3 International Economic Survey

Overview

The growth of **world output** is expected to decline to 2% in 1998 compared with 4.1% in 1997 due to escalating global financial turmoil. The recession in many of the East Asian emerging economies has deepened, aggravated by the deteriorating economic situation in Japan. Despite substantial fiscal stimulus measures being instituted in Japan, private demand remains particularly weak. Added to this, Russia has become a new source of contagion affecting the emerging economies, especially Latin America which has experienced significant slowdown in capital flows since the rouble was devalued in August 1998. Further negative spill-over effects in the world stock markets as well as continued decline in the commodity prices are all expected to lead to a deterioration in the world economic and financial situation. For 1998, the industrial economies are expected to register a growth of 2.3% (1997: 2.9%) as expansion strengthened in Germany, France and Italy, while growth in the United States, Canada and United Kingdom has been sustained at a strong pace. Meanwhile, growth in developing countries as a group is expected to substantially decline to 2.3% in 1998 (1997: 5.8%) and the countries in transition are expected to contract by 0.2% (1997: 2%). A moderate rebound of world output to 2.5 % is projected for 1999 though there are underlying risks of a protracted slowdown in growth.

Inflation rates in general are expected to show a mixed trend with the advanced economies registering a further decline in inflation rates to 1.7% in 1998 (1997: 2.1%) due to lower commodity prices and downward pressure on price levels arising from enhanced competiton from Asia. In the countries in transition however, an increase in inflation rates to 29.5% is expected in 1998 (1997: 27.9%), largely accounted for by steep inflationary pressures in Russia as a result of the devaluation of the rouble. Similarly in the developing countries an increase in inflation rates to 10.3% is estimated in 1998 (1997: 9.1%) accounted for mainly by sharp increases in inflation rates in the crisis affected Asian economies.

In line with the projection of slower global economic growth, **world trade** growth (in volume terms) in 1998 is expected to slowdown to 3.7% (1997: 9.7%). Imports from the advanced economies are estimated to decline sharply to 4.5% in 1998 (1997: 9%) and exports to 3.6% (1997: 10.3%). The United States is expected to register a decline in exports of 1.5% (1997: 12.8%), while imports will be sustained at 12.7% in 1998 (1997: 13.5%). Japan and to a lesser extent Australia and New Zealand, are likely to bear most of the impact that the Asian crisis will have on export market growth. Japanese exports and imports are estimated to contract further to 6.1% and 1.5% respectively in 1998 (1997: -0.2%: 10.8%). Exports from the United Kingdom and Canada will see a strong decline at 1.3% and 6.3% respectively in 1998 (1997: 8.0%; 8.0%). Because of the close trade links and increasing integration among the countries of the European Union, the recovery in domestic demand has had a strong multiplier effect that has produced sustained export growth. With a single currency, trade among EU members will no longer be influenced by movements in national exchange rate differentials. However, the major support for demand came from outside the region, including North America, the transition economies and developing countries outside East Asia. The increase in net exports was concentrated in those countries whose currencies have declined relative to the dollar, including France and Germany. The Asian crisis is expected to reduce the export growth in the EU by over 0.5%.

Export growth of the developing countries during 1998 is expected to fall sharply to 3.9% (1997: 10.9%) due to the Asian financial crisis while imports will deteriorate to 1% (1997: 9.8%). **Asia** is expected to be the hardest hit with exports falling from 14.8% in 1997 to 5.7% in 1998. Imports are also expected to be similarly affected, contracting to 2% in 1998 (1997: 6.6%). For the most affected Asian economies, the sharp fall in their real effective exchange rate and the existence of excess production capacity, together with sound economic fundamentals and past performance records, argue in favour of a strong export-led recovery. On the other hand, there are strong offsetting factors such as higher import costs and a severe liquidity crisis and credit crunch. Currently discernable in these countries are a greater contraction of imports and a lack of any significant expansion of exports. In **Africa**, a decline in exports in 1998 to 2.2% (1997: 4%) is expected while imports will register a slowdown of 4.2% (1997: 8.6%). The **Latin American** economies will also witness a decline in export growth to 6.2% (1997: 11.9%) and import growth to 9.7% in 1998 (1997: 17.1%). In the **Middle East,** exports and imports are expected to slow down to 3.3% and 4.9% respectively (1997: 6.5%; 12.9%). In 1999, world trade is projected to increase to 4.6%.

