

II

Global Repercussions of the Asian Crisis and Other Issues in the Current Conjuncture

The financial and foreign exchange market crises in Asia continued to worsen after completion of the *World Economic Outlook: Interim Assessment* published in mid-December 1997. The *Interim assessment* emphasized the downside risks to the outlook and in particular the need for steadfast implementation of stabilization and reform policies in the crisis countries. Subsequently, through December and much of January, hesitancy in the implementation of adjustment and reform programs in some cases resulted in further weakening of investor confidence and continued turbulence in financial markets in the region, with reverberations around the world. Since late January, downward pressures on Asian currencies have eased, and equity prices have stabilized and begun to recover (Figure 5). Financial market confidence, however, remains fragile, especially in view of continuing uncertainties about policies in Indonesia.

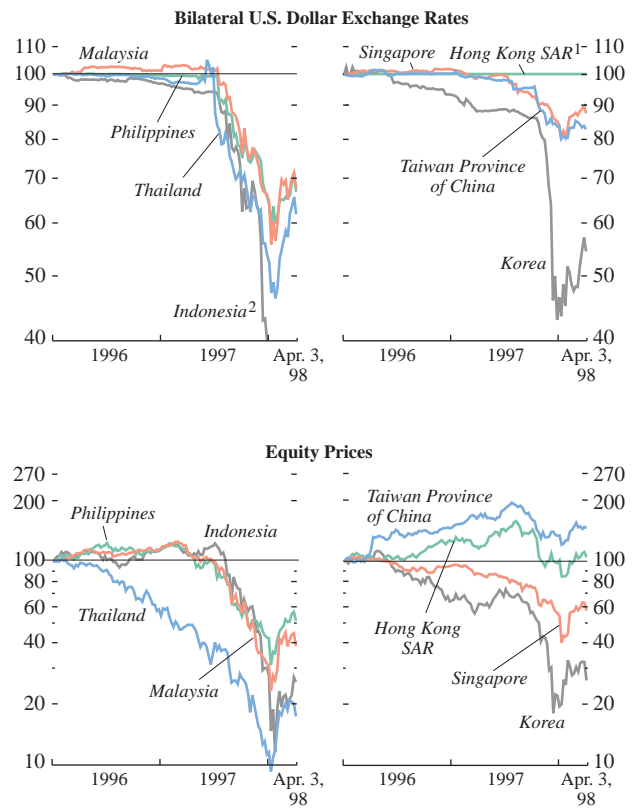
The Global Growth Outlook

Both the financial crises and their prospective effects on the economies directly concerned are now seen to be more severe than when the *Interim Assessment* was finalized in early December. In the crisis economies, the loss of funding by private investors, sharp currency depreciations, and the implementation of the stronger adjustment measures that are needed will slow the growth of domestic demand. This slowdown, combined with the improvements in competitiveness associated with the declines in currency values, will reduce the demand for imports and contribute to the expansion of exports, thereby fostering rapid external adjustment. Other countries are expected to experience negative effects of the Asian crisis through worsening trade balances, with many emerging market economies also suffering reduced capital inflows, higher interest costs, and weak commodity prices. In the industrial countries, declines in bond yields may be expected to provide a partially offsetting boost to demand. Some financial institutions in industrial countries may be expected to feel the effects of the difficulties experienced by Asian borrowers, but Asian exposures seem manageable

Figure 5. Selected Asian Economies: Bilateral U.S. Dollar Exchange Rates and Equity Prices

(In U.S. dollars per currency unit; logarithmic scale; January 5, 1996 = 100)

As the Asian crisis unfolded and deepened, exchange rates and equity prices plunged in the countries most affected.



Sources: Bloomberg Financial Markets, LP; International Finance Corporation; and Reuters.

¹Pegged to U.S. dollar.

²The Indonesian currency reached a low of 15.5 in the week ending January 23, 1998 and recovered to 26.8 in the week ending April 3, 1998.

Table 2. Overview of the World Economic Outlook Projections*(Annual percent change unless otherwise noted)*

	1996	1997	Current Projections		Differences from October 1997 Projections	
			1998	1999	1997	1998
World output	4.1	4.1	3.1	3.7	-0.1	-1.2
Advanced economies	2.7	3.0	2.4	2.5	—	-0.5
Major industrial countries	2.5	2.8	2.3	2.2	—	-0.2
United States	2.8	3.8	2.9	2.2	0.1	0.3
Japan	3.9	0.9	—	1.3	-0.2	-2.1
Germany	1.4	2.2	2.5	2.8	-0.1	-0.3
France	1.5	2.4	2.9	3.0	0.2	0.1
Italy	0.7	1.5	2.3	2.7	0.3	0.2
United Kingdom	2.2	3.3	2.3	2.1	—	-0.3
Canada	1.2	3.8	3.2	2.8	0.1	-0.3
Other advanced economies	3.8	4.0	2.9	3.6	0.1	-1.3
<i>Memorandum</i>						
Industrial countries	2.5	2.9	2.4	2.4	—	-0.3
European Union	1.7	2.6	2.8	2.8	0.1	—
Newly industrialized Asian economies	6.4	6.1	1.8	4.5	0.2	-4.2
Developing countries	6.6	5.8	4.1	5.3	-0.4	-2.2
Africa	5.5	3.2	4.6	4.9	-0.6	-0.4
Asia	8.3	6.7	4.4	5.9	-1.0	-3.0
ASEAN-4	7.1	3.9	-2.7	2.5	-1.7	-8.1
Middle East and Europe	4.9	4.4	3.3	4.0	-0.2	-0.9
Western Hemisphere	3.5	5.0	3.4	4.3	0.9	-1.2
Countries in transition	-0.1	1.7	2.9	3.4	-0.2	-1.3
Central and eastern Europe	1.5	2.7	3.9	4.2	0.6	0.3
Excluding Belarus and Ukraine	3.6	3.1	4.4	4.6	0.3	0.5
Russia	-2.8	0.4	1.0	1.9	-1.1	-4.1
Transcaucasus and central Asia	1.5	2.2	4.5	5.1	0.9	0.4
World trade volume (goods and services)	6.6	9.4	6.4	6.1	1.7	-0.4
Imports						
Advanced economies	6.4	8.6	6.8	5.6	1.4	0.4
Developing countries	9.3	12.1	5.2	7.8	3.7	-2.6
Countries in transition	7.6	5.4	5.1	5.6	-4.1	-3.4
Exports						
Advanced economies	5.9	9.8	6.2	6.0	1.6	-0.4
Developing countries	8.7	10.8	7.4	6.7	3.1	0.2
Countries in transition	4.9	3.5	4.2	6.6	-1.9	-2.9
Commodity prices						
Oil ¹						
In SDRs	24.3	-0.9	-22.8	9.1	-1.2	-22.0
In U.S. dollars	18.9	-6.0	-23.9	9.2	-0.9	-22.1
Nonfuel ²						
In SDRs	3.1	1.6	-6.0	0.8	-1.2	-4.4
In U.S. dollars	-1.3	-3.7	-7.4	0.9	-1.0	-4.9
Consumer prices						
Advanced economies	2.4	2.1	2.1	2.0	-0.1	-0.2
Developing countries	13.7	8.5	10.2	8.5	-1.5	1.4
Countries in transition	41.4	27.8	13.8	8.7	-0.4	0.3
Six-month LIBOR (in percent)³						
On U.S. dollar deposits	5.6	5.9	6.1	6.1	—	-0.2
On Japanese yen deposits	0.7	0.7	0.7	1.2	—	-0.4
On deutsche mark deposits	3.3	3.4	3.9	4.5	0.1	-0.1

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during February 9–March 4, 1998, except for the bilateral rates among ERM currencies, which are assumed to remain constant in nominal terms.

¹Simple 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 \$19.18 in 1997; the assumed price is \$14.59 in 1998 and \$15.94 in 1999.

²Average, based on world commodity export weights.

³London interbank offered rate.

Table 3. Advanced Economies: Real GDP, Consumer Prices, and Unemployment Rates*(Annual percent change and percent of labor force)*

	Real GDP				Consumer Prices				Unemployment Rates			
	1996	1997	1998	1999	1996	1997	1998	1999	1996	1997	1998	1999
Advanced economies	2.7	3.0	2.4	2.5	2.4	2.1	2.1	2.0	7.3	7.1	7.0	6.7
Major industrial countries	2.5	2.8	2.3	2.2	2.2	2.0	1.7	1.9	7.0	6.7	6.6	6.5
United States	2.8	3.8	2.9	2.2	2.9	2.3	2.0	2.4	5.4	4.9	5.0	5.0
Japan	3.9	0.9	-0.0	1.3	0.1	1.7	0.9	0.4	3.3	3.4	3.6	3.6
Germany	1.4	2.2	2.5	2.8	1.5	1.8	1.6	1.7	10.4	11.5	11.4	11.2
France	1.5	2.4	2.9	3.0	2.0	1.2	1.4	1.8	12.4	12.5	11.9	11.3
Italy	0.7	1.5	2.3	2.7	3.9	1.7	1.8	1.7	12.1	12.3	12.0	11.6
United Kingdom ¹	2.2	3.3	2.3	2.1	2.9	2.8	2.9	2.6	7.5	5.6	4.9	4.8
Canada	1.2	3.8	3.2	2.8	1.6	1.4	1.5	1.9	9.7	9.2	8.5	8.2
Other advanced economies	3.8	4.0	2.9	3.6	3.2	2.6	3.7	2.7	8.5	8.2	8.5	7.5
Spain	2.3	3.4	3.4	3.7	3.5	2.0	2.1	2.3	22.2	20.8	19.7	18.5
Netherlands	3.3	3.3	3.8	3.1	2.1	2.2	2.0	2.2	7.6	6.6	5.6	5.1
Belgium	1.5	2.7	2.6	2.8	2.1	1.6	1.7	1.8	12.7	12.5	12.3	12.1
Sweden	1.3	1.9	3.0	2.8	0.8	0.9	2.0	2.0	8.0	8.1	7.0	6.5
Austria	1.6	2.5	2.8	2.7	1.9	1.3	1.4	1.5	7.0	7.1	7.1	6.9
Denmark	3.4	3.0	2.7	2.7	2.1	2.2	2.6	2.7	8.7	7.8	7.3	6.9
Finland	3.6	5.9	3.5	3.4	0.6	1.2	2.3	2.5	16.3	14.5	12.6	11.1
Greece	2.6	3.3	3.5	3.3	8.2	5.4	5.0	3.7	10.3	10.3	9.7	9.4
Portugal	3.3	3.5	3.7	3.2	3.1	2.2	2.1	2.0	7.3	6.7	6.6	6.5
Ireland	7.7	8.3	8.2	6.8	1.7	1.5	2.2	2.1	11.5	10.2	9.3	8.7
Luxembourg	3.5	4.8	4.1	3.5	1.4	1.4	1.2	1.4	3.3	3.7	3.9	4.2
Switzerland	-0.2	0.7	1.7	2.0	0.8	0.5	0.4	1.3	4.7	5.2	5.0	4.8
Norway	5.3	3.5	5.3	3.0	1.3	2.6	2.7	3.0	4.8	4.1	3.6	3.6
Israel	4.5	2.1	2.5	3.3	11.3	9.0	5.8	5.4	6.7	7.7	8.1	7.4
Iceland	5.2	4.8	4.0	3.8	2.3	1.7	3.0	3.5	4.3	3.9	3.6	3.3
Korea	7.1	5.5	-0.8	4.1	4.9	4.5	10.5	4.3	2.0	2.7	6.3	3.4
Australia ²	3.6	3.1	3.2	3.4	2.7	1.7	1.9	2.5	8.6	8.6	8.1	7.5
Taiwan Province of China	5.7	6.9	5.0	5.2	3.1	1.1	4.0	2.0	2.6	2.7	2.6	2.4
Hong Kong SAR	4.9	5.3	3.0	4.3	5.2	6.5	4.5	4.5	2.8	2.2	2.5	2.4
Singapore	6.9	7.8	3.5	5.0	1.4	2.0	2.5	2.1	3.0	2.4	3.3	3.6
New Zealand ²	2.8	2.2	2.7	3.1	2.3	1.8	2.1	1.8	6.1	6.8	7.0	6.5
<i>Memorandum</i>												
European Union	1.7	2.6	2.8	2.8	2.5	1.9	2.0	2.0	11.4	11.1	10.6	10.2

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

for the mature banking systems and for most banks within them.⁹

The impact of the Asian crisis is the main factor contributing to the projected slowing of growth in the world economy from about 4 percent in 1997 to about 3 percent in 1998 (Table 2). The policy assumptions underlying the projections are discussed in Box 4. While the new growth projection for 1998 is about 1¼ percentage points lower than that in the October 1997 *World Economic Outlook*, it remains notably higher than the growth rates of 1¾ to 2¾ percent registered during the global slowdown of 1990–93, and only

slightly below the trend rate of growth of the past two decades. Inflation is expected to remain low in the advanced economies and to moderate further in the developing countries and the countries in transition. Recent and expected commodity price developments should help to keep global inflation low in the near future (see Annex II). The growth of world trade volume in 1997, at 9½ percent, was similar to the expansions registered in 1994–95, which were the fastest in two decades. Although trade growth is expected to slow to about 6½ percent in 1998, this would still be above the average for the 1990s.

Compared with the October 1997 *World Economic Outlook*, the projections for growth in the group of *advanced economies* have been revised downward by about ½ of 1 percent for 1998 (Table 3). The largest downward revisions are for Japan and the newly industrialized economies, particularly Korea. In Japan, following a strengthening of the recovery in

⁹Available, but incomplete, balance sheet data compiled by the Bank for International Settlements (BIS) indicate that, as of mid-1997, banking system exposures to Asian emerging market countries amounted to about \$260 billion in the EU (3¼ percent of GDP), \$210 billion in Japan (5 percent of GDP), and \$40 billion in the United States (½ of 1 percent of GDP).

Box 4. Policy Assumptions Underlying the Projections for Selected Advanced Economies

Fiscal policy assumptions for the short term are based on official budgets adjusted for any deviations in outturns as estimated by IMF staff and also for differences in economic assumptions between IMF staff and national authorities. The assumptions for the medium term take into account future policy measures that are judged likely to be implemented. Both short-term and medium-term projections are generally based on information available through the end of March 1998. In cases where future budget intentions have not been announced with sufficient specificity to permit a judgment about the feasibility of their implementation, an unchanged structural primary balance is assumed, unless otherwise indicated. For selected advanced economies, the specific assumptions adopted are as follows (see Table 4, and Tables A14–A16 in the Statistical Appendix for the projected implications of these assumptions).

United States. For fiscal years 1998–2003, the fiscal projections are based on the administration's February 1998 budget proposal, adjusted for differences between the IMF staff's macroeconomic assumptions and those of the administration. State and local government fiscal balances are assumed to remain constant as a percent of GDP.

Japan. The projections take account of the 1998 budget and the accompanying 1997 supplementary budget, including the personal income tax rebate announced for 1998. Consolidation plans legislated in the Fiscal Structural Reform Act are assumed to be implemented, including the front-loaded measures associated with the intensive reform period through 2000/01. This will imply a lowering of the general government deficit (excluding social security) to 3 percent of GDP by 2003/04. Public investment spending between 1995/96 and 2004/05 is projected at approximately ¥470 trillion, in line with the new medium-term target. The forecast also assumes that modest supplementary budgets (with extra spending of the order of ¥1 trillion) will be announced late in 1998 and subsequent years, and that the income tax rebate for 1998 will be withdrawn gradually. The interest rate costs of plans to inject public money into the banking system are included.

Germany. For 1998, the staff projection incorporates the 1998 federal budget, Financial Planning Council projections for the other levels of government, official tax estimates, and the unwinding of temporary measures implemented in 1997. The difference from the govern-

ment's 1998 deficit projection (2½ percent of GDP) is mainly due to slightly less sanguine macroeconomic assumptions. For the medium term, the IMF staff's projections assume unchanged policies, implying a constant structural primary balance.

France. The projection for 1998 takes account of the 1998 budget, plans for social security announced in the context of the 1998 social security financing law, and information provided by the authorities on the financial outlook for other levels of government. The projection for 1999 entails a slight decline in the ratio of expenditure to GDP, reflecting the impact of measures to reduce social security expenditure (implementation of the 1995 health care reforms, and limited means-testing of family allowances). Beyond 1999, the ratio of revenue to GDP is projected to remain constant, and an unchanged structural primary balance is assumed.

Italy. The projections take into account measures included in the 1998 budget and the recently announced change in the schedule of pension payments. For 1999–2000, the projections are based on IMF staff estimates for the "current services" budget (*tendenziale*), corrected for the measures announced in the three-year plan for those years. It is assumed that the plan's measures are fully implemented and yield the officially estimated amounts. Projections beyond 2000 assume an unchanged structural balance.

United Kingdom. The budgeted spending ceilings for 1997–98 and 1998–99 are assumed to be observed. Thereafter, noncyclical spending is assumed to grow in line with potential GDP. For revenues, the projections incorporate, for 1997–98 and 1998–99, the announced commitment to raise excises on tobacco and road fuels each year in real terms; thereafter, real tax rates are assumed to remain constant.

Canada. Federal government outlays for departmental spending and business subsidies are assumed to conform to the commitments announced in the February 1997 budget, the main exception being that the medium-term floor for transfers under the Canada Health and Social Transfer would be raised beginning in 1997–98. The employment insurance premium was cut by 20 cents in January 1998, and it is assumed to be cut by 5 cents a year during 1999–2003. Other outlays and revenues are assumed to evolve in line with the IMF staff's macroeconomic projections. After 1998/99, it is assumed that the

late 1996 and early 1997, activity declined sharply in the second quarter last year as domestic demand contracted in the wake of the April consumption tax increase. Business confidence subsequently weakened markedly on renewed concerns about the health of the financial sector, and as a result of the financial difficulties in neighboring countries. Growth in Japan is now projected to be zero in 1998. Developments and

prospects in Japan, and measures that could help to ensure a rebound in economic activity, are discussed further below.

