The outlook for *Japan* has deteriorated further since the October assessment, with output now expected to fall by 2¾ percent in 1998 and by ½ of 1 percent in 1999 (Table 4.2). The downward revisions reflect the continued stagnation of private domestic demand, which is linked to difficulties in the financial sector, as well as implications for net exports of the appreciation of the yen since September. These factors are expected to be only partially offset by additional countercyclical policy measures. The appreciation of the yen, in particular, represents a tightening of monetary conditions that could, on its own, reduce GDP by about 1 percent over a one- to two-year period (Figure 4.2).

Recent data point to a continued deepening of the recession. Retail sales have continued to decline, while

Table 4.3. Selected Advanced Economies and Regions: Importance of Merchandise Export Markets in 1996

(Exports to partner countries as a percent of exporter's GDP)

Exporters	Importing Partners: Asia[1]	Western Hemisphere[2]	Countries in transition	World[3]
North America	1.5	1.3	0.1	9.9
European Union	1.6	0.5	1.4	23.5
Japan	3.9	0.4	—	8.9
Asia[1]	12.3	0.7	0.4	30.0
Western Hemisphere[2]	0.7	2.7	0.1	13.6
Transition economies	1.5	0.2	8.4	23.6

Sources: IMF, *Direction of Trade Statistics*, and *World Economic Outlook* database.
[1]Excludes Japan, Australia, and New Zealand.
[2]Developing countries.
[3]Total exports as a ratio to total GDP. For the European Union, intraregional trade is included. Excluding this reduces the export share in GDP by about one-half.

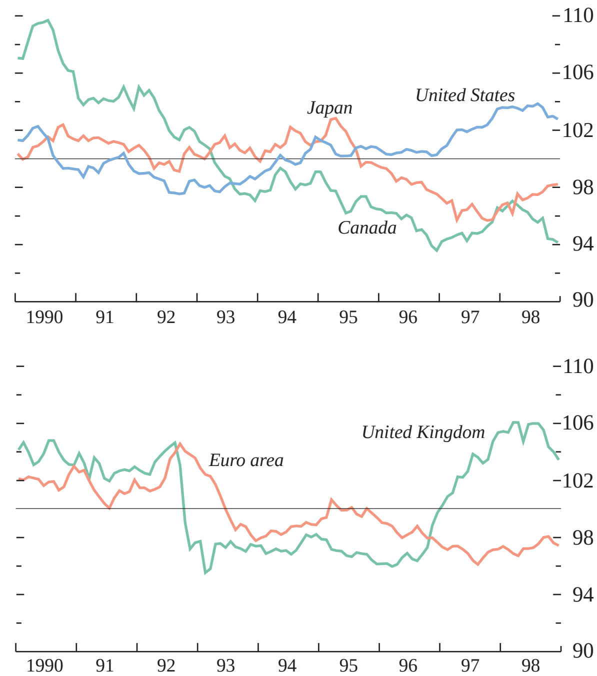
employment contracted again in the third quarter, and unemployment rose to 4¼ percent, contributing to consumer apprehension. GDP fell in the third quarter, by 2.6 percent at an annual rate, owing to declines in private consumption and investment that were partially offset by a boost from net exports and marginal increases in public spending. Industrial production shows no sign of sustained improvement; machine orders are low, signaling further declines in investment, as does the accelerating decline of bank lending; land price declines have picked up again; and business sector confidence remains depressed (Figure 4.3). The external sector contributed to growth in 1998 entirely through import compression. Looking ahead, it is unlikely that exports will contribute much to Japan's recovery in the near term, owing to the weakness of activity among many of Japan's trading partners, especially in Asia, and the recent yen appreciation. Indeed, uncertainties about the strength and timing of recoveries in the Asian crisis economies are an important risk factor for Japan, just as recovery in Japan will be critical for recovery in the rest of Asia (Tables 4.3 and 4.4).

The government announced a new fiscal stimulus package in mid-November, which will begin to be felt in the current fiscal year, although most of the impact is expected by IMF staff to be concentrated in FY 1999, which starts next April. The stimulus to be provided by fiscal policy as a whole in FY 1999, as measured by the change in the structural deficit from FY 1998, is now projected to be 1 percent of GDP. This is about ½ of 1 percent of GDP more than assumed in the October 1998 *World Economic Outlook*, where part of the stimulus in the November package was anticipated in the staff's projection.[1] Also in November, the Bank

[1]The actual stimulus is estimated to be below the "headline" figures largely because the package replaces temporary measures

Figure 4.2. Major Industrial Countries: Indices of Monetary Conditions[1]

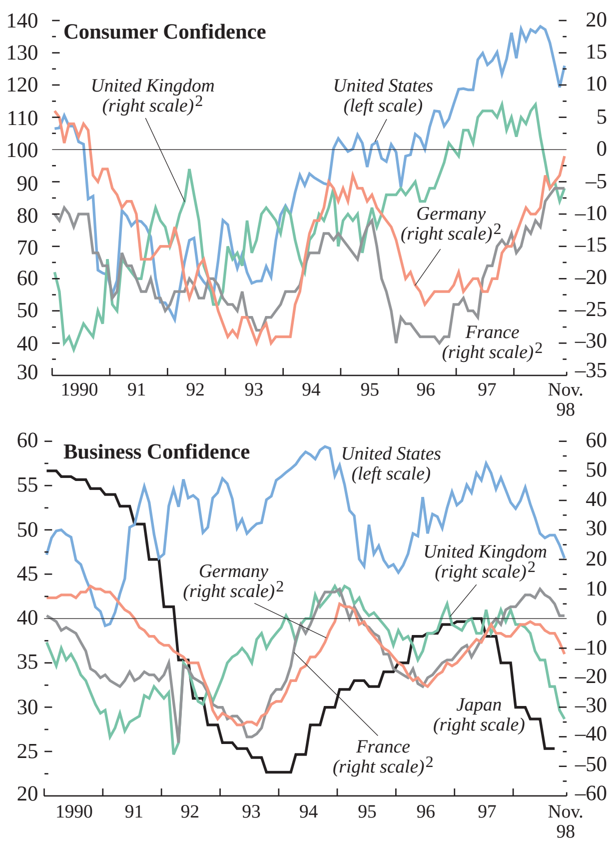
Monetary conditions—reflecting changes in both real interest rates and real exchange rates—have recently eased in North America and the United Kingdom but have tightened in Japan.



[1]For each country and the euro area, the index is defined as a weighted average of the percentage point change in the real short-term interest rate and the percentage change in the real effective exchange rate relative to a base period (Janaury 1990 to December 1997). Relative weights of 3 to 1 are used for Canada and the United Kingdom; 6.25 to 1 for the euro area; and 10 to 1 for Japan and the United States. The weights are intended to represent the relative impact of interest rates and exchange rates on aggregate demand; they should be regarded as indicative rather than precise estimates. For instance, a 3-to-1 ratio indicates that a 1 percentage point change in the real short-term interest rate has about the same effect on aggregate demand over time as a 3 percent change in the real effective exchange rate. For more details, see the October 1998 *World Economic Outlook*, Figure 2.7. For the euro area, a synthetic euro is constructed. For details, see the October 1998 *World Economic Outlook*, Box 5.5.

Figure 4.3. Selected European Countries, Japan, and the United States: Indicators of Consumer and Business Confidence[1]

Consumer confidence has continued to improve in France and Germany but has declined in the United Kingdom and the United States. Falling business confidence has been widespread.



Sources: Consumer confidence—for the United States, the Conference Board; for European countries, the European Commission. Business confidence—for the United States, the U.S. Department of Commerce, Purchasing Managers Composite Diffusion Index; for European countries, the European Commission; for Japan, Bank of Japan.

[1]Indicators are not comparable across countries.

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

of Japan announced new measures to alleviate corporate funding difficulties, broadening the scope of its repurchase operations by raising the maturity ceiling of eligible commercial paper to one year. These and other related measures are intended to alleviate the effects of the credit crunch caused by large volumes of nonperforming or substandard loans in banks' portfolios, but their impact on the economy is difficult to judge given the uncertainties about banks' ability and willingness to lend and about the demand for new loans. There has been some progress in establishing a framework to resolve Japan's banking problems, but there is a need for strong implementation.

The crisis-afflicted economies in east Asia—*Indonesia, Korea, Malaysia,* and *Thailand*—have suffered deep recessions in 1998, with output declines through the first half of the year, and probably also in the second half, in all countries (Table 4.5). Prospects for 1999 are better, with small declines in output or modest recoveries in prospect for all countries except Indonesia, where the reform process is less advanced and political uncertainties have complicated the economic difficulties (Table 4.6). The Philippines has fared better, with only a negligible decline in output in the year to the third quarter of 1998, in part reflecting the benefits of past stabilization and reform policies, but also the country's stronger export ties to North America, where import demand has remained robust.

In Korea and Thailand, financial markets have already recovered significantly: the exchange rate collapses of late 1997 and early 1998 have been partly reversed, international reserves have been substantially replenished, and stock markets have rebounded. Key factors behind the return of confidence in financial markets are the significant progress with policy programs in both countries and the emergence of large external current account surpluses, which provide assurance that external obligations can be met. The depreciation of the U.S. dollar since September and reductions in short-term interest rates throughout the industrial countries in recent months have also alleviated financial market pressures. Beyond the financial markets, however, there are few signs of incipient recovery, although there are some signs of bottoming out. The rate of decline in industrial production has begun to moderate in recent months; the unemployment rate in Korea has declined slightly after reaching over 7½ percent in July; and sales of new vehicles in Thailand, which have been an indicator of consumer confidence and of the strength of the nonbank financial sector, which extends the loans to buyers, rose in October on a 12-month basis for the first time since the beginning of the crisis. However, these signals are tenuous, and activity may well remain quite weak in

introduced in the FY 1998 budget. Estimates of structural budget positions in the major industrial countries are contained in the Statistical Appendix, Table 4.