International Financial Flows and Capital Markets.

The financial crisis in Asia and Russia has contributed to dramatic declines in international financial flows to the emerging markets. Against a record level of US$215 billion in 1996, **net private capital flows** (comprising net direct investment, net portfolio investment and other long and short-term net investment flows) declined to US$56.7 billion in 1998 (1997: US$123.5 billion). Net flows to Asia, including the newly industrialised countries, are forecast to be negative to the tune of over US$74 billion, with large net outflows projected for the crisis-affected countries namely Indonesia, South Korea and Thailand. Countries in the Middle East are expected to see sharp increases in net private capital flows as they resort to foreign borrowing to finance revenue gaps due to lower oil export prices, while the transition countries are projected to experience marginal declines. The Latin American countries, especially Brazil, experienced large capital outflows after the devaluation of the Russian rouble in August 1998 which caused investor panic about emerging markets. In Brazil, capital outflows during the period September 1 to 11, amounted to US$ 14 billion until the government increased its short-term interest rates to 50% from 30% earlier. In Asia a more substantial recovery of net flows is projected for 1999. However, net inflows to emerging markets globally are not expected to regain their 1996 peak until 2000.

Global **foreign direct investment (FDI)** flows did not show a decline in the wake of the Asian financial crisis though portfolio equity investment and bank lendings to the crisis–affected countries have fallen sharply. In 1997 FDI flows registered record levels reaching US$400 billion representing an increase of 18.6% over 1996. The driving force in the continued expansion of global FDI was the growth of large-scale cross-border mergers and acquisitions (M&As) among developed countries, which accounted for about a quarter of all M&As. These were facilitated by ongoing liberalisation and deregulation measures. Developed countries invested US$359 billion globally in 1997, up by 27% over 1996 and attracted US$233 billion inward FDI i.e. an increase of 19%.

Inflows to developing countries rose at a slower rate than that of the developed countries, but still showed a significant 15% increase to reach US$149 billion in 1997. FDI flows to the five most affected Asian economies, namely Indonesia, Malaysia, the Philippines, South Korea and Thailand remained unaffected in 1997 but are envisaged to show a decline in 1998. However, in these countries several conducive factors prevail such as decreased dollar costs for foreign investments, improvements in the international cost competitiveness of production due to devaluations and the ongoing liberalisation policies being pursued all of which are expected to attract foreign investors.

In the **foreign exchange and financial markets**, the effective exchange rate of the U.S. dollar reached its highest level in mid-July 1998 since December 1986, recording significant gains against the yen and, to a lesser extent, against the Australian dollar. The dollar's strength has been due to external factors, strong domestic demand growth and interest differentials that favoured dollar-denominated assets and the perception of the dollar as a safe haven in the wake of deteriorating sentiment toward emerging markets. However the dollar fell sharply in late August and early

September as the financial market crisis spread to Russia and Latin America, prompting a downward correction in U.S. equity prices.

Conversely, concerns about the worsening economic situation in Japan have led to strong selling pressure leading to further weakness in the Japanese yen, bringing in its wake negative spillover effects notably in Asia. Since mid-April 1998, the Japanese yen has weakened against all other major currencies, dropping by about 9% on a nominal effective basis and cumulatively to about 37% decline since April 1995. The yen's decline accelerated in May, early June and August as data released by the Japanese authorities indicated that the economy is on a contractionary path. In mid-June, the yen fell briefly to an eight-year low of more than ¥145 to the dollar before a rebound occurred in response to a coordinated intervention by U.S. and Japanese authorities and announcements in early July of new initiatives to prop up the banking sector. By early August however, the yen weakened again to around ¥145 to the dollar and by end September 1998, the yen stood at ¥135 to the dollar. The fall in the yen, apart from triggering renewed currency weakness in the Asian emerging market economies, also led to sharp declines in the Australian and New Zealand dollars against the U.S. dollar and European currencies. The Canadian dollar has also reached new record lows against the U.S. dollar, reflecting expectations that the downward trend in commodity prices would lead to a deterioration in Canada's external position and a slowdown in domestic demand.

In the European foreign exchange markets, the pound sterling has slowly weakened against both the U.S. dollar and currencies in the prospective euro area, although there was a temporary rebound in June, mainly after the Bank of England unexpectedly raised official rates. In the prospective euro area, currencies have fluctuated in a fairly narrow range against the U.S. dollar, firming modestly on an effective basis in response to the strengthening of domestic demand in the major economies. Most of these currencies have remained near their central ERM parities.