For the newly industrialized economies of Asia, growth projections for this year have been marked down substantially. In Korea, financial markets plunged in late 1997 as the full extent of short-term external borrowing and the decline in uncommitted

federal government will maintain a small budget surplus, which implies some small cuts in taxes and increases in program spending. The fiscal position of the provinces is assumed to be consistent with their stated medium-term targets.

Australia. Projections are based on the commonwealth government's 1997–98 midyear fiscal and economic outlook, adjusted for differences between the macroeconomic projections of the IMF staff and the authorities. Unchanged policies are assumed for the state and local government sector from 1998.

Belgium. Projections for 1998 are based on the official budget and the subsequently announced revised targets. Thereafter, fiscal projections are based on current primary expenditure and revenue policies, which result in a slight deterioration in the structural primary surplus over the medium term.

Greece. The projection for 1998 reflects the IMF staff's assessment of the official budget and of the corrective measures announced at the time of the drachma's entry into the ERM. Projections beyond 1998 assume an unchanged structural primary balance.

Israel. Projections are based on the 1998 budget and the government's medium-term fiscal plan, which establishes annual deficit targets for the central government until 2001. In the years thereafter, the projections assume an unchanged fiscal deficit as a percent of GDP.

Korea. The medium-term projections assume that the central and general government budgets will be broadly in balance. In the short term, however, unemployment is expected to pick up sharply, and the associated increase in social safety net expenditures will imply small fiscal deficits.

Netherlands. The projections assume that the continued current expenditure framework leads to a small increase in the primary structural balance over the medium term.

Portugal. The projection for 1998 is based on the official budget, and projections for 1999–2003 assume an unchanged structural primary balance.

Spain. The projections for 1998 assume that the budget is implemented as passed by parliament but allow for small expenditure overruns that are partially offset by lower interest payments and higher tax revenues resulting

from more rapid domestic demand growth. For 1999 and beyond, it is assumed that there is no major change in tax policy, public sector wages grow at the same rate as wages in the private sector, and public sector employment rises moderately.

Sweden. The projections are based on the authorities' fiscal objectives set out in the 1997 Fall Budget Bill, which includes a surplus of 1¼ percent of GDP in 1998 and an average surplus of 2 percent of GDP over the cycle starting in 2001.

Switzerland. The projection for 1998 is based on the 1998 budget plans. For 1999–2001, the projections are in line with official current service estimates but include a 1 percentage point increase in the standard value-added tax rate in 1999 and a phasing out of the unemployment contribution surcharge of 1 percent from mid-1999 onward. Beyond 2001, the general government's structural primary balance is assumed to remain unchanged.

* * *

Monetary policy assumptions are based on the established framework for monetary policy in each country. In most cases this implies a nonaccommodative stance over the business cycle, so that official interest rates will firm when economic indicators suggest that inflation will rise above its acceptable rate or range, and ease when indicators suggest that prospective inflation will not exceed the acceptable rate or range; that prospective output growth is below its potential rate; and that the margin of slack in the economy is significant. It is assumed that Economic and Monetary Union (EMU) in Europe will be implemented from the start of 1999, in accordance with the agreed timetable. Until then, for the exchange rate mechanism (ERM) countries of the European Union, which use monetary policy to adhere to exchange rate anchors, official interest rates are assumed to move in line with those in Germany, except that progress with fiscal consolidation may influence interest differentials relative to Germany. On this basis, it is assumed that the London interbank offered rate (LIBOR) on six-month U.S. dollar deposits will average 6.1 percent in 1998–99; on six-month Japanese yen deposits will average 0.7 percent in 1998 and 1.2 percent in 1999; and on six-month deutsche mark deposits, 3.9 percent in 1998 and 4.5 percent in 1999. Changes in interest rate assumptions compared with the October 1997 *World Economic Outlook* are summarized in Table 2.

foreign exchange reserves became clear. With Korea's strengthened commitment to policy action and an agreement with foreign banks to roll over short-term debt, the crisis in confidence began to subside in late January. Nevertheless, the economic slowdown seems likely to be sharper than projected in December, with real GDP now expected to decline by ¾ of 1 percent in 1998. Spillover effects from the regional crisis are also

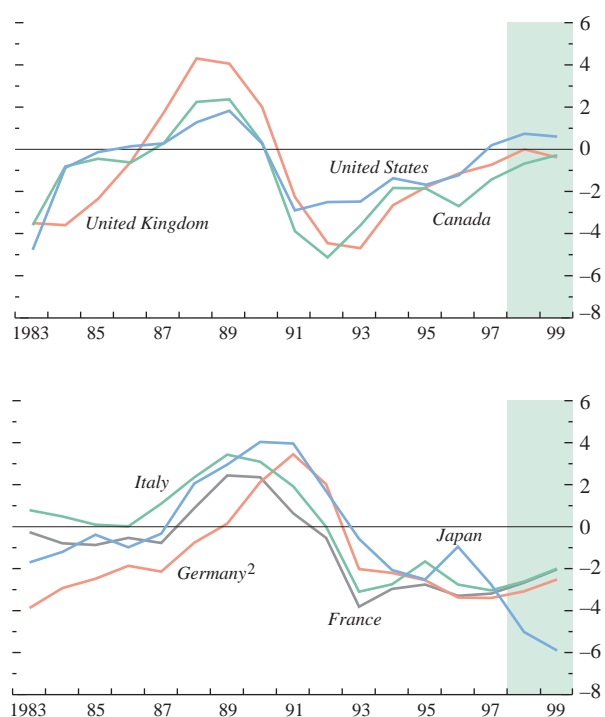
expected to slow growth in Hong Kong SAR, Singapore, and Taiwan Province of China.

In Australia, growth this year is expected to remain broadly unchanged at about 3¼ percent with weaker export growth, owing to the Asian slowdown, offsetting stronger domestic demand. The current account deficit is expected to widen to 5 percent of GDP. The impact of the Asian crisis is expected to be somewhat

**Figure 6. Major Industrial Countries:
Output Gaps¹**

(Actual less potential, as percent of potential)

Differences in the relative cyclical positions of the major industrial countries have persisted.



¹Shaded areas indicate IMF staff projections. The gap estimates 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.

²Data through 1991 apply to west Germany only.

less in New Zealand, where exports to Asia constitute a somewhat smaller proportion of GDP than in Australia. There has been a progressive easing of monetary conditions since mid-1997 mainly through a depreciation of the New Zealand dollar, and this should help growth reach about 2¾ percent in 1998. The current account deficit is projected to narrow slightly this year from the level of 7¾ percent of GDP reached in 1997.

The impact of the Asian crisis on growth prospects for the *major industrial countries*, with the important exception of Japan, is expected to be modest. Exports to Asia are likely to fall sharply, but the declines in bond yields in most industrial countries since mid-1997—reflecting reduced expectations of inflation and of monetary tightening as well as a portfolio shift away from emerging market investments—are likely to have an offsetting and stimulative effect on growth. Furthermore, equity prices in the most major markets reached new peaks in March.

Activity has remained strong in the United States and the United Kingdom, where expansions are in advanced stages (Figure 6). In the United States, above-potential growth throughout 1997 led to a further tightening in labor market conditions, with the unemployment rate falling to 4.7 percent by the end of the year and further signs of a gradual pickup in wage growth. Overall, however, inflation remains low, and the strong dollar and weak commodity prices will help it to remain so in the near term. Buoyant investment in new capacity has helped to contain cost pressures, with recent advances in productivity growth outpacing the rise in wages. The strength of the U.S. economy has buoyed government revenues, and the general government deficit was almost eliminated in 1997 (Table 4). The growth rate of real GDP in 1998 is projected to moderate to about 3 percent, reflecting the weakening of external demand associated with the Asian crisis, the strength of the dollar, and some modest tightening in monetary policy during the year, in line with market expectations.

Growth in the United Kingdom also continued at above-potential rates until the final quarter of 1997, with registered unemployment declining further to 5 percent. Inflation has been running close to its 2½ percent target. Although domestic demand has continued to provide the main impetus to growth, net exports have been surprisingly buoyant in view of sterling's substantial real appreciation since mid-1996. Growth in real GDP is expected to moderate to 2¼ percent this year as exports slow, owing to the loss in competitiveness and the Asian crisis, and as domestic demand moderates, partly reflecting the tightening of monetary conditions during 1997 and continuing fiscal consolidation (Figure 7).

The recovery in Canada gathered pace last year, with real GDP expanding by 3¾ percent. However, with continued slack in the economy, inflation de-

Table 4. Major Industrial Countries: General Government Fiscal Balances and Debt¹*(In percent of GDP)*

	1981–91	1992	1993	1994	1995	1996	1997	1998	2000	2003
Major industrial countries										
Actual balance	-2.9	-3.8	-4.3	-3.5	-3.4	-2.8	-1.4	-1.3	-0.6	0.3
Output gap	-0.4	-1.2	-2.4	-1.9	-2.0	-1.7	-1.3	-1.3	-0.9	-0.1
Structural balance	-2.7	-3.2	-3.0	-2.5	-2.4	-1.9	-0.7	-0.6	-0.1	0.3
United States										
Actual balance	-2.8	-4.4	-3.6	-2.3	-1.9	-1.1	-0.2	0.1	0.5	1.4
Output gap	-1.1	-2.5	-2.5	-1.4	-1.7	-1.2	0.2	0.7	0.5	—
Structural balance	-2.4	-3.4	-2.6	-1.7	-1.4	-0.6	-0.2	-0.1	0.3	1.4
Net debt	37.4	50.1	52.1	52.8	52.8	52.7	50.7	49.1	45.4	37.8
Gross debt	51.6	64.6	66.4	65.7	65.9	65.9	63.1	61.1	56.5	47.0
Japan										
Actual balance	-0.4	1.5	-1.6	-2.3	-3.6	-4.3	-3.4	-3.8	-2.1	-1.1
Output gap	0.7	1.7	-0.6	-2.1	-2.5	-1.0	-2.7	-5.0	-4.3	-0.1
Structural balance	-0.6	0.8	-1.4	-1.5	-2.6	-3.8	-2.3	-1.8	-0.3	-1.1
Net debt	19.7	4.2	5.2	7.7	13.3	15.4	18.5	29.2	32.8	33.2
Gross debt	67.8	70.0	75.1	82.2	89.7	94.2	99.7	113.6	120.3	121.5
<i>Memorandum</i>										
Actual balance excluding social security	-3.5	-2.0	-4.8	-5.1	-6.5	-6.8	-5.5	-5.6	-4.2	-3.0
Structural balance excluding social security	-3.7	-2.5	-4.6	-4.4	-5.6	-6.5	-4.6	-4.0	-2.8	-3.0
Germany²										
Actual balance	-2.1	-2.8	-3.2	-2.4	-3.3	-3.4	-2.7	-2.7	-2.2	-1.1
Output gap	-1.1	2.0	-2.0	-2.2	-2.6	-3.4	-3.4	-3.1	-1.7	-0.2
Structural balance	-1.6	-4.0	-2.2	-1.2	-2.0	-1.4	-0.6	-0.8	-1.0	-0.9
Net debt	21.1	27.7	35.1	40.5	49.0	51.6	52.5	53.7	53.5	50.9
Gross debt	41.0	44.1	47.9	50.2	58.0	60.4	61.3	62.5	62.3	59.7
France										
Actual balance	-2.2	-3.8	-5.6	-5.6	-5.0	-4.1	-3.0	-3.0	-2.4	-1.1
Output gap	0.4	-0.5	-3.8	-3.0	-2.7	-3.3	-3.2	-2.7	-1.4	—
Structural balance	-2.4	-3.4	-3.2	-3.6	-3.2	-1.9	-0.9	-1.2	-1.4	-1.2
Net debt ³	22.5	30.2	34.4	40.2	43.6	46.3	48.7	49.9	50.9	48.8
Gross debt	30.8	39.2	45.2	48.3	52.5	55.4	57.7	58.9	59.9	57.8
Italy										
Actual balance	-11.1	-9.6	-10.0	-9.2	-7.7	-6.7	-2.7	-2.5	-1.9	-1.4
Output gap	1.7	—	-3.1	-2.7	-1.7	-2.8	-3.0	-2.6	-1.1	-0.1
Structural balance	-11.9	-9.6	-8.5	-7.8	-6.8	-5.4	-1.3	-1.3	-1.4	-1.4
Net debt	75.5	103.0	112.8	118.3	117.6	117.4	115.2	112.5	107.3	99.2
Gross debt	83.0	108.7	119.1	124.9	124.2	124.0	121.6	118.8	113.3	104.7
United Kingdom										
Actual balance	-1.9	-6.3	-7.9	-6.9	-5.6	-4.6	-1.6	-0.3	0.7	1.7
Output gap	-0.8	-4.5	-4.7	-2.7	-1.8	-1.1	-0.7	—	-0.3	—
Structural balance	-1.3	-3.8	-4.4	-4.1	-4.0	-3.6	-1.0	-0.1	0.9	1.7
Net debt	42.1	29.0	33.8	39.4	42.3	45.7	47.9	43.6	39.2	29.5
Gross debt	50.1	36.1	42.5	48.4	50.5	53.8	54.5	51.8	47.4	37.4
Canada										
Actual balance	-4.2	-7.5	-7.3	-5.3	-4.0	-1.7	1.0	1.6	1.5	2.0
Output gap	-0.6	-5.1	-3.6	-1.8	-1.9	-2.7	-1.4	-0.7	—	—
Structural balance	-3.8	-3.9	-4.6	-4.0	-2.9	-0.1	1.9	2.0	1.5	2.0
Net debt	32.6	55.8	61.5	65.5	67.6	68.3	66.5	63.3	54.4	42.4
Gross debt	62.7	86.1	92.8	95.6	97.6	97.5	93.8	87.6	76.0	61.6

Note: The budget projections are based on information available through March 1998. The specific assumptions for each country are set out in Box 4.

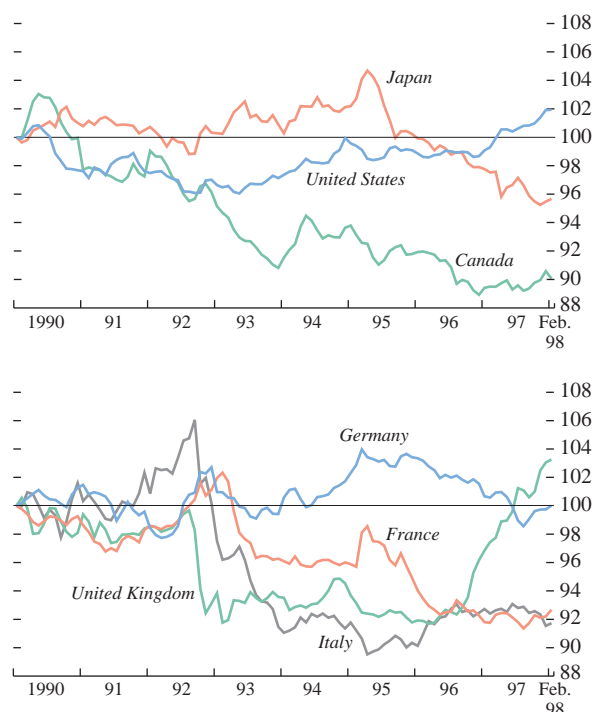
¹The output gap is actual less potential output, as a percent of potential output. Structural balances are expressed as a percent of potential output. The structural budget balance is the budgetary position that would be observed if the level of actual output coincided with potential output. Changes in the structural budget balance consequently include effects of temporary fiscal measures, the impact of fluctuations in interest rates and debt-service costs, and other noncyclical fluctuations in the budget balance. The computations of structural budget balances are based on IMF staff estimates of potential GDP and revenue and expenditure elasticities (see the October 1993 *World Economic Outlook*, Annex I). Net debt is defined as gross debt less financial assets, which include assets held by the social security insurance system. Debt data refer to end of year; for the United Kingdom they refer to end of March. Estimates of the output gap and of the structural budget balance are subject to significant margins of uncertainty.

²Data before 1990 refer to west Germany. For net debt, the first column refers to 1986–91. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by the general government. This debt is equivalent to 8 percent of GDP and the associated debt service to ½ of 1 percent of GDP.

³Figure for 1981–91 is average of 1983–91.

**Figure 7. Major Industrial Countries:
Indices of Monetary Conditions¹**

The marked tightening of monetary conditions—broadly defined to include both interest rates and exchange rates—in the United Kingdom since 1996 is expected to have a moderating influence on growth.



¹For each country, 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 from a base period (January 1990). Relative weights of 3 to 1 are used for Canada, France, Italy, and the United Kingdom; 4 to 1 for Germany; 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. Movements in the index are thus equivalent to percentage point changes in the real interest rates. The lag with which a change in the index may be expected to affect aggregate demand depends on the extent to which the change stems from a change in the interest rate or the exchange rate, and varies depending on the cyclical position; the lag also differs across countries. No meaning is to be attached to the absolute value of the index; rather, the index is intended to show the degree of tightening or easing in monetary conditions from the (arbitrarily chosen) base period. Small changes in the relative weights may affect the value of the index but not the qualitative picture.

clined toward the lower end of the authorities' target range. In response to the continued signs of robust growth, the Bank of Canada moved to tighten monetary conditions modestly in October 1997. Subsequently, it raised interest rates in November and December 1997 and January 1998 by a total of 125 basis points in order to maintain monetary conditions roughly unchanged in the face of a depreciating Canadian dollar. The federal budget is expected to be balanced in the 1997–98 fiscal year, and small surpluses can be expected thereafter. Growth is projected to ease somewhat during 1998, to about 3¼ percent.