Table 4.4. Selected Regions: Importance of Merchandise Export Markets in 1996
(Exports to partner countries as a percent of exporter's GDP)

	Importing Partners					
Exporters	Japan	Russia	Brazil	North America	European Union	World[1]
Asia[2]	3.9	0.2	0.2	6.2	4.4	30.0
ASEAN-4	6.2	—	0.1	6.7	5.2	34.0
Newly industrialized economies	5.2	0.3	0.4	11.5	7.3	53.6
China	3.8	0.2	0.1	3.5	2.4	18.3
Western Hemisphere[3]	0.5	—	0.6	7.0	2.1	13.6
Argentina	0.2	0.1	2.2	0.7	1.5	7.9
Brazil	0.4	0.1	—	1.3	1.7	6.1
Chile	3.6	—	1.4	3.9	5.3	21.5
Mexico	0.4	—	0.3	25.1	1.1	29.1
Venezuela	0.4	—	1.4	18.4	2.5	30.3
Countries in transition	0.4	2.1	0.1	1.1	9.9	23.6
Russia	0.7	—	—	1.5	6.3	19.1
Ukraine	0.3	12.8	0.1	1.2	3.8	31.1
Africa, Middle East, and Europe[3]	3.1	0.2	0.4	2.9	8.1	24.4

Sources: IMF, *Direction of Trade Statistics*, and *World Economic Outlook* database.
[1]Total exports as a ratio to total GDP.
[2]Excludes Japan, Australia, and New Zealand.
[3]Developing countries.

1999. In Malaysia, signs of an end to the recession, which has been as deep as that in Korea, also remain tentative. However, financial markets appear to have stabilized, and there are some indications of a turnaround in demand.

The return of financial market confidence has allowed monetary and fiscal policies to become quite supportive of activity in all the affected countries. Short-term market interest rates in Korea, Thailand, and the Philippines have fallen below precrisis levels, although lending rate spreads remain high owing to problems in the financial sectors. In Malaysia, capital and exchange controls introduced in September may have facilitated the easing of interest rates, but controls could be an impediment to recovery. Interest rates have also come down somewhat in Indonesia. Fiscal policy has helped to dampen the recession and lessen its impact on the poor in these countries in 1998, and some additional stimulus is assumed for 1999.[2] Recovery will also be aided by further easing of monetary policy to the extent that exchange market conditions permit; however, a sustainable rebound will also require financial sector reforms and corporate sector restructuring. Export market growth, which declined sharply in 1998, is expected to recover somewhat in 1999 but to remain well below trend, underscoring the external constraints on the pace of recovery.

Real GDP in *China* in the third quarter of 1998 is estimated to have been 7.6 percent higher than in the corresponding period of 1997, suggesting that growth has been better sustained than appeared likely at the time the October 1998 *World Economic Outlook* projections were prepared. As a result, the 1998 growth estimate has been revised up, to 7.2 percent. The stronger than expected growth in 1998 partly reflects policy measures—including a fiscal stimulus package equivalent to 2½ percent of GDP, consisting primarily of infrastructure projects, as well as reductions in domestic interest rates—that will continue to support growth in 1999. These measures appear to have more than offset the significant drags on the economy originating from the impact of the Asian crisis on exports, and severe flooding, but evidence of overbuilding and inventory accumulation, as well as financial sector fragilities, raise questions about the sustainability of growth at its recent pace. For these reasons, the staff projects some further slowdown in 1999, to 6½ percent. It should also be noted that the various signs of weakness in domestic demand may not be fully captured in the official GDP statistics (Box 4.1, page 78).

In *Hong Kong SAR* output is estimated to have contracted by 5 percent in 1998, reflecting the impact of the regional crisis and sharp falls in property and stock market prices; there have also been clear indications of declines in consumer prices and labor earnings. The authorities have responded to the weakening in activity with a fiscal stimulus of about 3 percent of GDP and measures to support the property market, including a suspension of government land sales. In addition, the authorities intervened in the stock market in August, purchasing about $15 billion of shares and significantly reducing the free float for many issues.

[2]See the October 1998 *World Economic Outlook*, Box 2.5, for a discussion of fiscal policies in the crisis economies.

Table 4.5. Selected Asian Economies: Macroeconomic Indicators

(Percent change from four quarters earlier unless otherwise noted)

	1997				1998		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Hong Kong SAR							
Real GDP	5.7	6.9	6.1	2.8	–2.7	–5.2	–7.0
Consumer prices	6.1	5.7	6.1	5.5	5.0	4.4	2.8
Trade balance (billions of U.S. dollars)[1]	–6.2	–6.2	–4.0	–4.1	–4.2	–4.5	–0.8
Import value[2]	4.2	4.7	5.5	5.8	–5.1	–6.1	–15.4
Export value[2]	2.0	4.0	2.5	7.4	–0.9	–3.2	–10.3
Export volume	4.0	6.2	4.4	9.6	1.4	–0.5	–7.3
Indonesia							
Real GDP	8.5	6.8	2.5	1.4	–7.9	–16.5	–17.4
Consumer prices	5.2	4.9	6.0	10.1	29.9	52.1	79.7
Trade balance (billions of U.S. dollars)[1]	1.7	2.4	3.6	4.0	3.4	4.3	5.4
Import value[2]	11.0	–7.8	–2.6	–10.1	–31.3	–26.7	–46.4
Export value[2]	10.4	7.5	9.6	2.4	–1.0	–8.8	–3.4
Export volume	26.2	20.4	33.5	33.0	32.8	19.1	27.6
Japan							
Real GDP	3.8	1.0	1.7	–0.8	–3.6	–1.8	–3.5
Consumer prices	0.6	2.0	2.1	2.1	2.0	0.3	–0.2
Trade balance (billions of U.S. dollars)[1]	11.6	21.0	22.2	27.2	22.8	27.0	27.0
Import value[2]	2.2	–2.8	–3.9	–10.0	–13.3	–19.4	–20.3
Export value[2]	–1.6	6.0	3.5	0.2	–2.8	–12.2	–13.1
Export volume	12.1	16.5	10.9	7.6	2.2	–3.5	–1.6
Korea							
Real GDP	5.7	6.6	6.1	3.9	–3.9	–6.8	–6.8
Consumer prices	4.7	4.0	4.0	5.1	8.9	8.2	7.0
Trade balance (billions of U.S. dollars)[1]	–7.3	–1.8	–1.5	2.2	8.4	11.7	9.3
Import value[2]	3.9	0.8	–3.8	–14.8	–35.5	–36.7	–39.6
Export value[2]	–5.6	7.1	15.6	3.5	8.5	–1.8	–9.6
Export volume	17.3	24.1	35.6	23.1	32.4	20.7	11.4
Malaysia							
Real GDP	9.2	8.4	7.5	6.0	–2.8	–6.8	–8.6
Consumer prices	3.2	2.5	2.3	2.7	4.3	5.7	5.7
Trade balance (billions of U.S. dollars)[1]	0.8	–1.9	0.5	0.5	2.1	3.4	4.1
Import value[2]	1.0	11.2	1.4	–8.2	–18.7	–33.1	–29.3
Export value[2]	6.2	0.1	2.0	–5.7	–11.3	–9.6	–10.0
Philippines							
Real GDP	5.5	5.6	4.9	4.8	1.6	–0.8	–0.1
Consumer prices	5.1	5.3	5.9	7.2	7.9	9.9	10.4
Trade balance (billions of U.S. dollars)[1]	–2.9	–2.8	–3.1	–2.4	–1.1	–0.3	0.5
Import value[2]	14.2	8.3	20.9	12.9	–5.9	–17.4	–10.6
Export value[2]	17.0	26.5	24.7	22.2	23.8	14.4	15.2
Singapore							
Real GDP	4.2	8.5	10.6	3.9	5.6	1.8	–0.7
Consumer prices	1.7	1.7	2.3	2.3	1.0	0.3	–0.9
Trade balance (billions of U.S. dollars)[1]	–0.2	0.8	–0.2	0.7	2.7	4.0	4.4
Import value[2]	–2.6	2.7	8.8	–5.2	–16.3	–24.4	–23.4
Export value[2]	–3.2	4.0	3.2	–4.0	–6.8	–14.0	–9.3
Export volume	–0.3	8.8	10.5	7.8	7.6	–2.1	–1.8
Taiwan Province of China							
Real GDP	6.6	6.1	7.0	7.2	5.9	5.2	4.7
Consumer prices	1.7	1.0	1.1	–0.2	1.5	1.7	0.6
Trade balance (billions of U.S. dollars)[1]	1.6	1.8	1.6	2.5	–0.1	1.3	3.5
Import value[2]	5.8	3.6	7.0	6.4	–5.4	–6.9	–15.4
Export value[2]	5.8	4.9	17.1	7.1	–0.3	–7.8	–9.6
Export volume	9.3	5.6	9.7	11.4	3.8	0.8	. . .
Thailand							
Manufacturing production	7.0	7.5	–4.2	–11.5	–16.8	–15.3	–11.3
Consumer prices	4.4	4.3	6.1	7.5	9.0	10.3	8.1
Trade balance (billions of U.S. dollars)[1]	–3.2	–3.1	–0.9	2.5	3.1	2.6	3.1
Import value[2]	–7.7	–7.6	–11.4	–27.5	–39.8	–38.2	–34.2
Export value[2]	–0.9	2.2	7.1	6.7	–2.9	–5.3	–8.7
Export volume	–1.7	4.0	11.7	16.2	14.1	12.8	5.7

Sources: Country authorities; IMF, *International Financial Statistics (IFS)*, and IMF staff estimates.

[1]On national accounts basis calculated as exports (f.o.b.) less imports (c.i.f), except balance of payments basis for the Philippines, Singapore, and Thailand. 1998:Q3 trade data for Indonesia exclude oil and gas.

[2]In U.S. dollar terms, on a national accounts basis, except balance of payments basis for the Philippines, Singapore, and Thailand.