Prices in **equity markets** reached record highs in a number of key industrial countries in 1998, before corrections occurred prompted largely by concerns about corporate profits brought about by the downturn in Asia. In the **international bond markets**, there have been further declines in yields in most industrial countries, again primarily influenced by the economic downturn in Asia, subdued inflationary pressures and as turmoil in emerging markets triggered a flight to quality. By early September 1998, nominal bond yields in most major industrial countries were almost at their lowest levels in three decades. Real yields on the other hand, remained close to their average levels recorded over the past decade. In Japan, as conditions in the economy and financial sector continued to deteriorate and inflation dropped to almost zero, long-term interest rates eased to an unprecedented low levels, reaching at one point to only slightly above 1% before a temporary rebound occurred in June and July. In continental Europe, yield spreads remained in a narrow range as the convergence of long-term interest rates among the prospective initial EMU participants had largely run its course. In the United Kingdom, bond yields are little changed, but rose somewhat in Canada as the Canadian dollar fell to new lows against the U.S. counterpart.

After further strong gains in most countries in early 1998, **stock market prices** generally consolidated or rose to new highs before a moderate downward correction in late July and early August. The global interest rate environment remained favourable for equities, but concerns that current market valuations may be difficult to sustain in the face of a slowdown in corporate earnings growth or an increase in inflation dampened further price increases, especially in the United States and the United Kingdom. In Germany and France, equity markets remained particularly buoyant reflecting strong business confidence, low or declining interest rates, and expectations of efficiency gains from corporate restructuring. In contrast, equity prices have fallen steadily in Japan, falling to a 12 year low in late August and early September on concerns about the economy and the banking sector. Markets also weakened in other countries with large direct and indirect exposures to the Asian crisis, including Canada, Australia and New Zealand.

Short-term **interest rates** in most industrial countries have remained steady for most part of 1998. The Asian crisis and its repercussions have lowered actual and prospective inflation in most industrial countries. The situation has permitted central banks to maintain a supportive monetary stance, such as in Germany, where significant economic slack remains and in the United States, where monetary policy was put on hold even though the business cycle can be considered to be already well-advanced. In contrast, Denmark raised official interest rates by 100 basis points in mid September; the United Kingdom raised official rates by 25 basis points in June; in Canada a 100 basis points hike in August and Norway, where rates were raised by 375 basis points in total in late June and August. Within the euro area, the scope for adjusting monetary policy in response to the significant differences in cyclical conditions has been rather limited by the need for short-term interest rates to converge by 1 January, 1999, i.e. the start date of EMU. In Asia, spreads have widened sharply reflecting negative sentiments towards emerging markets in general, making private debt financing more difficult.

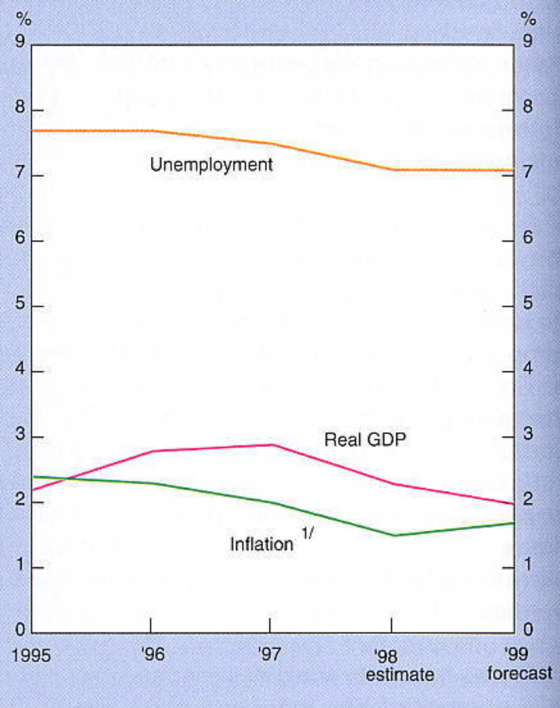
Economic Situation in the Industrial Countries