In continental Europe, the recovery gathered strength during 1997 and growth projections for 1998 and 1999 would have been revised upward had it not been for the expected dampening effect—mainly on export volumes—of the Asian crisis. Conditions remain in place, however, to support a moderate strengthening in economic activity, including a likely pause in the process of further fiscal consolidation, depreciated currencies, lower long-term interest rates, and stronger economic confidence (Figure 8). In Germany, growth in 1997 was driven mainly by continued buoyancy in exports; although there was a pickup in machinery and equipment investment, a solid recovery in domestic demand remains to be seen (Figure 9). The recovery in France, which has also relied heavily on exports, became better balanced, with a pickup in domestic demand emerging in the second half of 1997 and more than compensating for a moderation in export growth. Unemployment in both countries has fallen recently from historic peaks but remains close to 12 percent. Real GDP growth this year is expected to strengthen to 2½ percent in Germany, and to 3 percent in France.

Growth in Italy also firmed during 1997, despite a large fiscal correction, but remained below potential. The pickup was sustained by a recovery of private consumption (sparked by temporary tax incentives for automobile purchases), a strengthening of export growth, and a replenishment of inventories. While some of these factors will wane in 1998, lower interest rates and EMU-related buoyancy of expectations are likely to support real GDP growth of about 2¼ percent.

Elsewhere in continental Europe, after periods of sluggishness, more convincing expansions have emerged in Austria, Belgium, and Sweden—all of which are expected to experience growth of 2½–3 percent in 1998. Expansions are expected to strengthen or continue to mature in Denmark, Finland, Greece, Ireland, the Netherlands, Norway, Portugal, and Spain, with some risk of overheating in several cases.

In the *developing* countries, economic growth is expected to slow from about 5¾ percent in 1997 to about 4 percent in 1998, a rate considerably below the 6 percent average of the 1990s and constituting a 2¼ percentage point downgrading relative to the October

1997 *World Economic Outlook* (Table 5). The downward revisions affect all regions but the largest are for Asia, and the ASEAN-4 countries in particular. The outlook for those countries is discussed later in the chapter. Most other emerging market countries are expected to register a slowdown in growth in 1998 followed by a mild strengthening in 1999. Africa is the only region where a strengthening of growth is still foreseen for this year, but this projection is subject to significant downside risks.

Financial markets in China have remained relatively unaffected by the Asian crisis, reflecting the country's relatively closed capital account—capital flows consist primarily of direct investment—as well as its large foreign exchange reserves. Competitiveness has deteriorated somewhat as a result of the currency devaluations of Asian partner countries, but exports have remained strong, and the current account surplus has increased. Inflation should remain low following the sharp drop in 1997, and output growth is expected to slow moderately to about 7 percent this year, although the possibility of a more pronounced slowdown cannot be excluded.

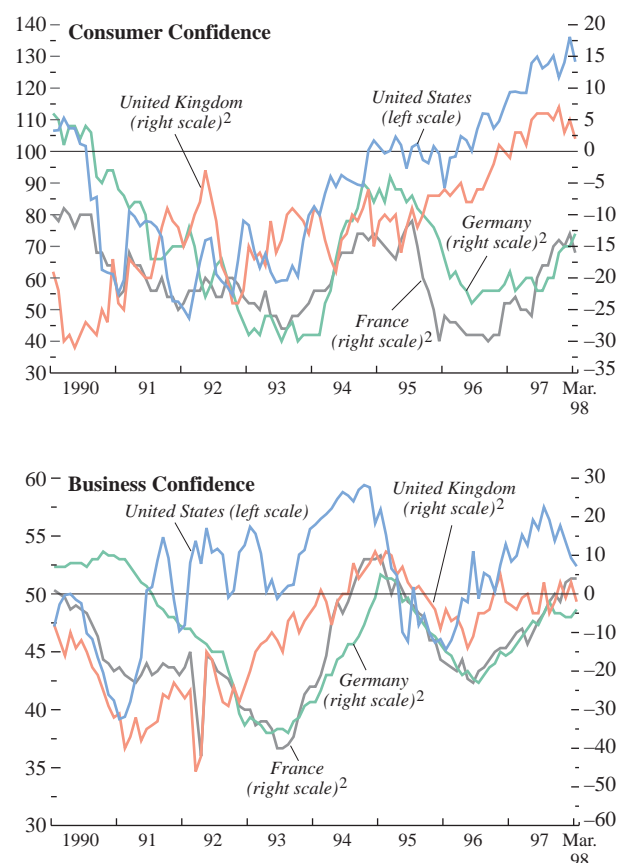
Output growth in India, which declined moderately in 1997, is expected to ease further to some 5¼ percent this year, reflecting the influence of political uncertainties and high real interest rates owing to significant fiscal deficits. Export growth is expected to slow as a result of weaker partner-country demand and infrastructure bottlenecks. In Pakistan, the government adopted a comprehensive program to strengthen macroeconomic policies and implement structural reforms following the widening of macroeconomic imbalances and the threat of a foreign exchange crisis in late 1996 and early 1997. Output growth is projected to rise to 5½ percent and inflation to fall in 1998, assuming that adjustment and reform policies are implemented as planned, but the balance of payments remains fragile.

The developing countries of the Western Hemisphere have weathered the Asian crisis relatively well, in part reflecting reforms and macroeconomic policies implemented over the past decade, including in the wake of the Mexican crisis. Nevertheless, as discussed below, growth in the region is projected to slow to some 3½ percent this year, partly as a result of spillovers from the Asian crisis and policy measures to reduce vulnerability to adverse shifts in investor sentiment, but also reflecting a natural slowdown of recovery in Mexico after almost three years of strong growth.

In Africa, growth in real GDP declined from 5½ percent in 1996 to 3¼ percent in 1997, which is ½ of 1 percentage point lower than projected in the October 1997 *World Economic Outlook*. The fall in output growth, resulting from a combination of commodity price developments, weather-related shocks, armed conflicts, and political uncertainties,

Figure 8. Selected European Union Countries and the United States: Indicators of Consumer and Business Confidence¹

Consumer confidence in the United States is near the highs reached in the 1960s; in Germany and France consumer confidence and business confidence have both improved markedly.



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

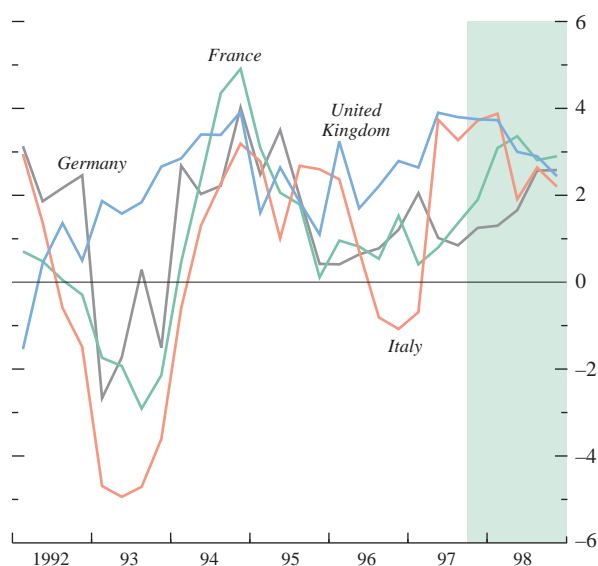
¹Indicators are not comparable across countries.

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

**Figure 9. Selected European Countries:
Real Total Domestic Demand¹**

(Percent change from four quarters earlier)

Domestic demand in France and Germany is expected to strengthen this year.



¹Shaded area indicates IMF staff projections.

was uneven across the continent, with countries in the north experiencing the most marked slowdown. In sub-Saharan Africa, GDP growth declined from 5 percent in 1996 to 3¼ percent in 1997. With the exception of South Africa, where the rand depreciated by about 4 percent in late October, the Asian crisis has had little effect on foreign exchange and financial markets in the region. Nevertheless, in 1998 some of the countries in sub-Saharan Africa may feel effects of the crisis because countries in east Asia, particularly Malaysia, are important sources of foreign investment to the region and because of generally higher costs of foreign borrowing. Commodity price developments will also have an adverse impact on some countries. For 1998, growth in Africa is projected to rebound to around 4½ percent, assuming the continued implementation of disciplined macroeconomic policies, further deepening of structural reforms, and successful resolution of armed conflicts in some areas. In some cases, however, significant downside risks remain, especially related to the possible adverse effects of the El Niño weather pattern on agricultural production in the region and of declines in commodity prices.

In the Middle East and Europe region, output growth slowed somewhat to 4½ percent in 1997 and is projected to weaken further in 1998. The slower growth in 1997 was mainly a result of developments in Turkey and the Islamic Republic of Iran. In Turkey, with the government planning to strengthen efforts to reduce inflation—now one of the highest rates in the world—activity may slow further in the short run, but the achievement of greater macroeconomic stability would help to strengthen the country's medium-term outlook. In the Islamic Republic of Iran, growth slowed to about 3¼ percent last year largely as a result of weaker oil and gas revenues, and the lower level of oil prices will continue to restrain growth in 1998. Indeed, the prospect of weak international oil prices poses a near-term risk to growth in the oil-producing economies in the region more generally, owing to the adverse impact on external current account positions and the associated adjustment needs. The outlook for Egypt is discussed in detail below.

In the *countries in transition* as a group, output in 1998 is projected to increase by 3 percent (Table 6). This will be the second consecutive year of positive output growth, after eight years of output decline, but the projection represents a downward revision of about 1¼ percent from the October 1997 *World Economic Outlook*. The downward revision is mainly accounted for by Bulgaria, Russia, Turkmenistan, Ukraine, and Uzbekistan. The lower growth forecast for Bulgaria reflects the intensity of the financial crisis that began in 1996 and carried over into 1997 until stabilization measures took hold. Higher interest rates and a reduction in access to foreign financing—attributable in part to the Asian crisis—are expected to

Table 5. Selected Developing Countries: Real GDP and Consumer Prices*(Annual percent change)*

	Real GDP			Consumer Prices		
	1996	1997	1998	1996	1997	1998
Developing countries	6.6	5.8	4.1	13.7	8.5	10.2
Median	4.5	4.5	4.5	7.1	5.6	4.8
Africa	5.5	3.2	4.6	26.2	10.5	7.5
Algeria	3.8	1.3	4.8	18.7	5.7	5.0
Cameroon	5.0	5.1	5.0	6.4	4.3	2.1
Côte d'Ivoire	6.8	6.0	6.0	2.7	5.6	3.0
Ghana	5.2	3.0	5.6	45.6	28.3	18.8
Kenya	4.2	1.3	2.7	9.0	11.2	9.6
Morocco	12.1	-2.2	7.6	3.0	1.0	2.0
Nigeria	4.6	5.1	2.7	29.3	8.3	9.0
South Africa	3.2	1.7	2.2	7.4	8.6	6.0
Sudan	4.7	5.5	6.5	114.0	32.0	15.0
Tanzania	4.1	4.1	4.7	25.7	17.1	13.0
Tunisia	6.9	5.6	5.9	3.8	3.7	3.7
Uganda	8.1	5.0	5.0	7.5	7.8	7.8
SAF/ESAF countries ¹	5.9	4.2	5.0	15.6	8.7	7.8
CFA countries	5.3	5.5	6.0	5.1	4.1	2.5
Asia	8.3	6.7	4.4	6.7	3.9	8.0
Bangladesh	5.6	5.5	5.2	4.5	5.1	7.5
China	9.7	8.8	7.0	6.1	1.5	2.0
India	7.5	5.6	5.2	6.9	6.1	6.1
Indonesia	8.0	5.0	-5.0	7.9	6.6	44.3
Malaysia	8.6	7.8	2.5	3.5	2.7	7.5
Pakistan	4.5	3.5	5.5	10.3	12.5	8.0
Philippines	5.7	5.1	2.5	8.4	5.1	8.0
Thailand	5.5	-0.4	-3.1	5.9	5.6	11.6
Vietnam	9.3	7.5	5.0	5.7	3.1	7.0
Middle East and Europe	4.9	4.4	3.3	24.5	22.6	26.6
Egypt	4.3	5.0	5.0	7.2	6.2	4.5
Iran, Islamic Republic of	5.1	3.2	2.8	23.1	16.9	22.7
Jordan	5.2	5.0	5.0	6.5	3.0	4.0
Kuwait	0.9	1.5	1.2	1.8	1.7	1.1
Saudi Arabia	1.4	2.7	2.1	0.9	-0.5	0.3
Turkey	7.1	5.7	4.9	82.3	85.4	103.7
Western Hemisphere	3.5	5.0	3.4	22.3	13.1	9.1
Argentina	4.2	8.4	5.5	0.2	0.8	0.3
Brazil	2.8	3.0	1.5	15.5	6.0	3.3
Chile	7.2	6.6	6.0	7.4	6.2	5.1
Colombia	2.0	3.2	4.0	20.8	18.5	19.0
Dominican Republic	7.3	8.2	5.5	5.4	8.4	5.7
Ecuador	2.0	3.3	2.5	24.4	30.6	28.1
Guatemala	3.0	4.1	4.4	11.0	9.4	6.6
Mexico	5.2	7.0	4.8	34.4	20.6	13.4
Peru	2.6	7.5	5.0	11.5	8.6	6.1
Uruguay	4.9	6.0	3.0	28.3	19.8	9.9
Venezuela	-0.4	5.1	3.3	99.9	50.0	33.1

¹African countries that had arrangements, as of the end of 1997, under the IMF's Structural Adjustment Facility (SAF) or Enhanced Structural Adjustment Facility (ESAF).

lower growth in both Russia and Ukraine. In contrast, in Hungary and Poland, strong export growth and the implementation of macroeconomic policies to address imbalances have raised growth prospects. In Kazakhstan, higher oil and gas production is expected to boost growth despite the decline in energy prices. The impact of the Asian crisis on the countries in transition is discussed further below.

Prospects for Global Inflation (or Deflation)

In late 1997 and early 1998, bond yields in most major industrial countries fell to levels not seen since the early 1960s, or before in some cases, continuing the broad downward trend evident over the past three years, while in Japan yields remained near historical lows for any country (Figure 10). The drop in yields

Table 6. Countries in Transition: Real GDP and Consumer Prices*(Annual percent change)*

	Real GDP			Consumer Prices		
	1996	1997	1998	1996	1997	1998
Countries in transition	-0.1	1.7	2.9	41	28	14
Median	2.8	3.2	4.6	24	15	11
Central and eastern Europe	1.5	2.7	3.9	32	38	17
Excluding Belarus and Ukraine	3.6	3.1	4.4	23	41	16
Albania	9.1	-7.0	10.0	13	32	22
Belarus	2.8	10.0	7.5	53	64	50
Bulgaria	-10.9	-7.4	4.0	123	1,089	35
Croatia	4.3	6.3	4.0	3	4	5
Czech Republic	4.1	1.2	2.2	9	8	11
Estonia	4.0	10.9	6.0	23	11	10
Hungary	1.3	4.0	4.8	23	18	13
Latvia	2.8	6.0	6.0	18	8	5
Lithuania	5.1	6.0	6.0	25	9	7
Macedonia, former Yugoslav Rep. of	0.9	1.5	5.0	2	1	3
Moldova	-7.8	1.3	3.0	24	12	7
Poland	6.1	6.9	5.7	20	15	11
Romania	3.9	-6.6	2.0	39	155	54
Slovak Republic	7.0	5.7	4.0	6	6	5
Slovenia	3.1	3.7	4.2	10	9	8
Ukraine	-10.0	-3.2	—	80	16	13
Russia	-2.8	0.4	1.0	48	15	8
Transcaucasus and central Asia	1.5	2.2	4.5	69	30	20
Armenia	5.8	3.3	5.2	19	14	13
Azerbaijan	1.3	5.8	7.0	20	4	5
Georgia	10.5	11.0	10.0	39	7	6
Kazakhstan	0.5	2.1	3.0	39	17	11
Kyrgyz Republic	5.6	6.2	5.9	30	26	14
Mongolia	2.6	3.0	4.0	49	37	12
Tajikistan	-4.4	2.2	4.4	418	88	64
Turkmenistan	-7.7	-25.9	20.0	992	84	21
Uzbekistan	1.6	2.4	1.8	64	45	35

has taken place across the maturity spectrum, apparently reflecting in some cases reduced market expectations of near-term monetary tightening. An important factor underlying the downward trend in bond yields has been a sustained fall in world inflation. This trend continued in 1997, with average inflation among the major industrial countries slowing to just over 2 percent from just under 2½ percent in 1996 (Figure 11). A new driving force behind the most recent drop in bond yields was the deepening crisis in Asia, which prompted a widespread flight to safety as well as further downward revisions in inflation expectations.

There are several channels through which the Asian crisis is expected to reduce inflation risks in the short term. First, it may be expected to reduce global inflationary pressures by weakening demand and activity in many countries. Second, slower growth in Asia has been an important factor behind the sharp drop since early 1997 in world prices for many primary commodities for which these countries account for a sig-

nificant share of global demand (see Annex II). Third, the large depreciations of a number of Asian currencies can be expected to reduce the U.S. dollar prices of those products for which these countries are important world suppliers.¹⁰

Some commentators have suggested that the effects of the Asian crisis may go beyond reduced global inflationary pressures, and that there is a risk that the world economy could slip into deflation. In addition to the channels noted above, they point to the excess capacity in some industries where Asian countries are important global producers, reflecting the effects of

¹⁰In the United States, these developments will reinforce the trend evident since late 1995, whereby falling import prices associated with the strengthening dollar have helped to contain the inflationary pressures that might otherwise have emerged in the face of sustained above-potential growth. Similar effects have been observed in the United Kingdom following the steep rise in the pound since mid-1996 and should be felt more generally in the period ahead by countries with significant imports from the Asia region.

previous overinvestment. They also note that some countries—for example, Japan—may already be facing the threat of consumer price deflation in circumstances where confidence and domestic demand are very weak, typically linked to financial sector weaknesses and sharp declines in asset prices.