Table 4.6. Selected Developing Countries: Real GDP and Consumer Prices
(Annual percent change)

	Real GDP			Consumer Prices		
	1997	1998	1999	1997	1998	1999
Developing countries	**5.7**	**2.8**	**3.5**	**9.2**	**10.2**	**8.4**
Median	**4.4**	**4.1**	**4.4**	**6.2**	**5.0**	**4.7**
Africa	**3.2**	**3.6**	**3.8**	**11.0**	**8.5**	**7.8**
Algeria	1.3	3.6	3.4	5.7	5.5	9.0
Cameroon	5.1	5.0	5.2	4.2	2.1	2.0
Côte d'Ivoire	6.0	6.0	6.0	5.6	3.0	2.5
Ghana	3.0	5.6	5.8	27.9	15.5	8.0
Kenya	2.1	1.5	3.5	11.2	9.6	6.7
Morocco	–2.0	6.8	4.0	1.0	2.8	2.5
Nigeria	3.9	2.0	—	8.5	10.2	8.0
South Africa	1.7	0.2	1.3	8.6	7.0	6.8
Sudan[1]	6.6	5.2	5.5	46.7	20.0	14.0
Tanzania	3.4	4.3	5.6	17.1	14.5	8.0
Tunisia	5.4	5.1	5.5	3.7	3.6	3.6
Uganda	5.4	6.2	7.0	8.2	5.0	5.0
SAF/ESAF countries[2]	4.8	4.6	6.0	8.7	7.1	5.1
CFA countries	5.5	5.7	5.4	4.3	2.7	2.5
Asia	**6.6**	**2.6**	**4.3**	**4.7**	**7.9**	**6.4**
Bangladesh	5.7	4.2	3.4	4.8	7.9	8.1
China	8.8	7.2	6.6	2.8	–0.8	2.0
India	5.7	4.7	4.8	6.3	7.2	7.6
Indonesia	4.6	–15.3	–3.4	6.6	61.1	26.8
Malaysia	7.7	–7.5	–2.0	2.7	5.2	5.8
Pakistan	–0.4	5.3	3.0	11.8	7.8	10.7
Philippines	5.2	0.2	2.5	6.0	9.8	8.8
Thailand	–0.4	–8.0	1.0	5.6	8.0	2.5
Vietnam	8.8	3.5	3.5	3.2	8.0	8.0
Middle East and Europe	**4.5**	**3.3**	**2.9**	**22.8**	**23.6**	**20.5**
Egypt	5.1	5.3	5.0	6.2	3.8	4.0
Iran, Islamic Republic of	2.6	1.7	2.0	17.3	22.0	12.0
Jordan	2.2	0.5	2.0	3.0	5.0	3.5
Kuwait	2.5	2.2	–2.0	0.7	0.5	1.6
Saudi Arabia	1.9	0.4	0.4	–0.4	—	0.7
Turkey	7.6	4.4	2.9	85.7	84.7	81.0
Western Hemisphere	**5.1**	**2.5**	**1.5**	**13.9**	**10.3**	**8.3**
Argentina	8.6	5.2	3.0	0.8	1.3	1.4
Brazil	3.2	0.5	–1.0	7.9	3.9	. . .
Chile	7.1	4.5	2.0	6.1	5.1	4.5
Colombia	3.1	2.7	1.9	18.5	18.8	14.4
Dominican Republic	8.1	7.0	7.3	8.3	4.6	6.2
Ecuador	3.4	0.5	1.5	30.6	36.2	34.4
Guatemala	4.1	4.8	4.0	9.2	6.0	7.0
Mexico	7.0	4.6	3.0	20.6	15.3	13.8
Peru	7.2	3.0	6.0	8.5	7.5	5.6
Uruguay	5.1	2.7	1.0	19.8	10.2	7.0
Venezuela	5.1	–2.5	0.1	50.0	36.1	29.6

[1]The inflation figures published in the May 1998 *World Economic Outlook* were end-of-period data.
[2]African countries that had arrangements, as of the end of 1997, under the IMF's Structural Adjustment Facility (SAF) or Enhanced Structural Adjustment Facility (ESAF).

Over the past few months the authorities have also adopted several measures to discourage speculation in the futures market, strengthen the regulatory framework for securities, and modify the discount window facility to buffer the effects of temporary market pressures on interest rates. Interest rates have come down as pressure on the currency has subsided. While activity is expected to remain weak in the first half of 1999, partly reflecting the impact of high real interest rates associated with falling prices, growth may pick up in the second half of the year. Considerable downside risks remain, however, given the economy's openness and exposure to developments in Japan and mainland China.

Effects of the Russian Crisis on the Domestic Economy and Other Countries in Transition

Economic and social conditions in *Russia* have deteriorated dramatically since the August crisis. The decline in output in 1998 is estimated at almost 6 percent, and projections for 1999 have been revised down further since the October *World Economic Outlook*, to show an 8 percent output decline (Table 4.7). There is clearly a risk of an even larger decline, however, given the continuing fiscal imbalances, banking sector problems, and signs of reversals in the reform process. Monthly inflation, which had accelerated to 38 percent in September, receded to 4½ percent in October, as new foreign exchange controls contributed to a stabilization of the exchange rate and as price controls limited open inflation. Inflation is projected to accelerate in 1999, however, because support to the banking system and the continuing large budget shortfall are expected to be financed largely through monetary expansion.

Russia's external current account is likely to have swung into surplus in the second half of 1998, owing to a sharp compression of imports that reflects import financing problems and the collapse of the ruble. Indications are that capital flight is also on the rise and, together with the collapse of private and official capital inflows, is putting pressure on the overall external position. In 1999 the current account surplus is expected to reach 6½ percent of GDP.

The financial crisis in Russia has significantly affected developments and prospects in many other transition countries, especially those that are dependent on external private financing or have maintained strong trade and financial ties with Russia. *Ukraine*, in addition to facing reduced trade with Russia, has been confronted with the consequences of persistent budgetary imbalances and inadequate reform efforts, which have contributed to a drying up of new financing and the need to repay some of its maturing external debt. The country has, however, managed to avert a complete cutoff from private financing by obtaining agreement to a voluntary conversion of a substantial part of its

Table 4.7. Countries in Transition: Real GDP and Consumer Prices

(Annual percent change)

	Real GDP			Consumer Prices		
	1997	1998	1999	1997	1998	1999
Countries in transition	**1.9**	**–0.8**	**–1.9**	**28**	**21**	**30**
Median	**3.4**	**4.2**	**3.7**	**15**	**11**	**8**
Selected countries						
Central and eastern Europe	2.8	2.5	2.2	38	18	16
Excluding Belarus and Ukraine	3.2	2.9	3.2	41	16	10
Albania	–7.0	8.0	8.0	32	21	8
Belarus	10.4	7.0	2.0	64	53	75
Bulgaria	–6.9	5.0	3.7	1,082	23	7
Croatia	6.5	2.4	1.3	4	5	4
Czech Republic	1.0	–1.5	1.0	8	11	8
Estonia	11.4	5.1	3.6	11	11	6
Hungary	4.4	5.2	4.8	18	15	11
Latvia	6.5	6.0	5.0	8	5	4
Lithuania	6.1	5.3	4.0	9	5	5
Macedonia, former Yugoslav Rep. of	1.5	5.0	5.0	2	2	3
Poland	6.9	5.6	5.1	15	12	8
Romania	–6.6	–5.5	–2.0	155	60	31
Slovak Republic	6.5	4.0	2.0	6	8	8
Slovenia	3.8	4.4	4.5	9	8	5
Ukraine	–3.2	–1.7	–3.5	16	11	32
Russia	0.7	–5.7	–8.3	15	26	56
Transcaucasus and central Asia	2.2	2.1	3.0	31	20	12
Armenia	3.1	5.5	4.0	14	9	10
Azerbaijan	5.8	8.0	7.5	4	4	5
Georgia	11.0	4.0	2.0	7	3	8
Kazakhstan	2.0	–1.5	—	17	8	8
Kyrgyz Republic	6.5	6.0	4.6	26	12	10
Mongolia	4.0	3.5	3.5	27	12	10
Tajikistan	1.7	3.4	4.0	88	64	19
Turkmenistan	–25.9	3.6	12.1	84	17	26

treasury bills held by nonresidents into Eurobonds and to a rescheduling of some loans from international banks. Following the adoption of a new exchange rate band in early September, the hryvnia depreciated by around 35 percent (against the U.S. dollar) before stabilizing at the limit of the band in mid-October, as administrative controls on the foreign exchange market were tightened. The depreciation has put upward pressure on inflation, which accelerated to 6½ percent on a monthly basis in October. Ukraine has not experienced positive growth in any year since transition began, and output is projected to continue to contract in 1999 (see Table 4.7).

In *Kazakhstan,* sharply reduced access to international financial markets has exacerbated the impact of the slowdown in trade with Russia, and output is estimated to have declined by 1½ percent in 1998. In *Belarus* and *Moldova*, which both rely on Russian markets for 60–70 percent of their exports, the main impact of the Russian crisis is occurring through trade. The effects of the decline in exports to Russia are expected to be more limited, but still significant, in the *Caucasian and Central Asian states* that have made progress in reorienting their trade toward new markets.

The three *Baltic countries,* in addition to being affected by reduced access to private external financing, are expected also to face significant direct effects from the Russian crisis through banking sector and trade links. Estonia and Lithuania, with current account deficits of around 10 percent of GDP in 1998, are particularly vulnerable to changes in sentiment in global financial markets. Latvia, whose commercial banks have around 10 percent of their assets loaned to Russia, with the two banks with the largest exposure already being restructured, is also substantially affected by spillovers from the Russian crisis.

The least affected transition countries are those in *central and eastern Europe,* where fundamentals are relatively strong. In these cases, financial market pressures in the wake of the Russian crisis have been mostly short-lived. Nevertheless, there are downward revisions of the growth projections for some countries. For the *Czech Republic*, continued weakness in domestic demand and economic activity in recent months, following the tightening of macroeconomic policies in 1997, suggests that real GDP is likely to have contracted by 1½ percent in 1998, and activity is expected to remain subdued in 1999. In *Hungary* and *Poland*, less favorable prospects for exports are projected to lead to some slowdown in growth in 1999, but not to much less than 5 percent in either case.