Output

Output growth in the industrial countries as a whole is expected to moderate to 2.3% in 1998 compared with 2.9% in 1997 on account of the impact of the Asian financial crisis as well as the prevailing economic conditions in Japan. However, the strength of economic growth particularly in North America and Europe is encouraging, underpinned by strong domestic demand with low inflation, high equity prices, supportive monetary conditions, improved fiscal positions, and strong consumer and business confidence. In the **United States (US)**, the robust economic expansion which is now in its seventh year, has been driven mainly by buoyant consumer spending and business fixed investment. Strong US growth is largely a reflection of sound fiscal consolidation and the emergence of budgetary surpluses combined with a supportive monetary policy has aided efforts to keep inflation at low levels, as well as, flexible product and labour markets. Retail sales and inventories are generally balanced, while manufacturing activity has remained at a high level despite the General Motors strike, weakening domestic demand for exports and general slowing in the high technology sector which threaten to dampen expansion. Throughout the first seven months of 1998, robust sales growth in residential and commercial real estate markets continued to fuel construction activity. Despite the high level of economic activity, labour shortages, shipping bottlenecks and continued weakness in East Asia are beginning to impact growth in the US. In the second quarter of 1998, GDP slowed sharply to 1.8% and real GDP growth in 1998 is expected to moderate to 3.5% (1997: 3.9%).

Among the industrial countries, **Japan** is the most directly exposed to and affected by the Asian crisis. The Japanese economy faltered after the first quarter of 1997, then slipped into recession in the fourth quarter of the year, with output contracting 5.3% in the first quarter of 1998 at an annual rate. Factors attributing to this disappointing performance include increasing financial strains in the banking system; the large withdrawal of the April 1997 fiscal stimulus package; the fallout from the neighbouring countries affected by the crisis and a weakening of confidence. The strains in the banking sector has had a severe impact on the availability of credit to business. In 1998, the Japanese Government has responded

Chart 3.1
Industrial Countries -
Major Economic Indicators

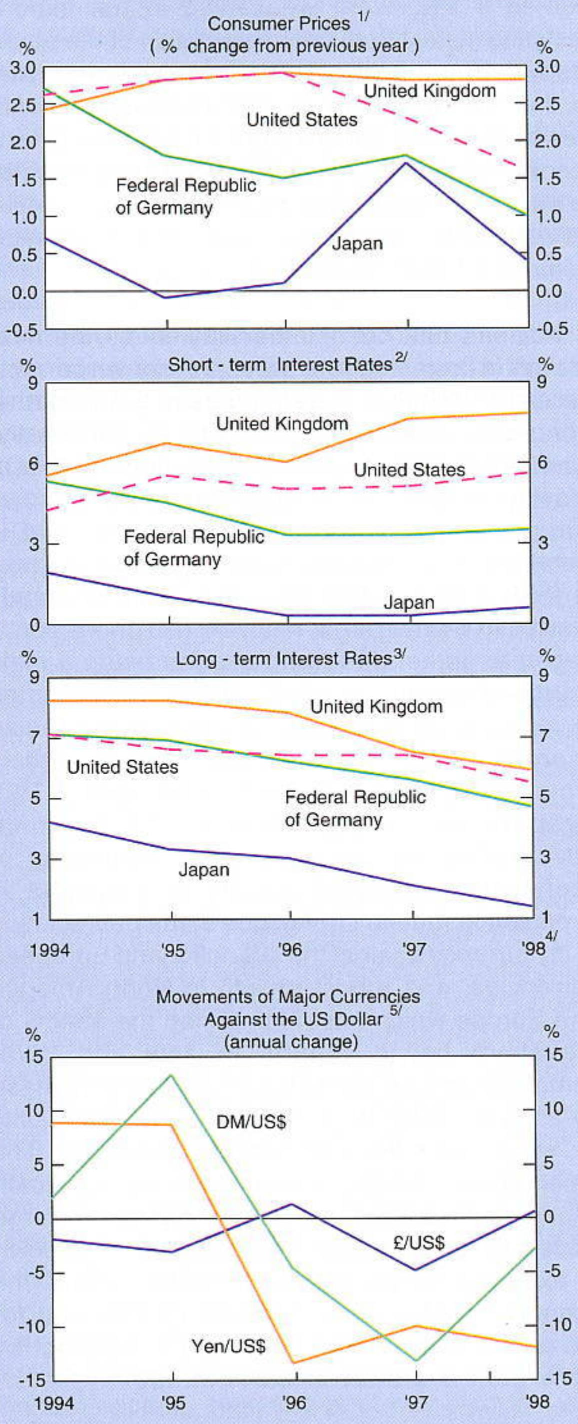


1/ Consumer prices
Sources :IMF World Economic Outlook , September 1998 and national sources