In assessing the risks of global deflation, it is important to distinguish *deflation*, a sustained fall in the overall price level, from *disinflation*, a decline in the rate of inflation. Disinflation has been an important achievement of macroeconomic policy since the early 1980s, as central banks around the world have pursued low inflation as their primary policy goal. It is important also to distinguish deflation from relative price movements involving sustained price declines for particular assets, products, or commodities against a background of rising overall prices. Indeed, in a low-inflation environment, falling prices of individual products, stemming, in particular, from productivity gains and technological advances, are likely to be more common than when inflation is higher and relative price adjustments occur more through differences among *rates of price increase*, with fewer absolute price declines. Primary commodity prices must also be distinguished from the prices of manufactured goods and services that dominate the price indices of overall output or consumer purchases. Movements in primary commodity prices tend to be much more volatile than movements in the overall price level, and there have been several episodes of significant declines as well as sharp increases in world commodity price indices since the early 1980s, while consumer price inflation in the advanced economies has been on a fairly steady downward trend (Figure 12).

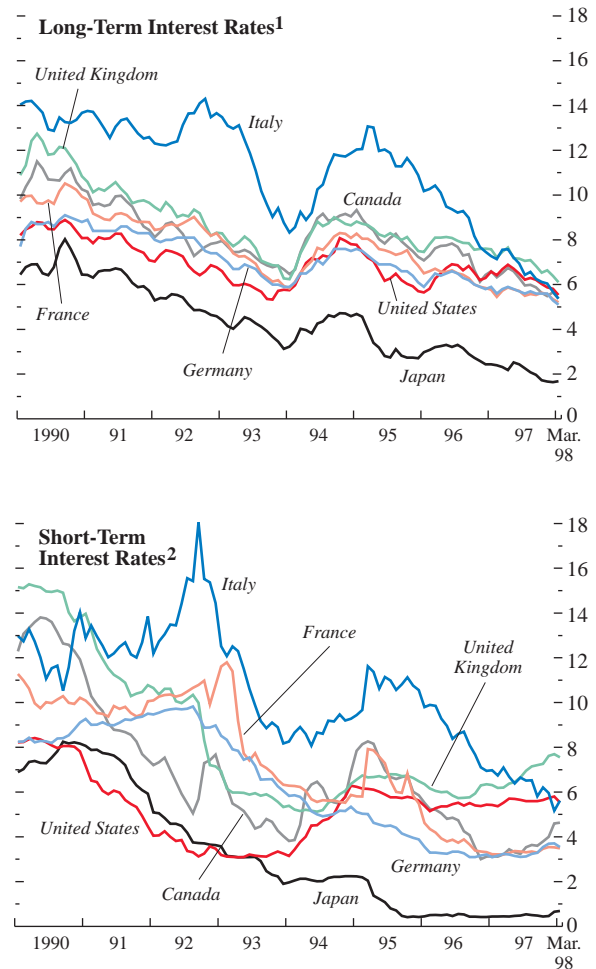
Episodes of global deflation were relatively common in the nineteenth and early twentieth centuries but have not been part of more recent experience. The last such episode of any significance was the Great Depression of 1929–33, when prices in the United States fell by about 30 percent amid a worldwide collapse of output and prices. Although a number of factors have been cited as contributing to the Great Depression, there is a broad consensus that a global monetary contraction, sparked by initial tightening in the major countries with external surpluses—notably the United States and France—and transmitted around the world via the gold standard system of fixed exchange rates, played a key role.¹¹ With the option of exchange rate adjustment precluded under the gold standard, the only adjustment mechanism available to countries facing an outflow of reserves was deflation through a contraction of the money supply, whereas surplus countries were able to sterilize the monetary

¹¹See, for example, Ben S. Bernanke, “The Macroeconomics of the Great Depression: A Comparative Approach,” *Journal of Money, Credit and Banking*, Vol. 27 (February 1995), pp. 1–28.

**Figure 10. Major Industrial Countries:
Nominal Interest Rates**

(In percent a year)

In most countries, long-term interest rates have continued on a downward trend, while short-term rates have shown mixed movements.



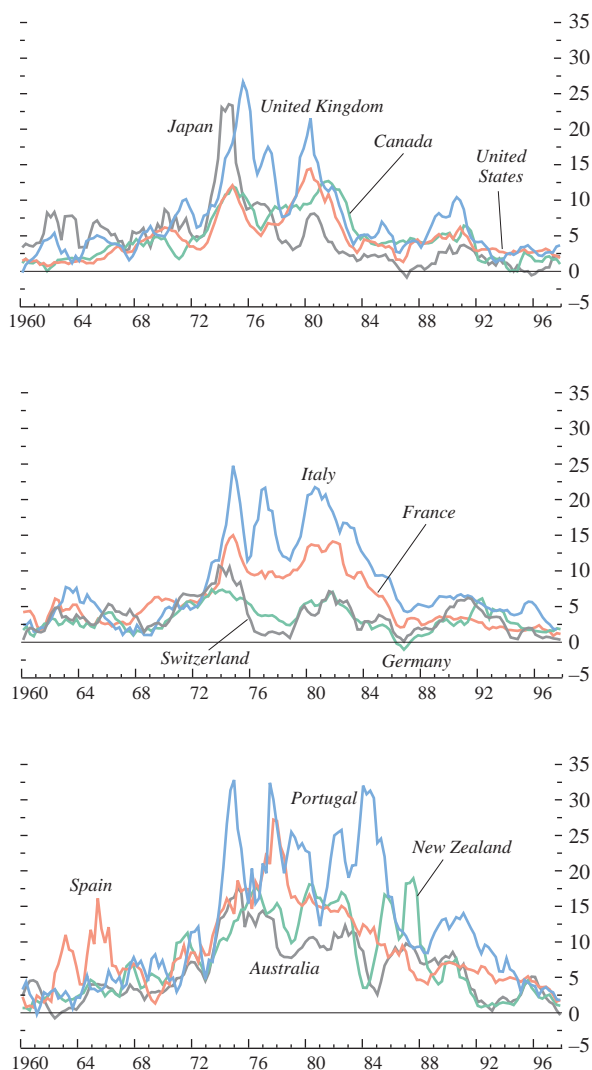
Sources: WEFA, Inc.; and Bloomberg Financial Markets, LP.

¹Yields on government bonds with residual maturities of ten years or nearest.

²Three-month maturities.

Figure 11. Selected Advanced Economies: Inflation
(Annual percent change)

Inflation in most advanced economies stabilized at low levels or continued to fall during 1997.



effects of reserve inflows. The result was a fall in the world money supply and global deflation. These effects were exacerbated by the financial crises that spread around the world in the early 1930s and contributed significantly to the declines in prices and output. Central banks had limited ability under the rules of the gold standard to ameliorate such crises through lender-of-last-resort operations and also appear to have placed little emphasis on their role in preventing banking system collapses.¹²

In assessing the risks of global deflation in present circumstances, it is important to note that the world economic and financial system differs substantially from that at the time of the Great Depression. A key difference is the shift to a system of predominantly flexible exchange rates, under which countries facing deflationary shocks may alleviate their effects to some degree by allowing their currencies to depreciate under market forces. This mechanism has played an important role in promoting adjustment among the world's largest economies in the past two and a half years, by redistributing demand from those countries where growth has been strong—notably the United States and the United Kingdom—to Japan and continental Europe, where growth has been relatively weak (see Chapter III). For the Asian countries in crisis, the stimulus to net exports from the recent, albeit excessive, currency depreciations is likely to provide an important boost to demand that will offset to some degree the deflationary effects of the crisis.¹³ A second important difference from the early 1930s is that central banks and governments, operating without the constraints of the gold standard, have more leeway to adjust monetary and fiscal policies to help to offset any adverse impact on demand from the Asian crisis. A third difference reflects the improved understanding of the crucial role of the central bank's function as lender of last resort in preserving financial market liquidity in a crisis, and the institutional advances in financial market supervision and regulation, which have played an important role in increasing resilience to shocks in the advanced economies. A fourth difference is that there is now a system of global monetary coop-

¹²The failure of the U.S. Federal Reserve to provide sufficient liquidity to the financial system in the early 1930s has also been attributed to a misreading of the stance of monetary policy and to concerns that an expansionary policy could have forced the United States off the gold standard. See, for example, Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton, New Jersey: Princeton University Press, 1963); and Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York: Oxford University Press, 1992).

¹³Indeed, the countries most affected by the crisis are all expected to experience higher inflation in the period ahead, the price effects of the large currency depreciations (combined in some cases with tax increases and subsidy reductions) will more than offset the deflationary impact of lower demand and asset price deflation.

eration that works to avoid policy responses that are harmful at the global level and provides financial support for corrective measures designed to minimize adverse effects both in the countries taking them and internationally.

In addition to these important institutional differences from the 1930s, the prospects for sustained moderate growth in the world economy also argue against any imminent threat of global deflation. Domestic demand is expected to remain robust or strengthen further across a broad range of advanced economies in the period ahead, providing an important offset to the deflationary effects of the Asian crisis. For some countries, moderate inflationary pressures associated with high capacity utilization and tight labor markets are already apparent, particularly in the services sector, and risks of overheating and a more generalized pickup in inflation down the road cannot be disregarded. Unless there is a much more serious downturn in global activity than is currently envisaged, therefore, generalized price deflation does not seem to be a major risk. And were the threat of such a downturn to increase—say in connection with a major correction in global financial markets—the world's major central banks would have considerable scope to ease monetary policy in order to limit the downside risks for activity and thus the likelihood of global deflation.

Implications of Recent Currency Realignments for Countries' International Competitiveness

As the Asian crisis deepened in the second half of 1997 and the beginning of 1998, the currencies of the ASEAN-4 countries and Korea fell precipitously in foreign exchange markets, before recovering partially in the period since January. Notwithstanding this rebound, the value of the Indonesian rupiah in March 1998, in terms of the U.S. dollar, was on average 74 percent lower than nine months earlier, and in the same period there were declines of 31–39 percent in the dollar values of the other currencies at the center of the crisis (Table 7). In Hong Kong SAR, the authorities maintained the exchange rate peg to the U.S. dollar under the currency board arrangement, and in China a stable exchange rate vis-à-vis the U.S. dollar was also maintained, but the Singapore and New Taiwan dollars, the Indian rupee, and the Australian and New Zealand dollars all weakened significantly in late 1997, and among these currencies only the Australian dollar has recovered significantly in early 1998. These declines reflected market pressures stemming, to varying degrees, from concerns about the erosion of competitiveness vis-à-vis the economies in crisis, slower regional growth, financial market linkages, and falling world commodity prices. During this

Figure 12. Advanced Economies: Inflation and Commodity Prices
(Percent change from a year earlier)

Despite sharp increases and decreases in commodity prices since the early 1980s, consumer price inflation in the advanced economies has continued on a steady downward trend.

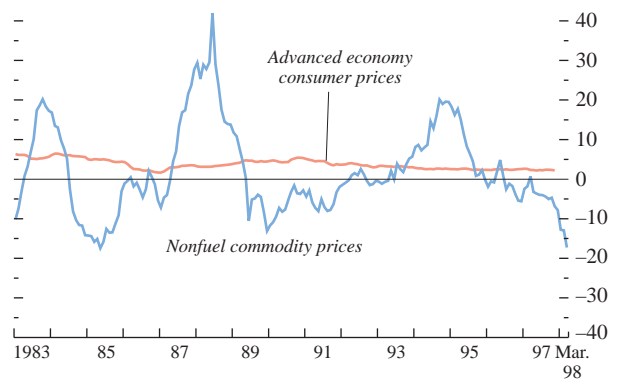
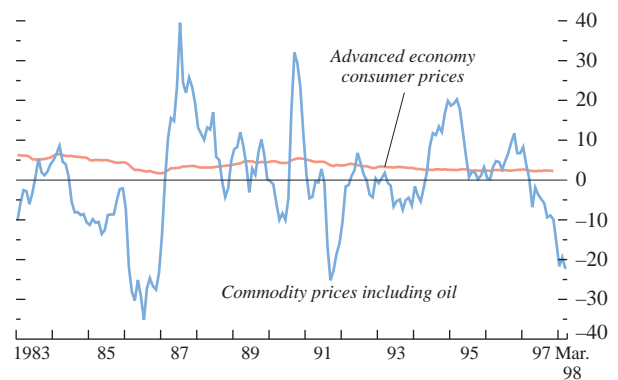


Table 7. Recent Exchange Rate Movements on Bilateral and Multilateral Bases¹*(In percent)*

	Bilateral Exchange Rate		Nominal Effective Exchange Rate		Real Effective Exchange Rate	
	Versus U.S. dollar	Versus Japanese yen	INS weights ²	DOTS weights ³	INS weights ²	DOTS weights ³
United States	—	13.0	9.3	11.8	8.6	9.4
Japan	-11.5	0.0	-2.4	5.3	-4.1	2.1
Germany	-5.4	6.8	-0.3	2.0	-0.8	0.5
France	-4.8	7.5	0.4	1.2	-0.1	—
United Kingdom	1.1	14.2	7.2	9.6	7.7	9.0
Italy	-5.8	6.4	-0.8	1.8	-0.2	1.3
Canada	-2.3	10.4	2.0	-0.7	1.5	-0.9
Australia	-11.1	0.4	-4.6	3.6	-5.6	1.3
New Zealand	-16.8	-6.0	-10.7	-6.9	-10.6	-7.2
China	-0.2	12.7	6.2	11.3	2.9	7.3
India	-9.5	2.2	-3.8	0.9	-0.2	3.7
Hong Kong SAR	—	12.9	7.7	12.1	11.2	14.3
Korea	-39.0	-31.0	-35.3	-30.6	-30.3	-26.4
Singapore	-11.9	-0.5	-0.7	6.2	-1.0	4.7
Taiwan Province of China	-14.1	-3.0	-7.4	-4.4	-9.6	-7.6
Indonesia	-73.9	-70.6	-71.4	-70.3	-63.2	-61.9
Malaysia	-32.3	-23.5	-24.8	-23.5	-23.6	-22.4
Philippines	-31.0	-22.1	-24.8	-24.3	-21.8	-21.4
Thailand	-37.5	-29.4	-31.8	-29.8	-27.1	-25.3
Argentina	—	12.9	5.6	9.4	4.7	6.8
Brazil	-2.6	10.1	2.7	5.5	6.6	8.1
Chile	-7.9	4.1	-2.5	0.6	1.5	3.5
Mexico	-7.1	5.0	-3.5	-5.7	7.8	5.3
Poland	-6.4	5.7	-1.7	-1.5	3.2	4.9
Hungary	-11.5	—	-6.8	-6.7	3.9	5.8
Turkey	-38.8	-30.8	-35.4	-34.3	11.1	12.8
South Africa	-9.5	2.2	-5.1	0.1	-2.2	2.5

Sources: IMF, *Direction of Trade Statistics* (DOTS) and Information Notice System (INS) databases; WEFA, Inc; and IMF staff calculations.
¹Change from June 1997 to March 1998 monthly average data; positive number means appreciation of currency of country indicated at left.

²Partner country weights capture both bilateral and third-country effects, based on data for 1988–90.

³Partner country weights capture only bilateral trade, based on data for 1994–96.

period, the U.S. dollar and pound sterling strengthened further while the yen weakened against all other major currencies.

In the crisis countries, the initial declines in currency values, against the background of financial system disruption and the collapse of investor confidence, took exchange rates below any reasonable assessment of their equilibrium levels on a real multilateral basis, even allowing for the economic dislocation associated with the crisis. The undershooting of equilibrium exchange rates pointed to the scope for rebounds as confidence and tranquility returned, and signs of recovery have already been apparent in exchange rate movements since January. Nevertheless, the size of the exchange rate movements since mid-1997 is such that the pattern of multilateral trade-weighted exchange rates and international competitiveness both in Asia and more generally has been significantly altered. The ultimate effects on competitiveness are difficult to foresee, particularly given the possibility that the exchange rate movements that

have occurred may alter competitiveness and trade shares in third-country markets in ways that are difficult to predict.¹⁴

One measure of international competitiveness is provided by the real effective exchange rate indices based on consumer prices that are computed at the IMF for most member countries and are used in its Information Notice System (INS). The weighting scheme used reflects the relative importance of partner countries in trade in manufactured goods, primary commodities, and, where significant, tourism services, as well as the importance of competition between countries in third-country markets for trade in manufactures.¹⁵ Movements in consumer price indices are

¹⁴The effects on competitiveness will also depend in part on the export pricing behavior of firms in the Asian countries most affected by the crisis.

¹⁵See Alessandro Zanello and Dominique Desruelle, "A Primer on the IMF's Information Notice System," Working Paper 97/71 (Washington: IMF, May 1997).

used to convert nominal into real effective exchange rate indices.¹⁶

For the countries in Asia most affected by the crisis, the large depreciations against the U.S. dollar have entailed substantial depreciations in both nominal and real effective terms (see Table 7). The differences between the depreciations in U.S. dollar terms and on a real effective basis reflect two main factors. First, these countries have significant trade with each other and with other countries whose currencies have fallen against the dollar, and they also compete with one another in third markets. As a result, the changes in trade-weighted nominal effective exchange rates are smaller than those in bilateral dollar rates. Second, the competitiveness gains from currency depreciation are partially offset by higher domestic inflation, related in part to the associated rise in traded-goods prices. As of early 1998, this effect has been fairly limited except in Indonesia, reflecting the significant lags between exchange rate changes and inflation, the effects of price controls or subsidies in some cases, and the sharp compressions underway in domestic demand. Over time, however, higher inflation could become a significant factor tending to erode the initial gains in competitiveness.¹⁷

A shortcoming of the database used to calculate the INS effective exchange rate indices is that the weights are based on trade data for 1988–90 and therefore do not capture more recent changes in trading patterns, including the expansion of trade within the Asian region since the late 1980s. To take account of more recent trade data, a set of alternative effective exchange rate indices was calculated using bilateral trade weights derived from the IMF's Direction of Trade Statistics (DOTS) database for 1994–96. These weights have the advantage of utilizing more up-to-date trade data but suffer from the disadvantages that the level of aggregation is higher and that third-market effects are not captured. In general, for the ASEAN-4 countries and Korea, the DOTS-based estimates of real effective depreciations are slightly smaller than those provided by the INS, but the overall picture is broadly similar (see Table 7, last column).