Brazil and Other Emerging Market Economies: Effects of the Global Crisis

Among the regional groups of developing countries, near-term growth prospects have weakened the most for the Western Hemisphere, reflecting the particularly severe impact of the emerging market crisis on *Brazil*, the largest economy in the region (see Tables 4.6 and 4.8). Growth projections for Brazil have been revised down sharply, with a small decline in output now projected for 1999. The policy program adopted by the authorities to reduce the fiscal deficit, address structural weaknesses, and restore investor confidence is discussed in Chapter I (Box 1.1). Effects of the reduced availability and increased cost of external finance, and tight domestic credit, have begun to show in the real economy, as indicated by a sharp fall in industrial production in September. The economy has also been adversely affected by a recent contraction of export earnings, reflecting lower commodity prices—notably for soya, sugar, and coffee—and a drop in demand for manufactured goods from trading partners (Figure 4.4). Even after the downward revisions, considerable downside risks to the outlook remain, including in relation to conditions in international financial markets and the possibility of steeper-than-projected slowdowns in export demand from partner countries. The projections assume that the policy program will be fully implemented and that investor confidence and willingness to roll over public debt will be maintained.

Spillover effects from the Russian crisis to the other large countries in Latin America have been less severe, and their output growth in 1999 is projected to be in the 2–3 percent range (except in Venezuela), little different from the previous projections. As reported in the October *World Economic Outlook,* the slowdowns in *Colombia* and *Venezuela* in 1998 have been due in part to the drop in world oil prices and declines in domestic oil production. For Venezuela, however, projected oil production has been revised upward, with the result that activity is no longer projected to decline further in 1999. For *Chile,* projected growth in 1999 has been revised to 2 percent from 3 percent, reflecting the external financial environment and the tightening of macroeconomic policies implemented in recent months.

Although pressures in financial markets appear to have eased, risks to the projections appear to remain predominantly on the downside for the countries in the region. First, access to international capital may not improve as assumed, and diminished access would necessitate further adjustment and lower domestic demand in the near term. Second, important export markets could turn out to be weaker than projected in the baseline. A sharper slowdown in North America would have particularly adverse implications for Mexico, whose exports there represent 25 percent of its total output (see Table 4.4). Activity in Argentina has already been adversely affected by the emerging market crisis, and output growth in 1999 is expected to slow to 3 percent.

Several countries in Central America—*El Salvador, Guatemala, Honduras,* and *Nicaragua*—were severely

Table 4.8. Selected Latin American Economies: Macroeconomic Indicators
(Percent change from four quarters earlier unless otherwise noted)

	1997:Q1	1997:Q2	1997:Q3	1997:Q4	1998:Q1	1998:Q2	1998:Q3
Argentina							
Real GDP	8.0	8.3	9.9	8.2	7.2	6.9	3.8
Consumer prices	0.7	0.7	0.6	0.0	0.6	1.2	1.1
Trade balance							
(billions of U.S. dollars)[1]	–0.7	–0.3	–1.3	–1.9	–1.7	–0.6	–1.9
Import value[2]	29.6	30.8	23.6	26.3	15.6	9.2	3.8
Export value[2]	20.2	8.2	6.4	4.0	1.1	5.5	–4.1
Export volume	17.3	14.8	12.7	6.9	10.0	10.6	3.3
Brazil							
Real GDP	3.8	4.8	2.7	1.9	0.9	1.5	. . .
Consumer prices	9.2	8.4	6.7	7.4	6.1	4.4	3.3
Trade balance							
(billions of U.S. dollars)[1]	–2.5	–1.3	–2.0	–2.6	–1.5	–0.5	–1.8
Import value[2]	22.2	23.5	19.0	0.3	2.2	–5.5	–9.7
Export value[2]	3.6	12.0	15.0	11.9	11.7	–0.5	–9.5
Export volume	4.2	10.9	13.8	10.8	10.6	5.8	–1.6
Chile							
Real GDP	3.6	6.0	11.2	10.6	7.9	4.6	. . .
Consumer prices	6.8	5.3	6.0	6.0	5.3	5.4	4.8
Trade balance							
(billions of U.S. dollars)[1]	0.6	0.2	–0.7	–1.3	–0.6	–0.5	–1.1
Import value[2]	5.3	7.3	12.6	15.3	15.3	7.2	–5.1
Export value[2]	14.3	2.1	13.7	11.9	–13.0	–8.6	–14.3
Export volume	3.3	4.1	8.2	14.7	5.3	12.5	. . .
Mexico							
Real GDP	4.9	8.6	7.9	6.7	6.6	4.3	5.0
Consumer prices	24.5	20.3	18.8	15.7	15.3	15.3	15.9
Trade balance							
(billions of U.S. dollars)[1]	8.4	5.0	2.4	–0.1	–1.9	–2.2	–4.6
Import value[2]	18.6	25.2	23.1	21.0	25.7	14.9	7.9
Export value[2]	10.3	15.5	15.1	11.1	15.6	10.5	6.6
Export volume	16.4	16.2	18.9	19.0	19.9	16.3	7.4
Venezuela							
Real GDP	0.5	7.5	7.4	4.9	7.6	–0.7	. . .
Consumer prices	83.1	52.5	39.7	38.1	37.3	39.4	36.2
Trade balance							
(billions of U.S. dollars)[1]	3.3	2.7	2.4	3.0	1.4	0.9	. . .
Import value[2]	21.3	7.0	39.3	37.0	28.3	8.4	. . .
Export value[2]	17.2	4.7	1.0	–11.9	–21.2	–25.3	. . .
Export volume	9.5	11.0	10.4	7.5	9.0	–0.2	. . .

Sources: Country authorities; and IMF, staff estimates (for GDP) and *IFS* (for inflation, trade balance, import value, export value, and export volume, except where noted).
[1]On a national accounts basis.
[2]In U.S. dollars terms on a national accounts basis.

hit in late October by Hurricane Mitch. The hurricane caused the most damage in *Honduras* and *Nicaragua* where, apart from causing large-scale loss of life, it took a heavy toll on infrastructure and the agricultural sector. At this stage, it is difficult to assess the impact on economic prospects, but the devastation of productive capital in agriculture and other sectors is likely to reduce output significantly in the short term. Emergency financial assistance to support rehabilitation and recovery is being arranged by bilateral and multilateral agencies, including the IMF.

Turning to other regions, growth in *India* is projected to slow to some 4½–5 percent in both 1998 and 1999, from almost 6 percent in 1997. Industrial growth has slowed markedly, with output during April–September 1998 only 3½ percent higher than in the corresponding period a year earlier. The slowdown in growth reflects a number of factors—slow progress in implementing key structural reforms; high real interest rates for the industrial sector; a decline in exports, owing to weak international demand and sector-specific factors; and fragile sentiment, which has been further undermined by the intensified weakness in the equity market since the revelation of financial problems in India's largest mutual fund (which may also have fiscal implications). Meanwhile, inflation has picked up to over 8 percent as a result of agricultural supply problems and an acceleration in broad money growth.

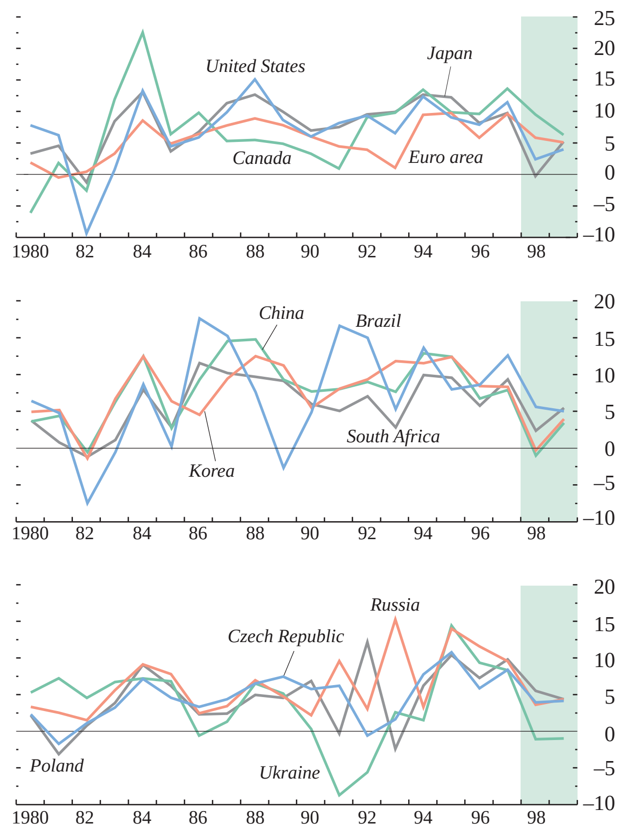
Output growth in *Pakistan* is projected to decline to 3 percent in 1999 after 5 percent growth in 1998, reflecting the deterioration in 1998 of the country's external financial situation, partly owing to the economic sanctions imposed after the nuclear tests in May and the ensuing loss of investor confidence. By end-November, the government had prepared a program of substantial macroeconomic adjustment and structural reforms designed to promote a sustainable improvement in growth performance. The program, which seeks to restore investor confidence and regularize Pakistan's relations with creditors, would require exceptional financing from the international community.

Among developing countries in the Middle East and Europe region, and in Africa, direct spillover effects from the Russian crisis have been largest in the countries with relatively developed capital markets. In *Turkey*, output growth is projected to slow further in 1999, reflecting both the tightening of macroeconomic policies over the past year, aimed at reducing inflation, and contagion from the emerging market crisis. Its international reserves have stabilized since early September, but real interest rates remain high, affecting the likely costs of the refinancing of almost one-third of the government's debt scheduled for early next year. In *South Africa*, interest rates were increased sharply around the middle of the year to defend the rand, but a strengthening of the exchange rate more recently has allowed monetary policy to be eased somewhat. Reflecting the tightening of financial conditions, GDP contracted in the third quarter. In *Kenya*, several commercial banks have been closed in recent months, owing to increases in nonperforming loans related to the economic slowdown this year. Repercussions of the bank failures have so far been limited to runs on deposits at the affected banks.