to these developments with two fiscal stimulus packages and by taking steps to address the banking problem, including making public money available to strengthen deposit insurance and to boost bank capital. The April package worth 2.5% of GDP should have helped to spur a pickup in activity beginning in the second half of 1998 but it failed and in August 1998, the government announced another fiscal package to address its weakening financial system and revitalise its economy. The August package comprised measures to promote economic structural reform including deregulation, administrative reform, privatisation of public sector and tax system reform. However Japan's economic conditions continued to deteriorate and by late August it was clear that the economy was in a recession as GDP had contracted for three consecutive quarters. For 1998 as a whole, real GDP is expected to contract by 2.5% compared with a growth of 0.8% in 1997 as business investments, household consumption and residential investment sharply decelerated. GDP could contract even further if the situation in the banking system and consumer confidence continue to deteriorate.

In **continental Europe**, economic recovery has gained momentum since early 1997, sustained by strengthening domestic demand reflecting continued strong business and consumer confidence as well as improvements in labour market conditions. Economic growth in France and Germany accelerated recently as a result of upturns in investment and consumer spending. In **Germany**, following two years of sluggish growth, real GDP for 1998 is expected to grow at a faster rate of 2.6% (1997: 2.2%) contributed by continuing strong export growth, resulting in a marked recovery in industrial production and a rise in capacity utilisation. In **France**, economic growth is expected to remain above potential at 3.1% in 1998 (1997: 2.3%) underpinned by strong exports and domestic demand. In **Italy**, real GDP growth is expected to rise to 2.1% in 1998 (1997: 1.5%). The strengthening of the economic activity in 1998 will emanate from dynamic domestic demand particularly gross fixed investment, high and rising rates of return on capital, and falling real interest rate as it converges towards the euro area average. However, private consumption is expected to lose some strength in 1998 mainly on account of the expiration of the car incentive scheme in July 1998.

Chart 3.2
Current Trends in Key Economic Determinants in Industrial Countries



1/ 1998 figures are estimates.
2/ Averages of interest rates weighted by the average US dollar value.
3/ Average yield on Government bonds.
4/ Up to June 1998
5/ End of period except for 1998, up to June.

Sources : IMF World Economic Outlook, September 1998 and other reports.

Outside of the prospective euro area, after five years of solid expansion, economic growth in the **United Kingdom (UK)** has slowed since late 1997, due to a significant weakening in net exports resulting mainly from the appreciation of the pound sterling and the rise in short-term interest rates in the last two years as well as lower domestic demand growth as a result of past fiscal and monetary tightening. Real GDP growth is expected to slow significantly to 2.3% in 1998 (1997: 3.4%), as net exports continue to weaken and domestic demand growth moderates.

In the countries like **Norway** and **Denmark**, growth is projected to slow to a more sustainable pace in 1998 due to currency depreciation together with rising inflationary pressures as well as the emergence of the signs of overheating. Real GDP growth in Norway is expected to slow down marginally to 3% in 1998 (1997: 3.4%) and in Denmark it is expected to be significantly lower at 2.5% (1997: 3.5%) after five years of steady growth. In **Switzerland**, recovery has only recently begun to gather pace with exports being a main source of growth. In 1998 exports are expected to increase at a slower rate due to the Asian financial crisis. However real GDP growth is projected to increase to 2% in 1998 (1997: 1.7%). Despite the deterioration in the regional environment and an associated weakening of confidence, economic activity in **Australia** is expected to remain strong, due to the depreciation of its currency against the US dollar and European currencies, and robust growth in North America and Europe which have dampened the effects of the sharp fall in exports to Asia and lower commodity prices. Growth is projected to increase by 3.5% in 1998 (1997: 3.3%) contributed mainly by export and bouyant domestic demand. The Asian financial crisis is having a more significant impact on **New Zealand** as this country has large trade exposure to Asia. The economic slowdown is expected to be marked in 1998, where the economy contracted in the first quarter and for the whole of 1998 it is estimated to contract by 0.5% from a growth of 2.3% in 1997.