For most other Asian economies, there are significant divergences between exchange rate movements against the U.S. dollar and on a real effective basis. In

addition, use of the more recent DOTS weights yields somewhat different results from the INS weights in some cases. The Singapore and New Taiwan dollars fell by 12–14 percent against the U.S. dollar in the nine months ended March 1998, but the movements in real effective terms were more modest, particularly for Singapore (where DOTS weights show an appreciation), reflecting its larger trade connections with the ASEAN-4 countries. The Hong Kong dollar appreciated in real effective terms by about 11–14 percent, suggesting that competitiveness has been eroded somewhat given its peg to the U.S. dollar. For China, the renminbi is estimated to have appreciated by 3 percent in real effective terms based on the INS weights, and 7 percent based on the DOTS weights, which would seem to better capture the growing importance of China's trade links with the region. The Indian rupee was little changed on a real effective basis, despite a 10 percent fall against the U.S. dollar. Similarly, the Australian dollar appears to have appreciated modestly in real effective terms using the DOTS weights; measured on the same basis, the depreciation of the New Zealand dollar was somewhat less than its fall against the U.S. dollar might suggest.

For developing countries outside Asia, the competitiveness effects of recent exchange rate movements seem to have been relatively limited, although potential third-market effects could be understated. In Latin America, the currencies of the four largest economies all appreciated somewhat in real effective terms, primarily reflecting the close links to the dollar in the case of Argentina and Brazil and inflation differentials in the case of Mexico. Inflation differentials also account for the moderate real appreciations shown for the other developing countries in Table 7.

Conversely, the sharp weakening in a number of Asian currencies contributed to the further strengthening of the U.S. dollar on a nominal and real multilateral basis.¹⁸ This appreciation extends the dollar's broadly based upswing that began in mid-1995, when the dollar was significantly undervalued, particularly against the yen. Since that time, the real effective value of the dollar has risen by about 25 percent, reaching its highest level since late 1986 and implying a significant erosion of international competitiveness (Figure 13). For the Japanese yen, the boost to competitiveness from its further decline against the dollar and the currencies of other industrial countries has been broadly offset by the yen's appreciation against other countries in the Asian region. As a result, a slight appreciation since mid-1997 is shown using the DOTS weights (in Table 7). Among the other major industrial

¹⁶As discussed in Zanello and Desruelle (cited above), real effective exchange rate indices are also calculated for 21 industrial countries using relative unit labor costs in manufacturing rather than relative consumer prices as the deflator. For an extension of this methodology to encompass 23 additional economies, see Anthony G. Turner and Stephen S. Golub, "Multilateral Unit-Labor-Cost-Based Competitiveness Indicators for Advanced, Developing, and Transition Countries," in *Staff Studies for the World Economic Outlook* (Washington: IMF, December 1997), pp. 47–60.

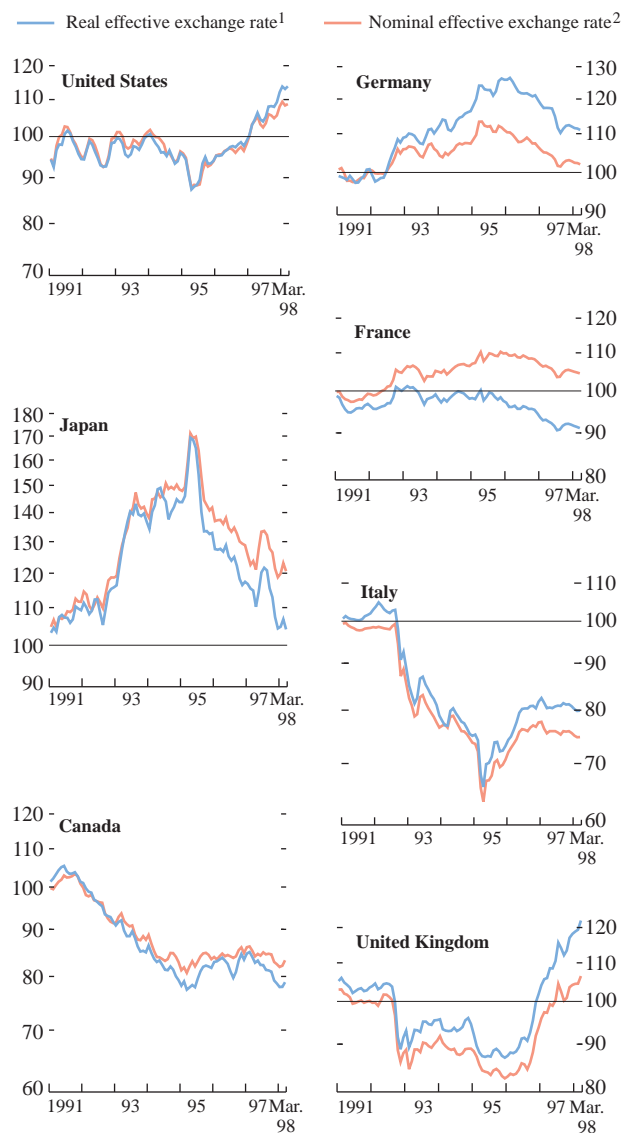
¹⁷Note that the consumer price index is not the best measure of price or cost developments in the traded-goods sector, particularly in the case of exports with a high import content.

¹⁸See also Figure 13, which shows the effective exchange rates for the major industrial countries using relative normalized unit labor costs as the deflator for the real effective exchange rate indices.

**Figure 13. Major Industrial Countries:
Effective Exchange Rates**

(Logarithmic scale; 1990 = 100)

Declines in Asian currencies have contributed to a further strengthening of the U.S. dollar; the U.K. pound has reached a 17-year high.



¹Defined in terms of relative normalized unit labor costs in manufacturing, as estimated by the IMF's Competitiveness Indicators System, using 1989–91 trade weights.

²Constructed using 1989–91 trade weights.

countries, for whom trade with the Asian region makes up a significantly smaller share of total trade, recent movements in real multilateral rates mainly reflect exchange rate movements against other industrial country currencies. The pound sterling has strengthened further on a real effective basis since mid-1997, reaching a new 17-year high, while the real effective values of the currencies of the other major European countries and Canada are little changed.

Prospects for Global Flows of Funds and Current Account Balances

Net private capital flows to emerging market countries (that is, all developing, newly industrialized, and transition countries) reached a record high of \$240 billion in 1996, with Asia attracting the largest share by far (Table 8). After rising further in the first half of 1997, net inflows then declined steeply as the crises in east Asia deepened. For 1997 as a whole, net inflows to emerging markets are estimated to have been \$67 billion less than in 1996, with net inflows to the developing countries of Asia falling to the lowest level since 1992. There was a smaller decline in inflows to the developing countries of the Middle East and Europe, while inflows to the Western Hemisphere and the countries in transition increased.

Data on gross private financing flows to emerging market countries indicate that new financing peaked in the second and third quarters of 1997 (Table 9). As the crisis unfolded, new bond issuance by the Asian economies dropped off considerably. Outside Asia, bond issuance was broadly unchanged initially, but by November bond issues by all emerging market countries had dropped to very low levels, where they remained through the end of the year, before recovering somewhat outside Asia in early 1998. New loan commitments to countries in Asia also fell during the fourth quarter and more broadly in early 1998. Equity issues generally fell to low levels in late 1997.

Net capital flows to emerging market countries in 1998 are projected to be some \$52 billion lower than in 1997, and thus about half the record level of 1996 and the lowest since 1992 (see Table 8). Net inflows to the developing countries of Asia are projected at only \$1.5 billion, compared with the peak of \$102 billion in 1996. These projections assume that there is some gradual recovery in the course of 1998 from the level of inflows seen at the turn of the year.¹⁹ Capital flows to Asia are expected to recover only slowly; Latin

¹⁹Secondary market yield spreads on dollar-denominated Eurobonds issued by emerging market countries increased significantly in the latter part of 1997 as the Asian crisis deepened and spread to other emerging market countries. See *World Economic Outlook: Interim Assessment* (December 1997), p. 19.

Table 8. Developing Countries, Countries in Transition, and Newly Industrialized Economies: Net Capital Flows¹*(In billions of U.S. dollars)*

	1984–89 ²	1990–96 ²	1994	1995	1996	1997	1998	1999
Total								
Net private capital flows ³	15.2	148.1	160.5	192.0	240.8	173.7	122.0	196.4
Net direct investment	12.9	63.1	84.3	96.0	114.9	138.2	119.6	119.7
Net portfolio investment	4.7	54.1	87.8	23.5	49.7	42.9	18.0	34.4
Other net investment	-2.5	30.9	-11.7	72.5	76.2	-7.3	-15.6	42.3
Net official flows	23.9	15.3	-2.5	34.9	-9.7	29.0	37.0	-8.9
Change in reserves ⁴	-13.8	-81.2	-77.2	-120.5	-115.9	-54.7	-67.1	-91.1
Developing countries								
Net private capital flows ³	18.2	131.2	136.6	156.1	207.9	154.7	99.5	168.6
Net direct investment	12.1	56.8	75.4	84.3	105.0	119.4	99.1	99.1
Net portfolio investment	4.2	49.3	85.0	20.6	42.9	40.6	19.4	32.2
Other net investment	1.9	25.1	-23.8	51.2	60.0	-5.3	-19.0	37.3
Net official flows	25.8	15.6	9.1	27.4	-3.4	17.5	28.6	5.7
Change in reserves ⁴	5.8	-55.7	-42.4	-65.6	-103.4	-55.2	-37.3	-80.8
Africa								
Net private capital flows ³	3.6	4.4	10.6	13.8	4.5	8.9	7.5	11.3
Net direct investment	1.1	2.9	3.6	4.2	5.3	7.7	6.0	6.9
Net portfolio investment	-0.8	-0.2	0.5	1.4	-0.3	2.6	1.7	1.8
Other net investment	3.3	1.6	6.5	8.1	-0.6	-1.3	-0.1	2.6
Net official flows	5.1	7.1	8.1	5.2	6.5	8.4	4.4	4.9
Change in reserves ⁴	0.2	-1.9	-4.4	-1.4	-6.4	-11.3	-2.2	-3.3
Asia								
Net private capital flows ³	13.0	55.9	63.1	91.8	102.2	38.5	1.5	58.8
Net direct investment	4.5	32.2	43.4	49.7	58.5	55.4	40.6	43.7
Net portfolio investment	1.5	6.8	11.3	10.8	10.2	-2.2	-7.0	5.3
Other net investment	7.0	16.9	8.3	31.3	33.5	-14.7	-32.1	9.8
Net official flows	7.7	8.4	6.2	5.1	9.3	17.7	24.7	7.0
Change in reserves ⁴	-2.1	-29.0	-39.7	-29.0	-48.9	-17.2	-24.4	-65.5
Middle East and Europe								
Net private capital flows ³	1.7	25.2	15.5	14.8	20.7	16.1	18.7	16.4
Net direct investment	1.1	3.0	4.2	5.1	4.3	5.1	4.6	5.8
Net portfolio investment	4.4	12.8	12.5	8.4	7.9	6.8	5.2	4.7
Other net investment	-3.8	9.4	-1.2	1.3	8.6	4.2	9.0	5.9
Net official flows	4.8	-1.8	-1.2	-4.8	-5.8	-1.3	-1.5	-1.4
Change in reserves ⁴	7.2	-6.4	-3.1	-9.4	-21.2	-14.3	-2.4	-3.4
Western Hemisphere								
Net private capital flows ³	-0.2	45.7	47.4	35.7	80.5	91.1	71.7	82.0
Net direct investment	5.3	18.7	24.3	25.3	36.9	51.2	48.0	42.6
Net portfolio investment	-0.9	29.9	60.6	-0.1	25.2	33.5	19.5	20.4
Other net investment	-4.6	-2.8	-37.5	10.5	18.5	6.5	4.2	19.0
Net official flows	8.2	1.8	-4.0	22.0	-13.4	-7.3	1.0	-4.8
Change in reserves ⁴	0.5	-18.4	4.7	-25.9	-27.0	-12.3	-8.3	-8.6
Countries in transition								
Net private capital flows ³	-1.0	12.8	18.4	29.8	21.3	34.5	35.4	39.2
Net direct investment	-0.2	6.3	5.4	13.2	13.1	18.2	18.5	20.0
Net portfolio investment	—	2.0	4.1	2.9	2.2	7.3	8.8	9.6
Other net investment	-0.8	4.6	8.9	13.6	5.9	9.0	8.2	9.6
Net official flows	0.2	0.5	-11.0	8.4	-5.5	0.8	3.5	-4.4
Change in reserves ⁴	-3.6	-7.8	-8.5	-35.9	0.4	-6.2	-4.9	-3.6
Newly industrialized economies⁵								
Net private capital flows ³	-2.0	4.1	5.5	6.1	11.7	-15.4	-12.9	-11.3
Net direct investment	1.0	0.1	3.5	-1.5	-3.2	0.6	2.0	0.7
Net portfolio investment	0.5	2.8	-1.2	0.0	4.6	-5.0	-10.2	-7.4
Other net investment	-3.6	1.2	3.2	7.6	10.3	-11.1	-4.8	-4.6
Net official flows	-2.0	-0.8	-0.6	-0.9	-0.8	10.7	5.0	-10.2
Change in reserves ⁴	-16.0	-17.7	-26.3	-19.0	-12.9	6.7	-24.9	-6.7

¹Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing.

²Annual averages.

³Because of data limitations, other net investment may include some official flows.

⁴A minus sign indicates an increase.

⁵Hong Kong SAR, Korea, Singapore, Taiwan Province of China, and Israel.

Table 9. Gross Private Financing to Emerging Market Economies*(In billions of U.S. dollars)*

	1996	1997	1997							1998	
			Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.	Jan.	Feb.
Total	226.6	319.8	58.7	94.5	93.8	72.8	32.2	22.3	18.6	5.9	7.8
Asia	121.9	147.6	34.2	45.8	39.8	27.9	16.9	5.3	5.8	1.4	0.9
Europe	23.4	44.0	5.9	15.5	9.1	13.6	5.8	5.4	2.5	1.2	2.5
Middle East and Africa	17.8	33.5	2.8	5.4	12.5	12.7	2.0	4.8	5.9	0.9	0.6
Western Hemisphere	63.7	94.9	15.9	27.7	32.5	18.7	7.5	6.8	4.4	2.4	3.7
Bond issues	101.9	127.9	27.7	43.0	44.8	12.4	9.3	1.7	1.4	4.0	5.1
Asia	43.1	45.5	12.7	15.9	14.2	2.7	2.2	0.1	0.4	—	—
Western Hemisphere	47.2	54.2	11.9	18.7	19.8	3.8	3.1	0.2	0.5	2.2	3.0
Other regions	11.6	28.2	3.1	8.4	10.8	5.9	4.0	1.4	0.5	1.8	2.1
Loan commitments	108.4	167.3	27.8	43.3	42.7	53.5	18.6	18.6	16.3	1.6	2.2
Asia	69.0	88.9	18.6	26.4	23.4	20.6	11.5	4.5	4.6	1.3	0.7
Western Hemisphere	12.8	35.6	3.9	7.4	10.2	14.0	3.6	6.5	3.9	0.2	0.7
Other regions	26.6	42.8	5.3	9.5	9.1	18.9	3.5	7.6	7.8	0.1	0.8
Equity issues	16.4	24.7	3.2	8.2	6.3	7.1	4.3	1.9	0.9	0.3	0.5
Asia	9.8	13.2	2.9	3.5	2.2	4.6	3.2	0.7	0.8	0.1	0.2
Western Hemisphere	3.7	5.1	0.1	1.6	2.5	0.9	0.8	0.1	—	—	—
Other regions	2.9	6.4	0.2	3.1	1.6	1.6	0.3	1.1	0.1	0.2	0.3

Source: Capital Data Loanware and Bondware.

America and the transition countries are expected to experience increases in their shares of private capital flows to emerging market countries.

The sharp declines in private capital flows in 1997–98 will require substantial adjustments of external positions by many emerging market countries, particularly those in Asia, although this adjustment is being cushioned by official financing flows. For the countries most severely affected by the Asian crisis—Indonesia, Korea, Malaysia, the Philippines, and Thailand—the large currency depreciations and compression of domestic demand are expected to generate a shift toward current account surplus between 1996 and 1998 amounting to about \$75 billion. Current account surpluses are expected in 1998 in all these countries except Malaysia and the Philippines, and they could turn out to be larger than projected here (Table 10).

Other emerging market countries also experienced declines in capital inflows as a result of contagion from the early stages of the Asian crisis. In Brazil, the current account deficit is expected to narrow to 3¼ percent of GDP in 1998, reflecting the tightening of policies implemented as the crisis was deepening. The Czech Republic and Pakistan are among other countries that are expected to reduce their current account deficits significantly in the period ahead, also as a result of adjustment measures. In a number of other emerging market countries, current account deficits are projected to increase. In Argentina, a slowdown in exports and higher interest payments are expected to outweigh a slowdown in imports, with the current account deficit widening to 4¼ percent of GDP in 1998 from 3¾ percent in 1997. In Mexico, fiscal restraint is expected partly to offset the effect

of lower oil prices, but the current account deficit is projected to widen to 2½ percent of GDP in 1998 from 1¾ percent in 1997. The sharp decline in oil prices is expected to result in deteriorations in the current account positions of several other oil-exporting developing countries in 1998; for the developing countries whose export earnings are dominated by exports of fuel, the deterioration from 1997 is projected at \$26 billion.