In the oil-exporting countries of the Middle East and Africa, the decline in world oil prices has worsened external balances and forced cutbacks in public expenditure that have contributed to the slowing of growth. In *Nigeria*, where output is expected to be flat in 1999 after weak growth in 1998, the authorities are implementing cuts in public expenditure to contain the fiscal deficit, given the limited scope for increasing non-oil revenues in the short term. There has been some spillover into neighboring countries, where growth has declined owing in part to reductions in worker remittances. Most other African countries are oil importers and have benefited from lower fuel import bills, but the majority are also non-oil commodity exporters facing losses in export earnings. In *Tanzania* and other neighboring countries, for example, export earnings declined in 1997–98, reflecting both the drop in primary commodity prices and weather-related production shortfalls. On balance, many countries in

Figure 4.4. Selected Economies: Export Market Growth[1]
(Percent)

Export market growth fell sharply in 1998 for most countries. The effect of the crisis in Russia can be seen particularly clearly in Ukraine's declining export market growth.



[1]Export market growth is a weighted average of trading partners' import growth. Shaded areas indicate IMF staff projections.

Box 4.1. Is China's Growth Overstated?

Over the past year, China's economy has been increasingly affected by the Asian crisis, as reflected in a sharp slowdown in exports. In addition, domestic demand slowed markedly in the first half of 1998, owing to the direct and indirect effects of rising unemployment, as well as the impact of serious flooding during the summer. As a result, GDP growth has weakened in 1998 but nevertheless has remained very high—indeed, GDP in the third quarter was 7.6 percent higher than in the third quarter of 1997. Some observers—pointing to the very low growth in electricity consumption (according to preliminary estimates), freight traffic, and other indicators of activity—have questioned whether official statistics may be overestimating the true growth rate.

Between 1992, when extraordinary growth of 14 percent was recorded, and 1997, China's growth rate was on a steadily declining trend, reflecting the authorities' efforts to reduce overheating. By 1997, GDP growth had fallen to 8.8 percent, broadly in line with past staff estimates of potential growth. In the first half of 1998, as the effects of the Asian crisis began to be felt, the GDP growth rate fell to 7 percent (relative to the first half of 1997), the lowest level since 1990. While the authorities do not publish quarterly data on the components of demand, this appears mainly to have reflected the weakening contribution of net exports. In addition, indicators of private consumption growth slowed, partly owing to rising unemployment. In response to these developments, the authorities reduced domestic interest rates twice during the first half of 1998, and in midyear announced a fiscal stimulus of Y 200 billion (2½ percent of GDP), financed equally through the budget and by domestic banks. During the third quarter, the stimulus package began to take effect. GDP growth rose to 7.6 percent in the third quarter, relative to the corresponding period of 1997, and this was reflected in a strong pickup in the growth of public investment, which increased from 13.7 percent in the first half of 1998 (relative to the same period of 1997) to 20 percent in the first three quarters of 1998 (relative to the corresponding period of 1997).[1] It was also reflected in a pickup in the growth of industrial production, from 9.3 percent in June 1998 on a 12-month basis to 12.8 percent in September 1998. GDP was also boosted by rising industrial inventories, although their contribution to growth has declined relative to last year.[2] With public investment and industrial production continuing to expand rapidly in October, GDP growth is likely to remain strong in the fourth quarter as well.

Taking all these factors into account, the staff has revised upward its growth projection for 1998 to 7¼ percent, well above the 5½ percent projection in the October 1998 *World Economic Outlook*, and close to the official target of 8 percent. For 1999, while the external environment will remain very difficult, China will benefit from lower U.S. interest rates, as well as from the recent appreciation of the yen. While export growth is expected to remain weak, the continued implementation of the fiscal stimulus package, combined with rebuilding following the flooding, should allow GDP to grow by about 6½ percent. However, this projection is subject to downside risks, especially with respect to demand in major trading partners.

Although much progress has been made in recent years, the quality of Chinese statistics remains a major difficulty for both policymakers and outside analysts, both in the national accounts and in other areas. For example, many analysts have argued that official statistics overstated GDP growth by 1 to 2 percentage points during the reform period: a study by the World Bank found that GDP growth may have been 1¼ percentage points lower than official figures suggest over the period 1978 to 1995, owing to an underestimation of consumption and investment deflators.[3] Beyond technical problems, misre-

[1]GDP data are provided on a cumulative quarterly basis during the year, and estimates for previous periods are not revised. (The data are published about two weeks after the end of each quarter—probably faster than in any other country in the world.) This does not provide sufficient basis for accurate estimation of quarterly developments in GDP, or to adjust appropriately for seasonal factors.

[2]Data on overall inventory accumulation—including agricultural inventories—are available only on an annual basis. Data on industrial inventories are available at a monthly frequency. Over the past 15 years, overall inventory accumulation has averaged 6 percent of GDP. Since a significant proportion of this has proved to be unsalable, the growth generated by inventory accumulation is of very low quality from an economic perspective.

[3]See World Bank, *China 2020: Development Challenges in the New Century* (Washington, 1997). In addition, valuation procedures for new goods, as well as for inventories, may also give rise to upward bias in growth estimates.

Africa will gain from developments in commodity markets because losses in export earnings are offset by lower oil import bills.[3] Output growth in most of the larger countries in Africa is expected to remain close to rates observed in 1998, or to pick up somewhat in 1999, partly, in a number of cases, owing to the abatement of weather-related problems. For countries in central Africa, however, regional conflicts are adversely affecting growth performance and prospects.

North America and Europe: To What Extent Is Growth Slowing?

The widespread financial market turmoil during August–October raised concerns that growth in many

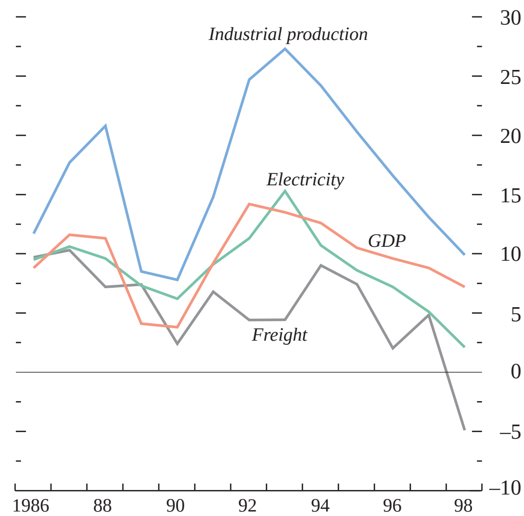
[3]See the October 1998 *World Economic Outlook*, Chapter II, for a more complete analysis of the impact of lower commodity prices on these countries.

porting of data may also be an issue, although any tendency to overreporting may be partly offset by the fact that official statistics do not fully capture the development of the nonstate sector, which has likely been more dynamic than the state sector during much of the reform period. (A 1997 investigation by the State Statistical Bureau found misreporting at the local and provincial levels to be an important problem, although they found examples of both under- and overreporting during the period they examined.)

From an immediate policy perspective, however, a key question is whether the degree of any overstatement or understatement may have widened in 1998, so that trends in key variables may have provided misleading signals. In this context, it is instructive to examine the changes in the relationship between growth in GDP and industrial production, on the one hand, and electricity consumption and freight traffic on the other.[4] On the basis of past trends, the slowdown in the growth of electricity consumption and freight traffic during 1998 would normally have been accompanied by somewhat lower GDP and industrial production growth rates (*see figure*). Beyond the important caveat that the statistics on electricity consumption and freight traffic may themselves not be entirely reliable, a number of specific factors can help to explain this apparent anomaly. These include the declining share of industry and of state-owned enterprises, which are both heavily energy-intensive, combined with the fact that the rapid-growth sectors are not heavy users of electricity; the substantial increase in the relative price of electricity in recent years, which has increased incentives for conservation; and declining output in the coal industry, which accounts for around 40 percent of freight traffic. In addition, electricity output from recently established small-scale power plants, and freight traffic carried by the private sector, may also not be fully captured in the official statistics. Notwithstanding these possible explanations—and the fact that movements over short periods can be misleading—the Chinese authorities themselves are concerned by the discrepancies and are currently studying them in more detail.

[4]The relationship has been significantly stronger for electricity output than for freight traffic.

China: Production Indicators[1]
(Annual percent change)



[1]For 1998, cumulative growth rates from corresponding periods of 1997, January to September.

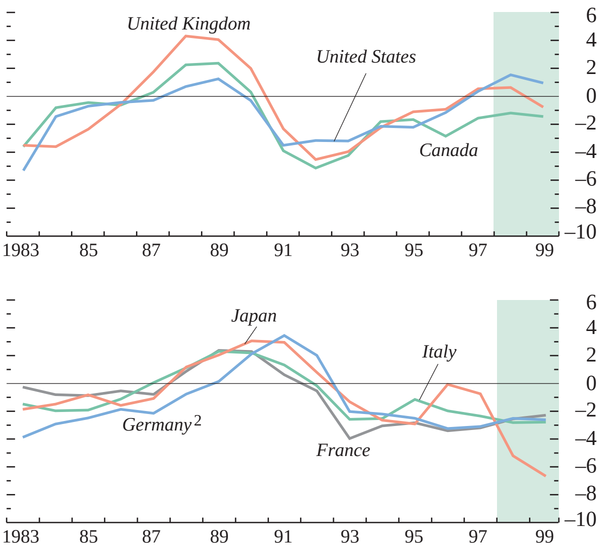
In general, GDP growth rates in China provide an important indicator of broad economic trends—for the third quarter of 1998, all indicators, including electricity consumption and freight traffic, as well as industrial production and money and credit growth, confirm a pickup in the rate of growth of activity. However, they have to be interpreted with care, taking into account the underlying statistical methodologies used and developments in other indicators. The composition of growth, and its underlying quality, also remains an important issue. The ongoing debate about China's GDP statistics highlights the urgent need for continued efforts to improve the quality, coverage, and timeliness of China's economic statistics, for the benefit of both policymakers and outside analysts.

of the industrial countries would slow sharply. This risk seemed most acute in the *United States*, where private consumption had been strong and saving rates low and where market-sensitive equity holdings account for a relatively large share of household wealth. Also troubling, because it could be viewed as threatening a credit crunch, was the widening of yield spreads in corporate bond markets, which are a much larger source of corporate finance in the United States than in other industrial countries. In the event, however, declines in government bond yields and the three reductions in the federal funds rate between late September and mid-November fostered a rebound in U.S. and other equity markets and contributed to a narrowing of spreads on corporate bonds, allaying concerns of a credit crunch and of a slowdown in demand induced by negative wealth effects.