Inflation

Inflation in industrial countries has been subdued in recent years. The decline in commodity prices since 1997 has helped to keep inflation low in these countries. In the **US**, inflation has remained subdued in an environment of strong domestic demand, surging equity prices and tight labour markets. Factors that have contributed to contain inflation include the appreciation of the US dollar, declines in energy and commodity prices, a moderation of the rise in health care costs and the dampening effect of the Asian financial crisis. Consumer price inflation in the US for 1998 is expected to decline to 1.6% (1997: 2.3%). In **Japan**, the weakness in domestic demand and a large output gap is expected to ensure that inflationary pressure remains muted throughout 1998. Further downward pressure on prices can be expected due to cheaper imports from Asia and softening of oil and non-oil commodity prices. Japan's annual average inflation for 1998 is expected to be contained at 0.4%. (1997: 1.7%).

In **continental Europe**, the inflation was around 1.5% in the first half of 1998. There are few signs of general inflationary pressure despite high capacity utilisation in some of the smaller countries. In **Germany**, inflation is expected to decline further to 1% in 1998 (1997: 1.8%) brought about by falling import prices due to declining commodity prices and declining unit labour costs in both eastern and western Germany. In **France**, consumer price inflation is expected to be curbed at 1.1% in 1998 (1997: 1.2%) mainly attributable to declining import prices.

In the **UK**, the appreciation of the pound sterling since August 1996 and recent fall in commodity prices have dampened inflation. In addition, tightening of fiscal and monetary conditions since early 1997, has restrained domestic demand and helped curb the underlying inflation pressures. For the whole of 1998, inflation in the UK is projected to be contained around the 1997 level of 2.8%. While in several other European countries, despite high capacity utilisation, there are signs of emerging inflationary pressures. Policy makers will continue to use monetary policies to contain these pressures and inflation in these countries is expected to be contained at the same range as in 1997 of between 1% and 3%. In **Australia**, following slight decline in productivity growth and the fading effects of the falling import prices in recent years, inflation is expected to increase to around 1.9% in 1998 (1997: 1.7%). In **New Zealand**, as an output gap persists in 1998, inflation pressures could be well contained despite the substantial exchange rate depreciation. Inflation is projected to decline marginally to 1.4% in 1998 (1997: 1.7%)

Unemployment

Unemployment across the industrial world has declined in 1997 and is projected to stabilise in the 1998-99 period at an average rate of 7.1%. A substantial decline is expected to be seen in the EU area, as employment rises by nearly 1% per year. In many continental European countries, unemployment has started to fall and it is expected to come down further as the recovery spreads to the service and construction sectors. Nevertheless, unemployment in the EU will remain a serious economic and social problem.

Table 3.1

Selected Industrial Countries– Major Economic Indicators (1995–1999)

	Industrial Countries	*United States*	*Japan*	*Germany*	*United Kingdom*
Growth of Real GDP (%)					
1995	2.2	2.3	1.5	1.2	2.7
1996	2.8	3.4	3.9	1.3	2.2
1997	2.9	3.9	0.8	2.2	3.4
1998	2.3	3.5	–2.5	2.6	2.3
1999	2.0	2.0	0.5	2.5	1.2
Inflation[1] (%)					
1995	2.4	2.8	–0.1	1.8	2.8
1996	2.3	2.9	0.1	1.5	2.9
1997	2.0	2.3	1.7	1.8	2.8
1998[e]	1.5	1.6	0.4	1.0	2.8
1999[f]	1.7	2.3	–0.5	1.4	2.8
Unemployment (%)					
1995	7.7	5.6	3.1	9.4	8.0
1996	7.7	5.4	3.3	10.4	7.3
1997	7.5	4.9	3.4	11.5	5.5
1998[e]	7.1	4.5	4.1	10.9	4.8
1999[f]	7.1	4.8	4.3	10.6	4.9
Current Account Balance (US$ billion)					
1995	50.3	–115.3	111.4	–22.6	–5.8
1996	38.7	–134.9	65.8	–13.8	–2.9
1997	64.0	–155.2	94.1	–4.0	7.3
1998[e]	–19.5	–236.3	131.4	6.4	–18.7
1999[f]	–66.4	–290.4	135.8	8.0	–21.1

[1] Consumer prices
[e] estimates
[f] forecast

Sources: IMF World Economic Outlook, September 1998 and OECD Economic Outlook, June 1998.