Taking all developing, newly industrialized, and transition countries together, an improvement of \$13 billion in current account positions is projected for 1998 compared with 1997. The overall current account deficit of the industrial countries is projected to widen by \$70 billion, with a \$61 billion deterioration projected for the United States; the current account surplus of the European Union is expected to narrow by \$23 billion (see Statistical Appendix, Table A27). The U.S. current account deficit is expected to increase to about 2¾ percent of GDP from its level of around 2 percent over the past several years, reflecting the effects of the Asian crisis together with continued buoyancy in domestic demand and the strength of the dollar. Canada's current account deficit is also projected to widen from its 1997 average level, and the United Kingdom's current account is expected to swing from a small surplus to a deficit of 1 percent of GDP in part owing to the appreciation of sterling. Elsewhere in Europe, however, recent currency depreciations and lower import prices are likely to offset the decline in exports to Asia, leaving the current account balances of the major continental countries as a whole broadly unchanged. In Japan, the substantial negative impact of

**Table 10. Selected Economies:
Current Account Positions***(In percent of GDP)*

	1995	1996	1997	1998	1999
Advanced economies					
United States	-1.8	-1.9	-2.1	-2.7	-2.6
Japan	2.2	1.4	2.2	3.0	2.9
Germany	-1.0	-0.6	-0.3	—	0.1
France	0.7	1.3	2.7	2.3	2.3
Italy	2.3	3.2	2.9	2.5	2.4
United Kingdom	-0.5	-0.1	0.6	-1.1	-1.1
Canada	-1.0	0.4	-2.0	-2.4	-1.7
Australia	-5.6	-4.0	-3.4	-5.0	-4.9
Austria	-2.0	-1.8	-1.8	-1.6	-1.5
Finland	4.1	3.8	5.3	5.2	5.0
Greece	-2.1	-2.6	-2.9	-2.5	-2.1
Hong Kong SAR ¹	-3.9	-1.3	-1.5	-0.4	0.4
Ireland	2.8	2.0	1.8	1.7	1.5
Israel	-5.6	-5.6	-3.4	-3.6	-3.9
Korea	-2.0	-4.9	-2.0	5.5	4.9
New Zealand	-3.7	-4.1	-7.7	-7.4	-6.7
Norway	3.3	7.1	5.5	4.0	5.5
Singapore	16.8	15.7	15.2	14.3	14.4
Spain	0.2	0.3	0.5	0.1	-0.2
Sweden	2.1	2.5	3.1	3.8	4.1
Switzerland	6.9	7.3	8.3	7.4	7.3
Taiwan Province of China	2.1	4.0	2.3	2.5	2.7
<i>Memorandum</i>					
European Union	0.6	1.1	1.4	1.1	1.2
Developing countries					
Algeria	-5.3	2.7	7.2	-0.5	-0.4
Argentina	-1.5	-1.9	-3.8	-4.3	-4.4
Brazil	-2.5	-3.3	-4.2	-3.3	-3.5
Cameroon	-0.4	-2.4	-1.3	-2.1	-2.3
Chile	0.2	-4.1	-4.0	-5.1	-5.0
China	0.2	0.9	2.4	2.1	1.9
Côte d'Ivoire	-6.0	-4.8	-4.5	-4.1	-3.2
Egypt	2.3	-0.3	0.7	-1.6	-2.6
India	-1.6	-1.2	-1.5	-1.1	-1.2
Indonesia	-3.3	-3.3	-2.6	1.9	0.5
Malaysia	-10.0	-4.9	-4.8	-0.5	-1.9
Mexico	-0.5	-0.8	-1.8	-2.5	-2.6
Nigeria	-1.4	4.4	1.5	-1.7	-2.5
Pakistan	-3.4	-6.5	-6.0	-5.1	-4.1
Philippines	-4.4	-4.7	-5.4	-3.2	-2.9
Saudi Arabia	-4.3	1.0	-1.7	-8.3	-6.0
South Africa	-2.0	-1.3	-1.5	-2.2	-2.8
Thailand	-7.9	-7.9	-2.2	3.9	2.2
Turkey	-0.6	-1.5	-1.7	-1.0	-1.0
Uganda	-2.5	-1.8	-0.9	-2.0	-2.3
Countries in transition					
Czech Republic	-2.7	-7.6	-6.3	-4.3	-3.6
Hungary	-5.7	-3.8	-2.2	-3.1	-3.5
Poland ²	3.3	-1.0	-3.2	-4.8	-5.4
Russia	1.3	0.5	-0.3	-1.2	-1.4

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

the adjustment of other Asian economies is expected to be outweighed by the weakness of domestic demand and the yen's depreciation against other industrial country currencies, so that the current account

surplus is projected to increase somewhat to 3 percent of GDP in 1998–99.²⁰

The outcome of the projected changes in current account balances in 1998 implies a widening in the global current account discrepancy of about \$57 billion. This increase—which seems unlikely to be realized, given that the global discrepancy has been broadly stable in relation to trade flows in recent years—suggests either that emerging market countries will need to undertake larger current account adjustments than allowed for in these projections or that the deterioration in industrial countries' current account positions will be smaller than projected, permitting larger net capital flows to the emerging market countries. Given the adverse shift in financial market sentiment toward emerging market countries and the efforts being made by many countries to contain external imbalances, it still seems more likely, as it did in the December 1997 *Interim Assessment*, that this tension in the projections will be resolved through lower-than-projected capital flows to the emerging market countries, with a correspondingly larger current account adjustment by them. The risks to the projections for emerging market economies' growth and imports therefore seem to remain on the downside.

Outlook for Japan

Economic conditions in Japan deteriorated sharply in 1997 following a temporary surge in activity prior to the April consumption tax increase. In part, the faltering of growth reflected underlying weakness in private demand that had been obscured by a shifting forward of spending in advance of the consumption tax increase. Fiscal policy was also more contractionary than initially expected. In addition, confidence was undermined by continuing strains in the financial sector and concerns about spillover effects from the financial crises elsewhere in Asia. Lower confidence, in turn, put downward pressure on equity prices toward the end of the year, weakening the capital base of the banks and reinforcing doubts about their ability to deal with nonperforming loans.

Continuing strains in the financial sector and their consequences for the supply of credit, low confidence, and weak activity elsewhere in Asia are likely to continue to adversely affect business investment further this year. Zero growth in real GDP is projected in 1998, with continued weakness expected in domestic demand. Important questions surround this outlook. How will the Asian financial crisis affect the

²⁰Despite the widening projected for the current account deficit of the United States and the current account surplus of Japan, both imbalances relative to GDP are projected to remain smaller than in the mid-1980s.

external sector, and to what extent will its contractionary effect on net exports be offset by yen weakness and developments in other foreign markets? What actions can be taken to restore confidence in the financial sector and to avoid a credit crunch? How will fiscal policy evolve following the sharp contraction in 1997?

As regards the Asian crisis, Japan will be affected more than the other major industrial countries, given Japan's strong trade linkages with and large volume of lending to the region. About 20 percent of Japan's merchandise exports in 1996 were to the five Asian countries most affected by financial turmoil, while about 17 percent of imports originated from these countries. Given these trade shares, if the combined import volume of these countries hypothetically fell by 15 percent as a result of the crisis, while their exports rose by half as much, Japan's real trade balance would be reduced by about $\frac{1}{2}$ of 1 percent of GDP. Allowing for second-round effects of lower activity and incomes on domestic spending, the overall impact on GDP could amount to about $\frac{3}{4}$ of 1 percent.

This represents the partial impact through trade of the Asian crisis on Japan, holding constant other factors affecting the external outlook. These include the yen's exchange rate. Movements in the exchange value of the yen in recent months have been mixed. As discussed above, the yen depreciated sharply against other major currencies in the latter half of 1997, reaching in early 1998 its lowest level against the dollar since early 1992.²¹ In multilateral terms, however, the declines against major currencies were balanced by the rise in the yen versus other Asian currencies, so that the nominal and real effective value of the yen fell by much less; in fact, it rose on the basis of the DOTS weights referred to earlier. Taking a longer view, however, there is likely to be some continuing positive effect on Japan's trade position from the substantial decline in the value of the yen from its peak in 1995. In addition, the prospect of solid demand growth in other major industrial countries should help to offset weak growth elsewhere in Asia, while weak domestic demand will restrain imports. Taking these considerations into account, a modest positive contribution to growth from the external sector seems plausible this year.

In the financial sector, strains intensified toward the end of 1997, as two major institutions failed, revealing unexpectedly large losses. The exposure of Japanese banks to Asia, in conjunction with the stagnation of the domestic economy, also heightened concerns about fu-

ture loan losses.²² Finally, falling equity prices reduced the banks' hidden reserves and Tier 2 capital ratios, impairing their ability to write off existing bad loans while providing new credit to solvent borrowers (Figure 14). These factors led to a sharp rise in the "Japan premium" to around 50–100 basis points by December, which in turn reinforced concerns about bank profitability and credit availability.²³

To address the deteriorating situation, the government has introduced a number of measures to restore confidence in the financial system and reduce the risk of a credit crunch. They included the provision of up to ¥17 trillion ($3\frac{1}{2}$ percent of GDP) in public funds to the Deposit Insurance Corporation (DIC) to protect depositors of failed banks, and the provision of an additional ¥13 trillion in funds to the DIC to purchase preferred shares and subordinated debt of solvent banks. These measures boost significantly the funds available to resolve failed institutions and protect depositors, and they have had some effect in boosting market confidence since mid-January. The commitment of significant public funds is expected to reduce the burden on healthy banks and allow a more decisive approach to winding up insolvent institutions. Injections of public capital into solvent banks are also desirable to avoid an unwarranted contraction of bank lending, but the criteria for such injections needs to be appropriate and transparent, with a view to making sure that banks receiving funds undertake the necessary restructuring to ensure their longer-term viability. Over the medium term, these short-term stabilization measures underscore the need to foster a competitive, efficient, and market-based financial system in line with the original Big Bang reform plans.

Fiscal policy was strongly contractionary in 1997, as the increase in the consumption tax, the ending of a temporary income tax cut, and a sharp decline in public investment led to a $1\frac{1}{2}$ percentage point drop in the structural deficit as a percent of GDP (including social security). The budget for fiscal year 1998 envisages significant further spending cuts. Although their impact would be partially offset by the reintroduction of ¥2 trillion in temporary income tax cuts and other tax measures, the structural deficit would decline by $\frac{1}{2}$ of 1 percent of GDP, implying a continued withdrawal of fiscal stimulus. In late March, proposals were announced for a fiscal stimulus package amounting nominally to ¥16 trillion or more than 3 percent of GDP, but with insufficient detail to permit an estimate of its economic impact. As prospects for sustained recovery become more assured, of course, firm consolidation

²¹The yen rebounded significantly against other major currencies during January and February, but fell back again during March and early April. The projections in this issue of the *World Economic Outlook* are based on the assumption that real effective exchange rates are constant at levels prevailing in the period February 9–March 4, 1998.

²²BIS data indicate that Japanese bank lending to the five most affected countries stood at about \$100 billion at end-June 1997, equivalent to about 3 percent of the banks' risk-weighted assets.

²³This is the premium charged on borrowing by Japanese banks in international interbank markets.

measures will be needed to address the existing fiscal imbalance as well as future strains associated with population aging.

Although sound macroeconomic policies are critical to supporting recovery in Japan, more rapid implementation of structural reforms and further deregulation measures are also necessary to help reinvigorate the Japanese economy.

Emerging Market Countries: Selected Issues

What Shape Is the Recovery in East Asia Likely to Take?

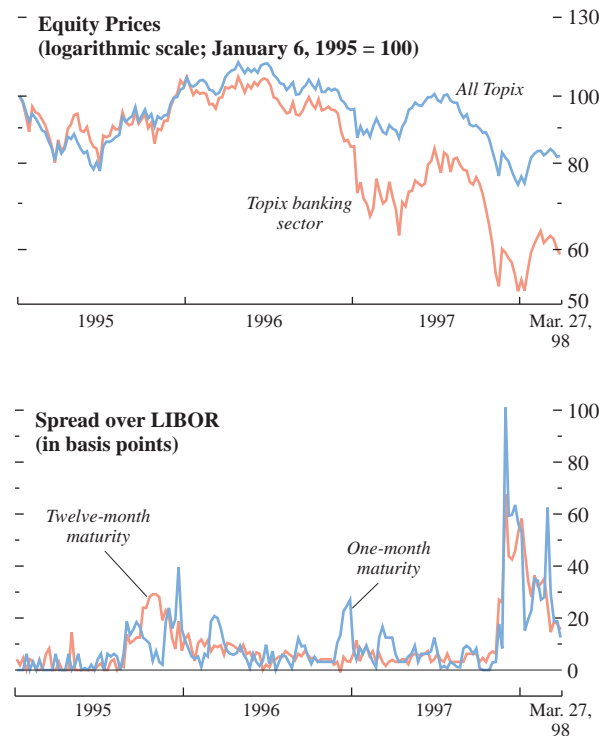
The recent financial crises in east Asian countries will result in sharp reductions in their near-term growth rates. Indeed, the combined output of the five countries most affected—Indonesia, Korea, Malaysia, the Philippines, and Thailand—is projected to decline this year after average annual growth of 7–8 percent during 1990–96. Downturns will be led by sharp compressions of domestic demand as real income and wealth are reduced by lower currency values and equity prices, access to international capital markets is cut, and financial sector problems disrupt domestic credit supply.

While there is little doubt that the region will experience a pronounced slowdown this year, it is less clear when recoveries will begin and how strong they will be. Two factors will be key in cushioning the downturns and providing the impetus for recovery. The first is the response of trade balances to the improved competitiveness provided by large real currency depreciations. The second is a recovery of financing flows, both internationally and domestically, that would pave the way for renewed growth in private spending. The trade effects are likely to come first. But there are limits to how far trade adjustments can go in initiating sustained growth. As discussed below, past experience suggests that full-fledged recoveries are unlikely to occur until confidence is restored in domestic financial sectors.

Considering first the outlook for trade, declines in the real effective exchange rates of these countries from precrisis levels have implied massive increases in both export competitiveness and relative import prices. To the extent that trade flows are responsive to real exchange rate movements, these depreciations, if maintained, would provide a significant buffer to the expected sharp declines in domestic demand. The experience of Mexico in 1995 is instructive in this regard. In the wake of the crisis that began in December 1994, domestic demand in Mexico plunged by 14 percent in 1995 compared with past trend growth of about 5 percent, while the real effective exchange rate declined by about 33 percent. In response, the trade

Figure 14. Japanese Banking Sector: Selected Indicators

Heightened concerns about the banking sector resulted in a sharp decline in equity prices and an increase in the “Japan premium.”



Source: Bloomberg Financial Markets, LP.

position turned around dramatically, swinging from a deficit of almost 5 percent of GDP in 1994 to a 3 percent surplus in 1995. In the five east Asian economies, the cumulative reduction in domestic demand during 1997–98 relative to trend growth is projected at over 20 percent (over two years), while real effective exchange rates as of early 1998 had fallen by an average of 40 percent from precrisis levels. If the response in the five Asian economies were proportional to that in Mexico, the swing in their combined trade position from 1996 to 1998 would therefore be even larger, relative to GDP, than in Mexico. The effect would be magnified additionally by the Asian economies' greater openness to trade, with precrisis ratios of exports and imports to GDP ranging from 25 percent for Indonesia to 90 percent for Malaysia, compared with only 20 percent for Mexico. Thus, improvements of 10 percent of GDP or more in trade positions seem quite possible, which would offset roughly half of the combined shock to domestic demand.

Of course, the extrapolation of the Mexican experience can be problematic, given the larger shocks the Asian economies have been experiencing. There may, for instance, be diminishing responses at the margin to movements in activity and relative prices. And special features of the Asian crisis, such as the financing constraints faced by exporters in some countries as a result of disruption of the financial system, could limit their ability to expand production in response to enhanced competitiveness. Finally, the declines in currency values observed through early 1998 may not be sustained, especially as the effect on trade positions of such large depreciations becomes apparent. Indeed, by late 1997, monthly trade data already indicated a significant improvement in the combined trade balance of the five Asian economies from levels a year ago (Figure 15). This trend is likely to continue in early 1998 as the full impact of the crisis is felt in these countries.

While trade adjustments will play a central role in containing declines in activity in the near term, they represent onetime responses to changes in activity and relative prices; full-scale recoveries will need to be driven by rebounds in domestic demand. Domestic demand, in turn, is unlikely to stage a meaningful resurgence until confidence is restored in the financial sectors of these countries. The extent to which confidence collapsed in late 1997 is evident from the plunge in gross private financing flows to Asian emerging market economies to \$6 billion in December 1997, from \$12 billion in December 1996 with a peak of about \$20 billion in July 1997. In addition to directly reducing credit availability, this collapse in external financing has exacerbated strains in domestic financial sectors. Combined with preexisting structural weaknesses in the financial sectors of Indonesia, Korea, and Thailand and a surge in bad loans as activity weakened and interest rates rose, domestic financial intermediation has been severely disrupted.

The historical experience of financial sector crises in other countries is instructive in terms of the conditions that would lead to sustained recovery in east Asia. Figure 16 shows the paths of output gaps in four such episodes: the Great Depression in the United States in the 1930s; the debt crisis in Chile in the early 1980s; the crisis in Mexico in the mid-1990s; and the prolonged slowdown in Japan beginning in the early 1990s. The severity of the financial crises and the associated downturns in activity vary widely across these episodes, of course, with the U.S. experience in the 1930s being at the most severe end of the scale; the Japanese downturn, while prolonged, has been relatively mild. They also illustrate quite different recovery paths following the onset of downturns: Mexico experienced a sharp but short-lived “V-shaped” cycle; Chile and the United States experienced much larger “U-shaped” recessions; and Japan has witnessed a shallow but prolonged “L-shaped” downturn that, as yet, shows no sign of ending.