Recent indicators of economic activity in the United States show continued strength despite some mixed signals. Third-quarter GDP growth, at almost 4 per-

Figure 4.5. Major Industrial Countries: Output Gaps[1]
(Actual less potential output, as percent of potential)

Output in the United States and the United Kingdom has recently exceeded potential levels. In Japan, output is falling further below capacity.



[1]Shaded areas indicate IMF staff projections. The estimates of output gaps are subject to a significant margin of uncertainty. For a discussion of approaches to calculating potential output, see Paula R. De Masi, "IMF Estimates of Potential Output: Theory and Practice," in *Staff Studies for the World Economic Outlook* (Washington: IMF, December 1997), pp. 40–46.

[2]Data through 1991 apply to west Germany only.

cent, was higher than expected, but there was a large increase in business inventories that may portend weaker future production. Industrial production in 1998 has shown the slowest growth in seven years, while durable goods orders fell by almost 2 percent in October, reflecting plummeting orders for machinery and heavy equipment. In contrast, private consumption remained strong in the third quarter, and net exports were less of a drag on the economy than earlier in the year owing to a high, but probably temporary, level of aircraft deliveries. Export volumes are likely to be lower in the fourth quarter. More recently, retail sales showed a further solid gain in October, but gains in personal income have slowed, so that the household saving rate has declined further, turning negative in September and October. Consumer confidence fell from its peak reached in June, recovering partially in November; but with the likelihood of a turnaround in personal saving, consumer spending is expected to moderate in 1999.

The projections assume that the interest rate reductions during September–November, the depreciation of the dollar, and the modest fiscal stimulus provided by the rise in spending implied in this year's federal budget (approximately ¼ of 1 percent of GDP) will moderate the cyclical slowdown, such that the pace of the expansion will slow below potential in 1999 but remain above 1½ percent. With output estimated to be above capacity currently in the United States, this slowing is expected to reduce, but not to eliminate, the positive output gap (Figure 4.5).

Seen against the surprisingly strong performance of the U.S. economy in recent years, it may be argued that the long expansion may continue at a stronger pace than in the baseline projections. However, some slowdown seems both inevitable and desirable on cyclical grounds. While subdued inflationary pressures indicate that at least some of the imbalances often associated with cyclical peaks are not pronounced, other, quite marked, imbalances have emerged. Thus, not only has the household sector's overall saving rate fallen to unusually low (recently negative) levels, but the private sector's saving-investment balance has recently fallen into an extraordinarily large deficit. In fact, strong private domestic demand over the past four years has caused net private saving—that is, household and corporate saving less investment, or the private sector's financial balance—to fall into uncharted waters at least by the standards of the past 40 years (Figure 4.6). This shift is the counterpart to the combination of the improvement in the U.S. fiscal balance (an increase in public saving), which has allowed a "crowding in" of investment in the 1990s, and the deterioration in the current account balance (reflecting an increased reliance on foreign saving) more recently.

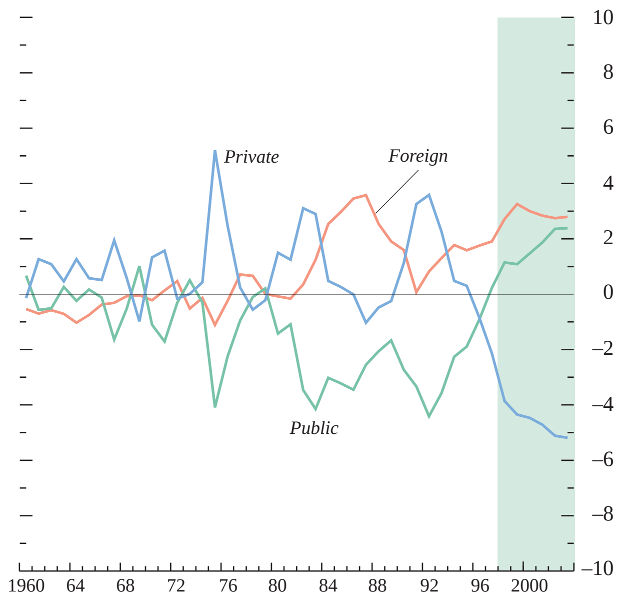
A key risk to the projections is that the recent pattern of saving-investment balances will prove unsustainable, and that it will be corrected. For example, if investors increasingly view the U.S. current account deficit and accumulation of external debt as unsustainable, dollar assets would become less attractive, which would result in a weaker dollar, raise U.S. import prices, and increase the cost of capital. Alternatively, or in combination, there is a risk of a significant, renewed correction in U.S. equity prices. Either case would trigger an adjustment process that would tend to weaken private consumption and investment and reduce the current account deficit. In all probability, the private sector's financial balance will need to be brought back toward historic norms sooner or later, but this need not involve a hard landing. From this perspective, a slowdown in domestic demand in the near term that would reduce the private sector's financial deficit could prove beneficial.

Canada has been significantly affected by the Asian crisis, mainly through its impact on global commodity prices. The associated adverse shift in Canada's terms of trade was reflected in steady downward pressure on the Canadian dollar through the first eight months of the year. Concerned that intensified pressure on the currency in August and an adverse swing in long-term interest rate differentials between Canada and the United States signaled a shift in market confidence in the Canadian dollar, the Bank of Canada raised short-term interest rates by a full percentage point in late August. Subsequently, the value of the Canadian dollar has recovered somewhat, and interest rates have come down—especially at the long end of the term structure—facilitated by the central bank's reversal of most of its earlier rate increase, in line with cuts in U.S. interest rates. In 1999, output growth is expected to slow to 2¼ percent, as further small declines in the terms of trade and softening consumer confidence work to reduce domestic demand growth.

In the *euro area,* the weakening of the economic outlook reflects largely external developments, although indicators of domestic demand have recently seemed less robust (Figure 4.7). Business confidence has turned down noticeably in France and Germany, though consumer confidence has continued to rise. Confidence indicators have turned down more generally in Italy. In each of these countries, there are no signs of a credit crunch. In *Germany,* credit growth has been well-maintained, and spreads between loan and deposit rates in the banking system have been declining. In *France,* however, corresponding spreads remain very large, which may reflect the burden of bad loans in the banking system. While the effective appreciation of euro-area currencies in 1998 and lower inflation tended to tighten monetary conditions, notwithstanding the downward convergence of interest rates among the member countries of the future euro area, the interest rate reductions in early December served essentially to reverse this tendency.

Figure 4.6. United States: Private, Public, and Foreign Net Saving[1]
(Percent of GDP)

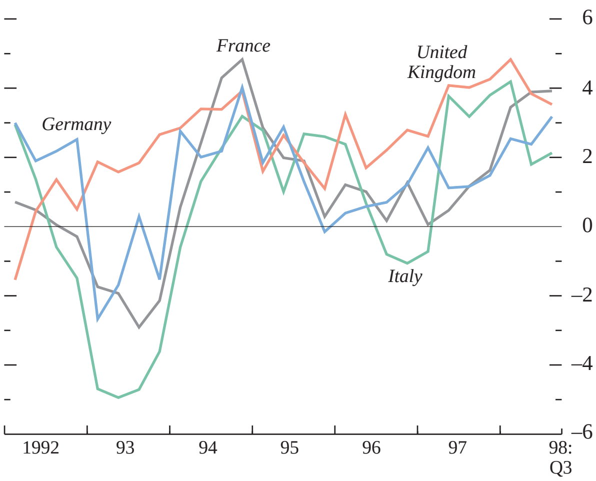
Private saving net of investment has declined sharply and, on the assumptions used for the projections (including constant real exchange rates), is projected to remain in deficit, well below levels experienced since 1960.



[1]Public net saving is the general government current balance less government net investment, as defined in the national accounts. Foreign net saving is the current account balance, shown with opposite sign; a positive value reflects capital inflows into the domestic economy. Net private saving is the sum of public and foreign net saving, with opposite sign. It represents household disposable income less expenditure, plus after-tax corporate profits, less investment. The net saving of a sector is also known as its financial balance. Shaded area indicates IMF staff projections.

Figure 4.7. Selected European Countries: Real Total Domestic Demand
(Percent change from four quarters earlier)

Domestic demand growth has strengthened since 1996 in France and Germany but has weakened since 1997 in Italy and the United Kingdom.



Recent indications of weakening domestic demand were preceded by signs of weaker export performance, especially in Germany beginning in early 1998. This reflects the sharp fall in export market growth for the euro area as a whole in 1998, which is not expected to improve in 1999. The recent appreciation of the euro-area currencies against the U.S. dollar will also affect exports adversely, although it is offset to some extent by the depreciation of these currencies against the Japanese yen. Apart from questions relating directly to foreign demand, risks to euro-area growth include possible inventory corrections (especially in Germany and *Italy*) which could become more likely if the outlook for the external sector weakens further; a greater-than-assumed drag on consumer spending from the phase-out of auto loan incentives (Italy); and a weakening of consumer confidence and spending if, for example, the recent declines in unemployment in a number of countries are halted or reversed. Overall, in France and most of the smaller euro-area countries, growth is expected to be maintained at or slightly above potential in 1999. However, growth is projected to be less vigorous in Germany and Italy, with the implication that the negative output gaps in these countries may stabilize at close to 2 percent of GDP (see Figure 4.5). Inflation in the euro area is projected to be around 1½ percent in 1999–2000, below the target ceiling of 2 percent. In December, the European Central Bank's governing council announced a quantitative reference value for monetary growth (M3) of 4½ percent. The latest monetary data are in line with this reference value.

In the *United Kingdom*, following several years of expansion at above-potential rates, growth has slowed markedly during 1998 and is expected to weaken further in the period ahead, with growth in 1999 as a whole now projected at just under 1 percent, the slowest in the EU. The slowdown stems from the sharp tightening of monetary conditions between late 1996 and early 1998 arising from the tightening of monetary policy and the substantial appreciation of sterling (see Figure 4.2), the impact of fiscal consolidation undertaken in recent years, and the deceleration of global growth. The weakening of net exports apparent since mid-1997 has been accompanied this year by a marked slowdown of domestic demand growth, and business confidence reached an 18-year low in October. The projected slowdown implies that output in the United Kingdom will fall below potential in the period ahead. With price inflation recently at its target and inflationary pressures weakening, the Bank of England has cut interest rates by 1¼ percentage points since early October. As with the other European countries, there is little evidence of a credit crunch: the gap between lending and deposit rates at banks has not widened, and bank lending has continued to grow strongly. Some pickup in demand is expected in the second half of 1999, spurred by the recent effective depreciation of sterling, cuts in short-term interest rates, and also declines in long-term rates that have been the largest among the major industrial countries in 1998.

Global Financial Flows and Current Account Balances

The large shifts in global financial flows since the onset of the Asian crisis have led to substantial adjustments in the external positions of many countries. Net private capital flows to emerging market economies (comprising for this purpose all developing countries, countries in transition, and the newly industrialized Asian economies except Hong Kong SAR) are estimated to have fallen by nearly $150 billion in the two years from 1996 to about $70 billion in 1998, with the decline in flows to the Asian developing and newly industrialized economies more than accounting for this change (Table 4.9). In 1999, net flows to emerging market economies are assumed to rise, mainly owing to a reduction in outflows from Asia, whereas flows to the countries in transition and to the developing countries of the Western Hemisphere are expected to remain near levels experienced in recent years. (Among the transition countries, Russia is assumed to experience a decline in net private inflows.) Following the virtual drying up of capital flows to emerging market countries in general in the wake of the Russian crisis, the baseline projections for 1999 assume, in effect, that the more recent stabilization of financial market conditions will be consolidated, with capital flows recovering from late 1998 through 1999. (See Chapter II for details on recent market conditions and private flows in 1998.)

The reversal of private capital flows to emerging market economies in Asia in 1997–98 has led to dramatic swings toward surplus in the current account balances of these economies (Table 4.10). In the five crisis-afflicted Asian economies, the combined current account balance is estimated to have swung by $118 billion in this direction between 1996 and 1998, with deficits of 3½–8 percent of GDP turning into surpluses of 1–13½ percent of GDP. The turnarounds have resulted mainly from import compression; large increases in export volumes to non-Asian markets, partly owing to gains in competitiveness, have been partially offset by falling intra-Asian trade and declines in export prices. A similar adjustment pattern, but much smaller in scale and thus with smaller implications for world trade, is occurring in Russia, where a small current account deficit in 1997 is expected to swing into a surplus of almost 7 percent of GDP in 1999. In Brazil, however, official financing and drawdowns in reserves are expected to contain the impact of smaller private capital inflows on the current account, which is projected to remain in deficit in 1999.

For the industrial countries as a group, the current account position is estimated to deteriorate by $123 billion between 1997 and 1999 (see the Statistical Appendix, Table 6). This is more than accounted for by the growing deficit of the United States, where export growth has slowed sharply, but domestic demand and imports have been buoyant. Elsewhere, the current account surplus of Japan is projected to increase by $45 billion between 1997 and 1999 because of weak domestic demand and lower commodity prices, while the current account surplus of the euro area is projected to remain largely unchanged at $100 billion.

As in the October 1998 *World Economic Outlook,* the projections for current account balances imply a widening of the current account discrepancy—in the revised projections, to $101 billion in 1999 from $57 billion in 1996. The increase in the discrepancy to levels beyond historical norms shows that the projections for world imports and exports are moving further out of balance and may be interpreted as indicating a tension in the forecast, which could be resolved by either a larger-than-projected external adjustment in the crisis-afflicted countries or a smaller-than-projected deterioration in the current account balances of the industrial countries, or a combination of the two.

Alternative Scenario

Chapter I lists a number of uncertainties about the world economy that have not been taken into account in the baseline scenario, but that nevertheless warrant some consideration. Consequently, an alternative scenario was constructed to examine the possible implications if three of these risks were to materialize—namely, a failure of capital flows to emerging economies to recover, a correction in equity prices in the industrial countries, and a shift in the pattern of exchange rates among the major advanced economies as investors become concerned about the sustainability of the large current account deficits of the United States.[4]

As discussed in the preceding chapters, there is some risk that the recent loss of appetite for investments in emerging markets would continue into 1999, either as a result of high risk aversion or perceptions, or in response to continued contagion or new crises. To illustrate this risk, capital flows to emerging market countries are assumed to decline further in 1999 by $25 billion to a level of some $75 billion lower than assumed in the baseline for 1999. A similar shortfall is assumed for 2000, with adjustment toward baseline levels thereafter.

[4]The scenario was estimated using the IMF's international macroeconomic model, MULTIMOD. See Douglas Laxton, Peter Isard, Hamid Faruqee, Eswar Prasad, and Bart Turtelboom, *MULTIMOD Mark III: The Core Dynamic and Steady-State Models,* Occasional Paper 164 (Washington: IMF, May 1998).

Table 4.9. Developing Countries, Countries in Transition, and Selected Newly Industrialized Asian Economies: Net Capital Flows[1]

(Billions of U.S. dollars)

	1984–89[2]	1990–96[2]	1994	1995	1996	1997	1998	1999
Total								
Net private capital flows[3]	12.5	141.7	156.3	194.0	214.8	117.8	69.5	89.7
Net direct investment	13.1	64.6	83.5	99.3	121.1	145.0	127.3	119.2
Net portfolio investment	4.4	64.0	106.6	39.3	79.9	66.6	42.0	25.1
Other net investment	–4.9	13.0	–33.8	55.4	13.9	–93.8	–99.8	–54.5
Net official flows	26.5	17.4	–2.4	22.9	2.4	22.5	36.8	7.2
Change in reserves[4]	–11.2	–71.3	–65.3	–120.0	–105.5	–44.2	–29.2	–32.7
Developing countries								
Net private capital flows[3]	17.5	128.8	133.6	147.3	190.9	131.8	87.6	104.1
Net direct investment	12.2	57.9	76.3	86.3	108.6	126.7	106.2	96.2
Net portfolio investment	4.9	51.1	85.8	22.2	52.5	51.8	38.0	18.9
Other net investment	0.4	19.8	–28.6	38.8	29.7	–46.6	–56.6	–11.0
Net official flows	27.4	16.8	9.9	31.9	2.6	–3.0	15.6	12.6
Change in reserves[4]	5.1	–55.8	–43.6	–72.2	–95.5	–50.9	13.0	–12.7
Africa								
Net private capital flows[3]	2.3	3.7	8.8	10.4	5.1	14.1	7.3	14.2
Net direct investment	1.2	2.9	3.5	4.2	5.1	7.3	6.2	7.1
Net portfolio investment	–0.8	–0.2	0.5	1.5	–0.3	2.9	2.8	–0.1
Other net investment	1.8	0.9	4.8	4.7	0.3	3.9	–1.7	7.3
Net official flows	6.7	7.6	9.2	7.4	6.6	–2.7	2.9	0.2
Change in reserves[4]	0.1	–2.2	–5.0	–1.9	–6.7	–13.5	0.3	1.2
Asia								
Net private capital flows[3]	13.1	56.0	64.8	91.7	100.2	21.5	–18.3	–7.3
Net direct investment	4.5	32.9	44.4	51.0	60.2	60.2	45.1	35.0
Net portfolio investment	1.5	6.7	11.5	10.0	10.1	7.5	–6.5	–3.0
Other net investment	7.0	16.4	9.0	30.8	29.9	–46.3	–56.9	–39.3
Net official flows	7.8	8.5	5.6	5.1	10.3	7.9	12.7	12.2
Change in reserves[4]	–2.1	–29.7	–39.8	–33.0	–49.1	–12.1	–7.3	–8.9
Middle East and Europe								
Net private capital flows[3]	2.3	22.9	13.0	7.0	3.9	7.9	24.9	21.9
Net direct investment	1.1	2.9	3.7	5.1	4.1	5.0	3.9	5.6
Net portfolio investment	5.1	12.3	13.0	9.1	2.8	3.0	7.5	7.0
Other net investment	–3.9	7.7	–3.6	–7.1	–3.0	–0.2	13.4	9.3
Net official flows	4.8	–0.4	–1.0	–1.1	–0.6	–0.6	–0.9	–1.2
Change in reserves[4]	6.6	–5.6	–3.1	–11.6	–11.3	–10.3	—	–1.2
Western Hemisphere								
Net private capital flows[3]	–0.2	46.1	46.9	38.1	81.7	88.3	73.6	75.3
Net direct investment	5.3	19.1	24.8	26.0	39.2	54.2	51.0	48.6
Net portfolio investment	–0.9	32.3	60.9	1.7	40.0	38.3	34.2	15.1
Other net investment	–4.6	–5.3	–38.7	10.4	2.5	–4.1	–11.5	11.6
Net official flows	8.2	1.2	–3.9	20.5	–13.7	–7.7	0.8	1.5
Change in reserves[4]	0.5	–18.4	4.2	–25.7	–28.3	–15.0	20.0	–3.8
Countries in transition								
Net private capital flows[3]	–1.7	10.6	18.9	42.6	16.0	22.6	13.2	16.4
Net direct investment	–0.2	6.4	5.4	13.4	13.4	18.2	17.1	18.2
Net portfolio investment	—	10.4	20.5	18.8	24.3	20.8	7.0	8.2
Other net investment	–1.6	–6.2	–7.0	10.4	–21.7	–16.4	–10.9	–10.0
Net official flows	0.2	1.1	–12.1	–8.4	–0.2	9.7	11.4	0.9
Change in reserves[4]	–2.7	–5.0	–6.9	–36.2	–0.2	–6.3	–3.4	–6.5
Selected newly industrialized Asian economies[5]								
Net private capital flows[3]	–3.2	2.3	3.9	4.1	7.9	–36.6	–31.2	–30.8
Net direct investment	1.0	0.4	1.8	–0.4	–1.0	0.1	4.0	4.8
Net portfolio investment	–0.5	2.5	0.3	–1.7	3.1	–5.9	–3.0	–2.1
Other net investment	–3.7	–0.6	1.9	6.2	5.9	–30.7	–32.2	–33.5
Net official flows	–1.1	–0.5	–0.3	–0.6	—	15.8	9.8	–6.4
Change in reserves[4]	–13.6	–10.5	–14.8	–11.7	–9.9	13.0	–38.8	–13.5