It is interesting that, in the first three cycles, turnarounds did not occur until decisive actions were taken to deal with the bad loans of the banking system and to wind up insolvent institutions. In the United States, this occurred at the time of the bank holiday of 1933; in Chile, the decisive actions were taken in 1984, when the central bank purchased the bad loans of the commercial banks; in Mexico, the turning point came in 1995, with the establishment of programs to recapitalize banks and restructure nonperforming loans. Sustained recoveries began in all three cycles in the year following these actions, with steps to address macroeconomic imbalances also playing an important role.

In Japan, in contrast, the actions taken prior to this year to resolve financial sector problems were much more limited in scope, based on the expectation that banks would be able to earn their way out of difficulties. With strains in the financial sector having intensified in late 1997, however, the authorities responded early this year with a more comprehensive plan that includes significant amounts of public funds to facilitate the closure of insolvent institutions and recapitalize others. Financial markets reacted favorably, and it is hoped that these actions will help to establish the basis for a durable recovery in the period ahead.

While each crisis has unique elements, these experiences suggest that the implementation of decisive reforms to restore confidence in the financial sector is key to initiating sustained recoveries. In Asian economies such as Indonesia, Korea, and Thailand, this will require actions to close insolvent institutions and recapitalize viable banks, combined with longer-term structural reforms to strengthen prudential standards and supervision. Considerable progress has been made in this direction, and the market response has been favorable, with significant reversals of exchange rates and equity prices from the troughs reached in

mid-January. The full effects of the economic downturns on corporate bankruptcy and overall asset quality have yet to be felt, however, and access to new private capital flows remains limited. Following through on financial reforms in the face of these constraints will undoubtedly involve further difficult policy decisions, but past experience suggests that appropriate actions will set the stage for renewed growth, which in turn will help to restore the health of the financial system.

How Well Has Latin America Weathered the Asian Storm?

As the financial crisis in Asia intensified in the closing months of 1997, financial markets in some of the Latin American emerging market countries also came under pressure, most markedly in Brazil, but significantly also in Argentina, Chile, and Mexico. In all four countries, however, immediate policy tightening helped to ease the pressures significantly.

In Brazil, the authorities have since March 1995 maintained an adjustable exchange rate band, and since 1996 they have depreciated the *real* against the U.S. dollar at an annualized rate of 7 percent. However, the *real* came under intense downward pressure in late October 1997, as a stubbornly large budget deficit and a growing current account deficit renewed doubts about the sustainability of the band. The authorities initially responded by intervening in the exchange market, but very quickly thereafter they tightened monetary conditions through a sharp increase in short-term interest rates (Figure 17). Furthermore, in November, the government introduced a strengthened fiscal package that included several revenue-enhancing and expenditure-cutting measures aimed at reducing the fiscal deficit to 3½ percent of GDP in 1998 from 6 percent in 1997. Financial markets reacted positively to these measures, and exchange rate pressures eased. Economic growth is expected to weaken temporarily as a result of the tightening of policies. Thus projected growth for 1998 has been revised down to 1½ percent from around 4 percent in the October 1997 *World Economic Outlook* (Table 11).

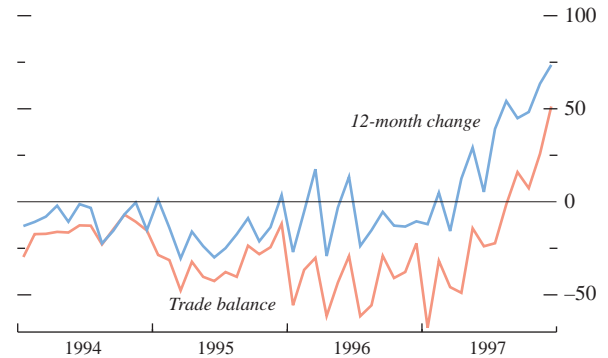
Financial market pressures were also felt in Argentina, with spreads on sovereign debt widening significantly during November, and corresponding upward pressure on domestic interest rates. Subsequently, interest rates declined markedly as pressure eased, returning to their precrisis levels. These tighter financial conditions together with the projected economic slowdown in Brazil—Argentina’s main trading partner—are expected to lead to more sluggish growth in overall activity in Argentina this year than was projected earlier. Growth of real GDP, which reached almost 8½ percent in 1997, is currently projected to slow to 5½ percent in 1998.

In Mexico, the peso declined by about 7 percent against the dollar when the Asian crisis intensified in

Figure 15. ASEAN-4 plus Korea: Aggregate Trade Balance¹

(In billions of U.S. dollars; annual rate)

By late 1997 the aggregate trade balance of the five Asian countries had already registered a significant improvement from levels a year ago.



¹The ASEAN-4 countries are Indonesia, Malaysia, the Philippines, and Thailand.

Figure 16. Paths of Output Gaps in Cases of Financial Sector Shocks

(Percent of trend output)

The severity of the financial crisis and associated increase in the output gap vary widely across episodes of financial crisis.

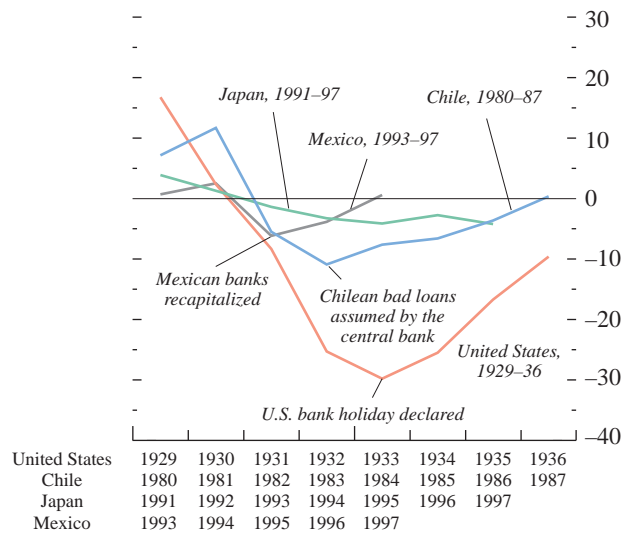
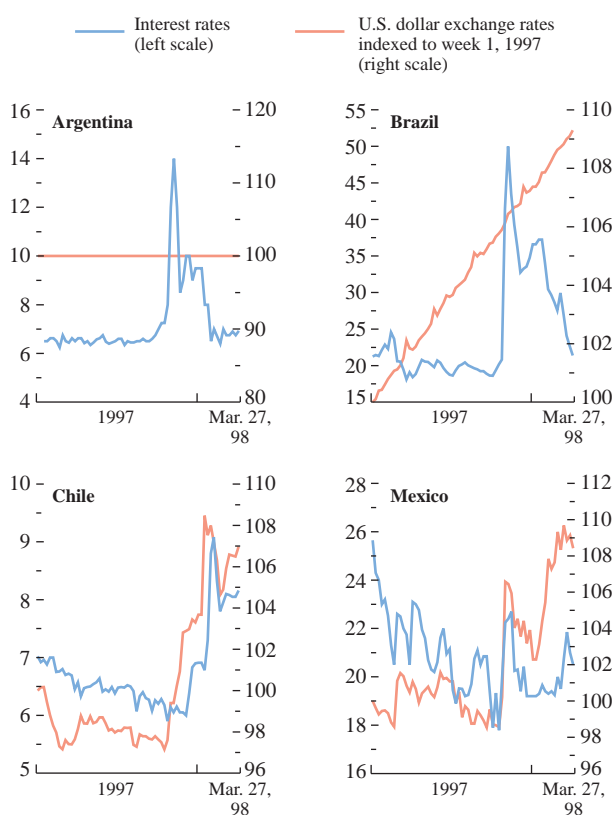


Figure 17. Selected Latin American Countries: Short-Term Interest Rates and Exchange Rates

(In percent a year unless otherwise noted)

As the financial crisis in Asia intensified, financial market pressures emerged in Latin America—most markedly in Brazil, but also in Argentina, Chile, and Mexico.



the closing week of October. But a moderate increase in interest rates was sufficient to relieve the pressure. Since then, the peso has displayed bouts of volatility and has been the main shock absorber for the economy. In December 1997, the congress approved the government's 1998 budget proposals aimed at maintaining the overall fiscal deficit at about 1¼ percent of GDP, and in January 1998, the government announced spending measures to contain the deficit at this level despite the declines in oil prices and tax revenues. The higher interest rates that were necessary to defend the peso are likely to curb the growth of credit, domestic demand, and thus overall activity. Real GDP growth, which is estimated to have reached 7 percent in 1997, is projected to moderate to around 4¾ percent this year.

In Chile, the peso came under increasing pressure in December and early January and depreciated in spite of moderate foreign exchange intervention; but it regained most of its losses after the authorities raised interest rates, tightened liquidity, and announced cuts in public expenditure. Real output growth is expected to slow to 6 percent in 1998, from about 6½ percent in 1997.

The fallout from the Asian crisis in Latin America was therefore limited in part by the prompt tightening of monetary policy and, particularly in Brazil, by additional fiscal adjustment measures. In the Brazilian case, before the crisis the fiscal deficit was large, the current account deficit was widening, and questions were being raised about the sustainability of these imbalances. The Asian crisis may be considered to have brought forward the timing of fiscal policy action that was needed anyway. Although financial markets stabilized after these measures were adopted, and the current account balance is expected to improve in 1998, these results have been achieved at the cost of a temporary slowdown in growth. And there may still be downside risks. Some countries, particularly Brazil, have relied quite heavily on privatization proceeds to finance significant portions of their current account deficits. In the less benign global environment for capital inflows to emerging country markets that seems likely in 1998, continued reliance on this source of financing may turn out to be more demanding.

Another key factor helping Latin America to withstand possible contagion from the Asian crisis has been the substantial improvement in policies and economic fundamentals that has occurred over the past decade. An interesting feature of the emerging market crisis of 1997–98 is that the effects of the Asian crisis on Latin America have been relatively limited.

Can Africa Continue to Improve Its Growth Performance?

Since the early 1990s, economic performance and prospects in sub-Saharan Africa have improved con-

Table 11. Selected Latin American Economies: Macroeconomic Indicators*(In percent of GDP unless otherwise noted)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Argentina									
GDP growth	-1.3	10.5	10.3	6.3	8.5	-4.6	4.2	8.4	5.5
Inflation ¹	2,314.7	171.7	24.9	10.6	4.2	3.4	0.2	0.8	0.3
Fiscal balance	-1.7	-1.2	0.4	-0.2	-1.7	-3.4	-3.2	-1.9	-1.4
Current account balance	3.3	-0.2	-2.8	-3.1	-3.7	-1.5	-1.9	-3.8	-4.3
Brazil									
GDP growth	-4.3	1.0	-0.5	4.9	5.9	4.2	2.8	3.0	1.5
Inflation ¹	2,740.0	414.8	991.4	2,111.4	2,166.2	59.7	15.5	6.0	3.3
Fiscal balance	1.6	1.4	-2.2	0.2	0.6	-7.2	-5.9	-5.9	-3.5
Current account balance	-0.9	-0.4	1.6	-0.1	-0.3	-2.5	-3.3	-4.2	-3.3
Chile									
GDP growth	3.3	7.3	11.0	6.3	4.2	8.5	7.2	6.6	6.0
Inflation ¹	26.0	21.8	15.4	12.7	11.4	8.2	7.4	6.2	5.1
Fiscal balance	3.5	2.5	3.0	2.2	2.4	4.0	2.8	3.0	1.9
Current account balance	-1.8	0.3	-1.6	-4.5	-1.2	0.2	-4.1	-4.0	-5.1
Mexico									
GDP growth	5.1	4.2	3.6	2.0	4.5	-6.2	5.2	7.0	4.8
Inflation ¹	26.7	22.7	15.5	9.8	7.0	35.0	34.4	20.6	13.4
Fiscal balance	-2.9	-0.6	1.3	0.7	-0.1	-0.9	-0.4	-1.3	-1.8
Current account balance	-2.8	-4.7	-6.7	-5.8	-7.0	-0.5	-0.8	-1.8	-2.5

¹Annual percent change.

siderably. Growth of real GDP across the 49 countries of sub-Saharan Africa averaged 4¼ percent a year during 1995–97, compared with 1½ percent during 1990–94 and 2½ percent during 1981–89 (Table 12). Some countries in the group realized average growth of nearly 8 percent in recent years, becoming regional “engines” of growth.²⁴ In per capita terms, real output rose at an average annual rate of about 1¾ percent over the past three years compared with an average annual decline of over 1 percent in the early 1990s. In addition, average annual inflation dropped to about 14 percent in 1997, and fiscal and external current account deficits were significantly improved relative to the early to mid-1990s.

Although exogenous developments, including developments in the global business cycle, may have helped, the recent improvements in African economic performance appear to have resulted more often from improved macroeconomic discipline—in particular, fiscal reforms—as well as progress with implementing structural reforms. The key question now is whether African countries can sustain their recent stronger growth performance and improve further on it.

Looking forward, trade liberalization can be a potentially important element in strengthening sub-Saharan Africa’s medium-term growth prospects. In contrast to

emerging market economies in other regions, improved growth performance in sub-Saharan Africa in recent years appears to owe little to international trade. Rather, Africa’s lack of integration with the world economy has continued to hamper growth. (Its share in world trade declined from 3 percent during the mid-1950s to 1 percent recently.)²⁵ In fact, recent evidence suggests that if African economies had pursued more open commercial policies during 1965–95, they would have achieved an extra 1½ percentage points in annual per capita income growth, a significant increase relative to actual average annual growth of about 1 percent.²⁶ A few African economies—for example, Botswana and Mauritius—did liberalize their trade regimes at an early stage, and these economies have outperformed the rest of Africa by a wide margin. Many other African countries began to liberalize their trade by the end of the 1980s; their subsequent liberalization measures are estimated to have raised their average growth by ¾ of 1 percent a year.

Even with a more open trade regime, however, sustained growth is dependent on other economic factors, in particular the growth of investment, and further successful implementation of structural reforms.

²⁵See Benno Ndulu and Njuguna S. Ndung’u, “Trade and Growth in Sub-Saharan Africa,” paper presented at the IMF-AERC Seminar on Trade Reforms and Regional Integration in Africa, Washington, D.C., December 1–3, 1997.

²⁶Estimates are from Jeffrey Sachs and Andrew Warner, “Sources of Slow Growth in African Economies,” *Journal of African Economies*, Vol. 6 (October 1997), pp. 335–60.

²⁴See Stanley Fischer, Ernesto Hernandez-Catá, and Mohsin S. Khan, “Africa: Is This the Turning Point?” paper presented at the Allied Social Science Association Meetings, Chicago, January 2–5, 1998.

Table 12. Sub-Saharan Africa: Selected Economic Indicators*(Annual percent change unless otherwise noted)*

	1981–89	1990–94	1995–97	1990	1991	1992	1993	1994	1995	1996	1997
Real GDP growth											
Sub-Saharan Africa	2.5	1.6	4.3	2.3	1.8	0.1	1.5	2.2	4.1	4.9	4.0
Recent strong performers ¹	3.0	2.3	7.0	2.3	1.9	0.6	2.2	4.6	7.4	7.8	5.9
Excl. South Africa and Nigeria	2.8	1.4	4.9	1.7	1.6	0.2	1.4	2.3	4.6	5.6	4.5
CFA countries	2.4	-0.1	5.1	-1.2	0.6	0.1	-2.0	1.9	4.5	5.3	5.5
Real per capita GDP growth											
Sub-Saharan Africa	-0.5	-1.2	1.8	-0.4	-1.0	-2.8	-1.2	-0.5	2.0	2.1	1.4
Recent strong performers ¹	-0.1	-0.5	4.1	-0.6	0.3	-2.8	-0.8	1.3	4.5	4.7	3.0
Excl. South Africa and Nigeria	-0.3	-1.4	2.3	-0.5	-1.3	-2.8	-1.7	-0.7	2.8	2.5	1.6
CFA countries	-0.5	-3.2	2.0	-4.1	-2.5	-3.0	-5.0	-1.2	1.5	2.2	2.4
Investment (in percent of GDP)											
Sub-Saharan Africa	20.3	17.7	17.7	16.5	18.0	18.2	16.8	17.8	17.7	17.8	17.5
Recent strong performers ¹	17.2	18.3	21.5	16.1	17.4	17.1	18.4	20.4	20.7	21.4	22.4
Excl. South Africa and Nigeria	18.3	17.8	19.4	16.8	17.2	16.7	18.1	19.3	19.2	19.6	19.4
CFA countries	20.0	14.9	18.0	14.7	14.4	13.0	14.6	17.5	17.4	18.7	18.0
Private investment (in percent of GDP)											
Sub-Saharan Africa ²	...	11.3	12.0	...	11.5	11.5	10.4	11.6	12.0	12.3	11.8
Recent strong performers ¹	...	10.6	13.6	8.5	10.4	10.6	11.1	12.2	12.9	13.5	14.4
Excl. South Africa and Nigeria ²	...	11.4	12.9	...	11.1	10.4	11.6	12.4	12.4	13.2	13.1
CFA countries	...	10.1	13.0	9.4	9.7	8.4	10.3	12.6	12.3	14.0	12.8

¹Recent strong performers comprise Angola, Benin, Botswana, Côte d'Ivoire, Equatorial Guinea, Ethiopia, Guinea Bissau, Lesotho, Mauritius, Nigeria, South Africa, Togo, and Uganda.

²The 1990–94 average in this case refers to 1991–94 data only.

The share of public investment in total investment has tended to be quite large in Africa, with the channels of finance for private investment often not well-developed. In many sub-Saharan African countries there has been a chronic shortage of funds and unproductive use of public expenditures, which have crowded out more productive public investment in human resources and infrastructure, as well as private investment.²⁷ Evidence has accumulated in recent years that public investment has not had as beneficial an impact on growth as private investment. For example, recent estimates for African countries suggest that the social rate of return to private capital is about 50–60 percent higher than that for public capital.²⁸ An implication is that expanding private investment while maintaining or improving its efficiency will increase Africa's long-run growth.

Openness to trade and international finance can facilitate the financing of private investment, increase the returns to investors, and help to foster conditions that are otherwise conducive to growth. However, high debt burdens that crowd out private investment

expenditure must also be reduced. And the perceived risks of investing in sub-Saharan Africa must be reduced. Although rates of return on investment appear to be relatively high in Africa, surveys indicate that investors perceive the risks to be higher there than in other regions.²⁹ Reducing actual and perceived risk is clearly important in attracting private investment, and this requires action to improve legal frameworks and other elements of governance, as well as macroeconomic and structural policies to foster steady economic growth.

Despite the handicaps, some countries in the region have begun to attract private capital inflows. During 1980–95, private capital flows to non-CFA countries in sub-Saharan Africa recovered to levels (in proportion to GDP) not much lower than those to developing regions outside Africa. Although Africa still receives only about 2–3 percent of total world foreign direct investment, such flows have shown a significant increase since the late 1980s for non-CFA countries. The recipients of the largest net private capital flows have been those countries that have created and maintained open markets, minimal regulations, superior infrastructure, and low production costs. In other countries, civil strife, macroeconomic instability, slow economic

²⁷See Janet G. Stotsky and Aseggedech WoldeMariam, "Tax Effort in Sub-Saharan Africa," Working Paper 97/107 (Washington: IMF, September 1997); and Dhaneshwar Ghura and Michael T. Hadjimichael, "Growth in Sub-Saharan Africa," *Staff Papers*, IMF, Vol. 43 (September 1996), pp. 605–34.

²⁸Estimates based on Mohsin S. Khan and Manmohan S. Kumar, "Public and Private Investment and the Growth Process in Developing Countries," *Oxford Bulletin of Economics and Statistics*, Vol. 59 (February 1997), pp. 69–88.

²⁹See, for example, Amar Bhattacharya, Peter J. Montiel, and Sunil Sharma, "Private Capital Flows to Sub-Saharan Africa: An Overview of Trends and Determinants," in Zubair Iqbal and Ravi Kanbur, eds., *External Finance for Low-Income Countries* (Washington: IMF, 1997), pp. 207–32.

growth, small domestic markets, and slow progress in privatization and infrastructure development—financial, judicial, physical, and human—have impeded inflows of foreign direct investment as well as the ability to contract foreign private loans. Likewise, the reputation created by previous poor policies has in some cases persisted as a deterrent to investment.

Given the relatively low levels of private capital flows to Africa, the impact of the Asian crisis is expected to be smaller in Africa than in other developing country regions. Nevertheless, the increases in risk premia for emerging market debt associated with the Asian crisis will substantially increase the cost of foreign borrowing for African countries. And the significant weakening of commodity prices in the wake of the Asian crisis has also added to uncertainties about Africa's near-term growth performance.

Egypt—An Improved Performer in the Middle East: Can Its Success Be Sustained?

Economic stabilization in Egypt during the 1990s stands out as a remarkable success story.³⁰ Adherence to strong monetary and fiscal policies beginning in 1991 and renewed efforts to implement a program of structural reform have led to a resumption of growth, a sharp decline in inflation, improved public finances, a stable currency, a strengthened banking system, and an improved balance of payments. These efforts and accomplishments, together with a large-scale reduction in external debt through the Paris Club, are creating the conditions for sustained, strong growth over the medium term that would raise living standards, reduce poverty, and facilitate Egypt's accelerated integration into the world economy.

The Egyptian economy faced mounting difficulties in the second half of the 1980s. In the late 1970s and early 1980s, increased oil export prices, buoyant workers' remittances, foreign assistance, and external borrowing on commercial terms masked the economy's considerable underlying structural weaknesses and an erosion of external competitiveness. With less favorable external conditions by the mid-1980s, a legacy of excessively expansionary macroeconomic policies, and considerable price distortions, substantial external deficits emerged, payments arrears mounted, inflation increased, and growth in real GDP declined sharply. The economy's deep-rooted weaknesses (including complex regulations, heavy trade protection, price distortions, widespread state ownership, a reliance on the public sector for investment and employment, and a weak banking sector) were clearly exposed. Although efforts were made by the Egyptian government to

reform the economy,³¹ implementation was too slow and inadequately coordinated. By the end of the 1980s, inflation was over 20 percent, the fiscal deficit was about 14 percent of GDP, the current account deficit exceeded 15 percent of GDP, and the overall external position had become precarious, with the possibility that Egypt could not finance either its food imports or its debt-service obligations (Figure 18).

In April 1991, the government launched a comprehensive stabilization and reform program. The centerpiece of the program was to reduce the fiscal deficit, and it was cut by 15 percentage points over a three-year period to about 2 percent of GDP, an achievement that has few parallels. The program introduced the exchange rate as a nominal anchor supported by monetary and credit targets. Also, at the outset of the program the different markets for foreign exchange were unified, interest rates were liberalized, most prices were decontrolled, and public sector banks were recapitalized. These efforts, which were supported by large-scale external assistance in the form of grants and debt relief, resulted in a significant economic turnaround. Real output growth, which stagnated in the first two years of the stabilization program, rebounded in 1993/94, and growth has continued to pick up gradually, registering 5 percent in 1997, fueled primarily by private sector investment. Tight control of liquidity reduced inflation to under 11 percent in 1993 and to about 4 percent by the end of 1997.

In contrast to the determined efforts at macroeconomic stabilization, progress with structural reform during the 1990s continued, at first, on a piecemeal basis. By 1994, the privatization program had stalled, and other planned reform measures had been postponed.³² However, the structural reform program was reinvigorated by a new government in 1996, and since then there have been noteworthy achievements: one-third of the state industrial portfolio has been divested;³³ private involvement in commercial banks, securities, and insurance firms has increased; and average tariff rates have been reduced.

Strong macroeconomic stabilization policies and the reinvigorated structural reform program have resulted in rising growth, a strong external position, and low inflation, and have helped to prevent serious financial market spillovers from the Asian crisis. However, with lower oil prices, the decline in tourism proceeds related to a recent act of terrorism, and less favorable remit-

³⁰For a detailed discussion of the Egyptian stabilization experience, see Arvind Subramanian, "The Egyptian Stabilization Experience: An Analytical Retrospective," Working Paper 97/105 (Washington: IMF, December 1997).

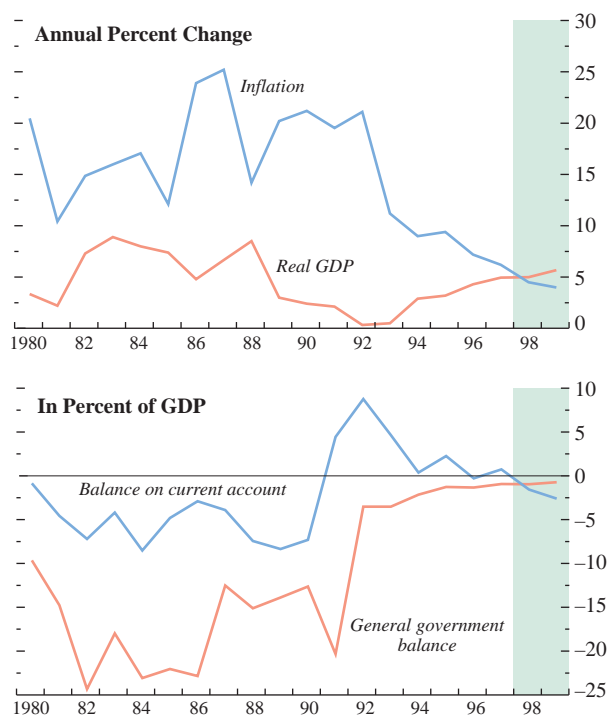
³¹For example, price controls were made more flexible, administered prices of a number of consumer goods were raised, tariffs and taxes were reformed, and interest rates were increased, albeit modestly.

³²For example, planned measures were not implemented to cut tariffs, to expand the sales tax, and to liberalize and streamline government investment spending.

³³Excluding state operations in the infrastructure and utility sectors.

Figure 18. Egypt: Basic Macroeconomic Data¹

Implementation of a strong stabilization program beginning in 1991 has resulted in markedly improved economic conditions.



¹Data are based on fiscal years ending June 30. Shaded areas indicate IMF staff projections.

tance inflows, the external current account is expected to move from a small surplus in 1997 to a deficit of 2½ percent of GDP by 1999. Moreover, the capital account has weakened in recent months. As a result of these developments, projected real GDP growth in 1998 has been revised downward somewhat: it now seems unlikely to be stronger than in 1997.

Despite the recent progress in stabilizing and reforming the Egyptian economy, the task of ensuring sustained growth and reducing widespread poverty over the medium term is incomplete.³⁴ A fundamental policy challenge facing Egypt is to consolidate and extend the ongoing recovery. This will require continued strong macroeconomic policies, accelerated structural reforms, and diversification of exports. To stimulate private investment, the financial sector also needs to be strengthened and modernized, and the scope for private sector activity needs to be broadened further. Strengthening the financial sector, together with the maintenance of disciplined macroeconomic policies and improvements in competitiveness, will also help to minimize the economy's vulnerability to adverse disturbances, especially given Egypt's increasing integration with global financial markets.

How Serious Have the Spillover Effects from the Asian Crisis Been on the Countries in Transition?

Financial and foreign exchange markets in a number of the countries in transition have been significantly affected by the Asian crisis. But the impact has differed widely across individual countries, depending on such factors as the development and degree of international integration of domestic financial markets, pre-existing economic weaknesses and policy problems, and the importance of economic links with the countries in crisis. Contagion from the Asian crisis to financial markets has been most clear in Russia and Ukraine. In Russia, pressures in the foreign exchange market intensified at the end of October 1997, receded in early December, but reemerged in January. In response to these pressures, the central bank raised interest rates on several occasions, increased reserve requirements on foreign exchange deposits, and intervened in the foreign exchange as well as the treasury bill market. And, as planned earlier, a new exchange rate policy was announced.³⁵ Stock market prices dur-

³⁴Despite recent improvements, poverty is a severe problem, and Egypt remains among the ranks of the low-income developing countries.

³⁵In November 1997, it was announced that, as of January 1, 1998, the crawling band vis-à-vis the U.S. dollar would be replaced by a mechanism under which the ruble would be allowed to fluctuate within a 15 percent band on either side of a yearly adjusted central rate vis-à-vis the dollar—6.10 (new) rubles per U.S. dollar for 1998. The larger fluctuation margin is meant to reduce the risk of speculative attacks, while the fixity of the central rate should instill greater confidence in the currency.

ing this period declined considerably, and as of late March 1998, they had not recovered from the lows reached in late Fall. In Ukraine, pressure on the exchange rate built up from the end of October 1997, particularly as nonresidents began to reduce their holdings of treasury bills. Measures to defend the exchange rate—including a widening of the exchange rate band, increases in the refinance rate, an increase in the required reserve ratio, and a shortening of the maturity of treasury bills offered for sale—were insufficient to stem the pressures, and the central bank had to intervene heavily in the foreign exchange market.³⁶ The exchange rate remained under pressure in early 1998, mainly reflecting problems financing the budget deficit.

In the Baltic countries, also, interest rates and equity prices were affected. The impact was mainly felt in Estonia, where international financial integration has progressed the furthest, and where the current account deficit in 1997 reached 13 percent of GDP. The three-month interbank rate more than doubled during the last quarter of 1997, while the stock market, in part also reflecting domestic factors, slid more than 60 percent from its summer high by the middle of November. By the end of March, interest rates had declined, although they remained above the levels observed in the fall, while equity prices recovered modestly.

In the Czech Republic (which had experienced a foreign exchange crisis in May 1997—see below), Hungary, and Poland, the spillover effects of the Asian financial crisis in late 1997 were substantial in equity markets only. The Czech and Polish markets fell around 20 and 25 percent, respectively, in November–December 1997, and as of late March were still below their October levels. In Hungary, the stock market was adversely affected during the initial weeks of the crisis in the fall of 1997, falling by about 35 percent, but it subsequently recovered, consolidating and extending the very substantial gains made in the first eight months of 1997. These three countries avoided major interest rate and currency movements by maintaining tight macroeconomic policies and (especially in the case of Poland) maintaining exchange rate arrangements that allowed a significant degree of short-term flexibility. The Czech Republic and Poland, in particular, have become relatively attractive to emerging market investors, receiving considerable short-term capital inflows in the first quarter of 1998; and as a result their currencies appreciated in nominal terms against the U.S. dollar.

In the other countries in transition, the contagion effects of the Asian crisis on domestic financial markets

were minor. The significant interest and exchange rate pressures that emerged in recent months in Romania and Slovakia were attributable partly also to domestic economic imbalances and policy uncertainties. In Bulgaria and Kazakhstan, international financial turbulence created unfavorable conditions for the launch of the stock exchange in October and September 1997, respectively.³⁷ In other countries in transition, spillover effects were limited simply because domestic financial market development and integration into international financial markets are still at early stages.

The Asian financial crisis has also had consequences for transition countries' access to international bond and credit markets. In the early fall of 1997, there were more than 100 mandated international bond issues waiting to come to market from the region, with a total value of around \$25 billion. The cost of issuing international bonds after turmoil hit the markets in the early fall increased substantially. As a result, a large numbers of borrowers in the transition countries postponed their issues or switched to the syndicated loan market.

Although the Asian financial crisis has had a significant impact on some of the countries in transition, major currency crises have been avoided. Several factors appear to have contributed to the containment of spillover effects. First, the transition countries have accumulated relatively little foreign currency debt, and for many countries most foreign currency borrowing is centralized by the government. Second, banking systems, capital markets, and financial systems as a whole are relatively small. At the same time, differences among transition countries in the severity of interest rate and equity price movements illustrate the importance of appropriate domestic macroeconomic and structural policies to limit vulnerability to worsening conditions in international financial markets. With regard to Russia and Ukraine, remaining weaknesses in structural and financial sectors, a high dependence on short-term government borrowing, and, in Russia, chronic revenue collection problems largely explain why these two countries were more severely affected by the Asian turmoil than the central and eastern European countries. The Asian financial crisis exposed more fully some of these underlying problems and made more apparent the need to address them.³⁸ In Estonia, domestic pressures, which had been reflected in a burgeoning current account deficit, and a steep

³⁶The stock market in Ukraine, which is still relatively undeveloped and which is little traded by nonresident investors, was not strongly affected by international spillover effects.

³⁷Interest rates and exchange rate arrangements in these two countries have remained stable in recent months.

³⁸The importance of differences in domestic economic conditions and economic policies is also reflected in diverging credit rating movements. Standard and Poor's in December 1997 revised Russia's outlook to negative because of worsening fiscal pressures, but in January 1998 it upgraded the rating outlook for Hungary to positive in view of the country's rapidly diminishing foreign debt burden and successful implementation of structural reform.

rise in equity prices were exacerbated by the spillover from the Asia crisis.³⁹

Czech Republic: Responding to Policy Challenges

After early and impressive progress in the transition, the Czech Republic encountered difficulties in 1997, which culminated in a foreign exchange crisis in May. As discussed in the October 1997 *World Economic Outlook*, the crisis was largely attributable to an unsustainable current account deficit resulting from large capital inflows, an associated real appreciation of the domestic currency, insufficiently tight fiscal policy, and domestic demand pressures. Wage growth in excess of productivity gains was another feature of domestic inflationary pressures that contributed to declining competitiveness and a rising trade deficit. Wage growth stemmed in part from weak corporate governance, reflecting uneven progress in privatization and other structural reforms.

The policy response to the May 1997 crisis included a switch to a floating exchange rate, which led to a 10 percent depreciation of the koruna, along with expenditure cuts of 2½ percent of GDP aimed at restoring fiscal balance and reducing the current account deficit. Along with a further tightening of monetary policy in the months following the depreciation, these steps restored stability to the koruna and contributed to a narrowing of the current account deficit to around 5 percent of GDP in the second half of 1997 from 7½ percent in the first half of the year. However, GDP growth slowed from 4 percent in 1996 to 1¼ percent

in 1997 as investment contracted and consumption growth decelerated, while unemployment rose to 5¼ percent at the end of 1997. Severe flooding in July 1997 caused damage equivalent to 3½–4 percent of GDP and accounted for about ½ of 1 percentage point of the decline in GDP growth in 1997. Spillovers from east Asia and heightened domestic political uncertainty affected the Czech foreign exchange market from late October 1997 to early January, leading once again to increased interest rates and official intervention in support of the koruna. Meanwhile, inflation has remained stuck at around 10 percent, although moderation in wage growth has for the most part offset the inflationary effects of the depreciation.

Although the external balance has improved and greater stability has returned to the foreign exchange market, the Czech economy is still facing important challenges. Depreciations of Asian currencies will increase competition for Czech exporters, while competitiveness gains from the depreciation of the koruna in 1997 may be eroded if wage increases continue to outpace productivity growth. Slowing demand has also reduced enterprise profitability, affecting investment and putting pressure on the quality of banks' loan portfolios. The authorities stand ready to increase interest rates in order to stabilize the currency and support the adjustment effort, although there are limits to which interest rates can be raised given the prevailing financial position of highly geared enterprises and the large share of nonperforming assets held by the banks. Continued fiscal restraint and greater wage discipline are needed for further progress toward a sustainable current account, lower underlying inflation, and maintenance of confidence in the exchange rate. Equally important is the need to deepen structural reforms aimed at improving corporate governance and productivity growth, and preparing the Czech Republic for its eventual accession to the EU.

³⁹The Estonian stock market index rose more than 150 percent from the beginning of 1997 to the middle of October, and in 1997 the current account deficit net of foreign direct investment amounted to around 9 percent of GDP.