[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing.
[2]Annual averages.
[3]Because of data limitations, other net investment may include some official flows.
[4]A minus sign indicates an increase.
[5]Korea, Singapore, and Taiwan Province of China.

Events over the past few months have also underscored the risk of a renewed correction in equity markets (see Chapter III and Box 3.2). As noted above in the context of the projections for the United States, a stock market correction would be expected to have significant effects on consumer and business spending. To examine the effects of such a correction, the scenario assumes a (relatively modest) drop in stock market prices in all the major industrial countries of about 13 percent in the first year of the shock. Finally, the scenario assumes that the U.S. dollar depreciates by about 10 percent against other major currencies. This assumption carries implications for the distribution of the large trade imbalances that have emerged as a result of the Asian crisis.

Each of these risks might materialize independently. However, they are potentially interrelated, with the materialization of any one giving rise to a chain reaction and an increasing chance that the other risks might emerge. For example, a generalized increase in risk aversion might make investors in Japan and Europe less willing to finance the U.S. current account deficit, at the same time as they may attempt to reduce their exposure in emerging markets generally, as has been the case in Asia. The resulting negative impact of these events on global growth prospects and business profits might then lead to price declines in the major stock markets. Because these risks are potentially interrelated, they are assumed to occur simultaneously in the scenario.

The results of the alternative scenario are summarized in Table 4.11. In the first year of the shock, global output falls relative to the baseline by 1¼ percent, with slightly larger relative adjustment—an output fall of 1½ percent—occurring in the emerging market economies owing to the compression of imports required by the reduction in external financing. This import compression, taken alone, results in lower exports from the industrial economies and accounts for about one-fourth of the initial fall in output in those economies. In the developing countries, domestic demand falls more sharply than total output, with declines in domestic spending generating most of the fall in imports.

Within the industrial country group, the assumed depreciation of the U.S. dollar relative to other major currencies tends to amplify the decline in output in the euro area relative to the United States as the latter becomes more competitive. This improvement in competitiveness contributes to the reduction in the U.S. current account deficit (by $25 billion after three years) and to smaller surpluses in Europe and Japan. The assumed decline in equity prices in mature markets contributes to reductions in domestic demand in the industrial countries and helps to reduce the private saving-investment deficit in the United States relative to the baseline projections and thus to reduce the U.S. current account deficit. Output in Europe and Japan is

Table 4.10. Selected Economies: Current Account Positions

(Percent of GDP)

	1995	1996	1997	1998	1999
Advanced economies					
United States	–1.6	–1.8	–1.9	–2.7	–3.3
Japan	2.2	1.4	2.2	3.4	3.3
Germany	–0.9	–0.6	–0.2	0.1	0.2
France	0.7	1.3	2.8	2.1	1.6
Italy	2.3	3.3	2.9	2.5	2.5
United Kingdom	–0.5	–0.2	0.6	–0.5	–0.7
Canada	–0.8	0.5	–1.5	–2.1	–1.7
Australia	–5.5	–4.0	–3.2	–5.2	–5.6
Austria	–2.0	–1.8	–1.3	–0.6	–0.6
Finland	4.1	4.0	5.5	4.6	4.3
Greece	–2.1	–2.6	–2.4	–2.3	–2.0
Hong Kong SAR[1]	–3.9	–1.1	–3.1	—	1.2
Ireland	2.7	2.7	2.8	3.0	2.9
Israel	–5.6	–5.4	–3.3	–2.8	–2.9
Korea	–1.9	–4.7	–1.8	13.2	8.7
New Zealand	–3.1	–3.9	–7.7	–6.9	–6.9
Norway	3.3	6.7	5.2	0.1	2.7
Singapore	16.9	15.9	15.4	19.2	18.4
Spain	0.2	0.3	0.5	0.2	–0.3
Sweden	2.1	2.4	2.7	2.8	2.5
Switzerland	7.0	7.4	8.9	9.1	9.1
Taiwan Province of China	2.1	4.0	2.7	2.0	2.2
Memorandum					
European Union	0.6	1.0	1.5	1.2	1.0
Developing countries					
Algeria	–5.3	2.7	7.4	–2.2	–2.1
Argentina	–1.5	–1.9	–3.5	–4.5	–4.2
Brazil	–2.6	–3.0	–4.1	–4.2	–3.6
Cameroon	–0.8	–2.3	–1.3	–2.4	–2.5
Chile	–2.1	–5.4	–5.3	–6.8	–5.2
China	0.2	0.9	3.3	2.4	1.8
Côte d'Ivoïre	–6.0	–4.8	–4.5	–3.8	–2.6
Egypt	0.7	–0.3	0.2	–3.4	–3.0
India	–1.6	–1.4	–1.6	–1.9	–2.0
Indonesia	–3.3	–3.3	–1.8	3.0	2.0
Malaysia	–10.0	–4.9	–4.2	11.0	9.2
Mexico	–0.6	–0.7	–1.9	–3.5	–2.2
Nigeria	–3.2	11.9	4.9	–11.6	–16.0
Pakistan	–3.4	–7.1	–5.8	–2.9	–2.8
Philippines	–4.4	–4.7	–5.2	1.2	0.6
Saudi Arabia	–4.3	0.2	0.2	–8.0	–6.8
South Africa	–2.0	–1.3	–1.5	–1.4	–0.9
Thailand	–7.9	–7.9	–2.0	11.4	8.4
Turkey	–0.5	–1.4	–1.4	–2.2	–2.6
Uganda	–2.4	–1.5	–1.4	–2.9	–3.2
Countries in transition					
Czech Republic	–2.7	–7.6	–6.1	–2.0	–2.0
Estonia	–5.1	–9.7	–12.9	–9.1	–6.9
Hungary	–5.7	–3.8	–2.2	–2.9	–3.3
Latvia	–3.4	–4.0	–5.0	–5.5	–6.9
Lithuania	–10.2	–9.1	–10.2	–13.5	–15.0
Poland[2]	3.3	–1.0	–3.2	–3.8	–4.9
Russia	1.6	0.6	–0.1	1.6	6.7
Slovak Republic	2	–11	–11	–10	–4
Ukraine	–4	–3	–3	–2	–2

[1]Data include only goods and nonfactor services.
[2]Based on data for the current balance, including a surplus on unrecorded trade transactions, as estimated by IMF staff.

Table 4.11. Alternative Scenario: Simulation Results[1]

(Deviations from baseline, in percent unless otherwise noted)

	First Year	Second Year	Third Year	Fourth Year
World				
Real GDP	–1.3	–0.7	0.2	0.2
Industrial countries[2]				
Real GDP	–1.3	–0.8	0.3	0.3
Real domestic demand	–1.0	–0.5	0.3	0.4
Short-term interest rate	–0.4	–0.7	–0.6	–0.5
Long-term interest rate	–0.3	–0.2	–0.1	–0.1
Consumer price index inflation	–0.2	–0.3	–0.1	0.0
Current account balance (billions of U.S. dollars)	–52.4	–72.9	–19.2	–28.3
Developing countries[3]				
Real GDP	–1.5	–0.4	0.0	0.1
Real domestic demand	–2.6	–1.3	–0.1	–0.2
Current account balance (billions of U.S. dollars)	52.4	72.3	19.3	28.3

[1]Baseline is based on current *World Economic Outlook* database, with shocks starting in 1999. The scenario models a reduction in financial flows to the emerging market economies of $70–75 billion in 1999 and 2000, a reduction in equity prices in the industrial countries, and a depreciation in the value of the U.S. dollar.

[2]Comprises Canada, France, Germany, Italy, Japan, the United Kingdom, the United States, and the following smaller industrial countries: Australia, Austria, Belgium, Denmark, Finland, Greece, Ireland, the Netherlands, New Zealand, Norway, Portugal, Spain, and Switzerland.

[3]Comprises all countries except the industrial countries.

more affected by the combined demand shocks than output in the United States, in part because of greater rigidities in the former economies. For the same reasons, the rise in unemployment is smaller in the United States.

* * *

This alternative scenario, it should be emphasized, deals with risks to a baseline projection that summarizes the most likely path for the world economy going forward—comparatively weak growth in 1999, but the avoidance of world recession. The baseline scenario, however, is contingent upon a set of assumptions that may not be realized. The turbulent events of August–October and the subsequent policy responses that have restored an important measure of calm testify both to the importance of taking risks seriously when they emerge and to the role and importance of timely and vigorous policy response.