After falling to 4.3 % in April and May 1998, the unemployment rate in the **US** stood at 4.5 % in June 1998, close to the lowest level reached in three decades. For 1998, the unemployment rate is expected to be around 4.5% (1997: 4.9%) owing to the above potential growth that has reduced the unemployment rate and the output gap while putting upward pressure on the growth of labour earnings as well as greater flexibility in the labour markets. Factors contributing to the high degree of flexibility in the US labour markets include low minimum wages, low rates of unionisation, and relatively low levels of unemployment and social welfare benefits. In **Japan**, the labour market is expected to continue slackening in 1998 given the poor prospects for the Japanese economy over the short term, the likelihood of further bankruptcies in the corporate and financial sectors and the continuing efforts of companies in deregulated industries to increase their competitiveness. Employment in sectors such as construction and manufacturing decreased significantly during the first half of 1998. By employment status, numbers of regular employees has declined by 0.6% year-on-year basis in February 1998, while numbers of temporary employees increased by 2.1%. Total monthly hours worked in the manufacturing sector declined and likewise overtime has also been falling. This trend is expected to continue as companies switch to temporary workers, who are easier to fire and who are therefore more dispensable in times of economic downturn. For 1998, the unemployment rate in Japan is expected to reach 4.1% (1997: 3.4%), the highest in the decade.

In many of the **continental European** countries, unemployment has trended sharply upwards over the last decade, reaching post-war high in 1997 in countries such as France, Germany and Italy. While unemployment in Germany and France has declined somewhat in the first five months of 1998, it is still high, more than double compared to the current unemployment rate in the United States. However, the unemployment rate is dipping sharply in the United Kingdom and the same trend has also been seen in the Netherlands in recent years. In **Germany**, although employment started to pickup in the western states in early 1998, growth is not projected to be strong enough to lead to any marked reduction in unemployment. For 1998 as a whole, the unemployment rate in Germany is expected to decline to 10.9% (1997: 11.5%). In **France,** the economic expansion seen in 1997 has resulted in a revival of private sector employment, with continuing job loses in the industry and construction sectors more than offset by gains in services, largely in the form of temporary employment. The unemployment gains induced by output growth would be augmented by the government's creation of youth jobs. The unemployment rate will drop in 1998 to 11.8% (1997: 12.5%), but remain well above the estimated EU average level of 10.3%.

In the **UK,** labour market conditions remained tight. Employment growth has accelerated and the unemployment rate is expected to fall further to 4.8% in 1998 (1997: 5.5%). In **Australia,** employment growth increased by 1.3% in the first half of 1998 and it is projected to further strengthen as the number of full-time jobs increase. The unemployment rate is expected to decline to 8.1% (1997: 8.6%). However, in **New Zealand,** the unemployment rate is expected to increase to 7.8% in 1998 (1997: 6.7%) as the projected sharp slowing down in the economic growth will dampen job opportunities.

Balance of Payments

Current account balances in the industrial countries as a group are expected to deteriorate significantly by US$83.5 billion to record a deficit of US$19.5 billion in 1998 from a surplus of US$64 billion in 1997. The large shifts in external positions is an inevitable outcome of the Asian financial crisis. The deterioration in the current account of the industrial countries will help to ameliorate the contraction in output in the crisis countries, as well as reduce the risk of overheating in countries that are nearly at a mature stage of the business cycle. These adjustments are expected to be reversed in the near future involving shifts in relative cyclical positions, changes in the global flows of funds and in exchange rates.

In the **US**, the current account deficit is projected to increase by US$81.1 billion to US$236.3 billion (or 2.8% of GDP) from its levels of US$155.2 billion (or 1.9% of GDP) in 1997. The deterioration mostly reflects the downturn in Asia combined with the continued buoyancy of domestic demand and the strength of the dollar. Although the widening current account deficit is a drag on growth, it is currently offset by the robust expansion of final domestic demand. Adjustment of the imbalance could be promoted by a tightening of monetary policy. In **Japan,** the impact of adjustments in several Asian countries is expected to affect its current account balance. The impact will be outweighed by the weakness of domestic demand, lower commodity prices and the depreciation of the yen against other major currencies. In 1998, Japan's current account surplus is expected to widen to US$131.4 billion (or 3.6% of GDP) compared with US$94.1 billion (or 2.2% of GDP) in 1997, the largest surplus since 1987. This movement will largely be driven by the rising trade surplus, which is estimated to reach US$75.4 billion in 1998 (1997: US$47.3 billion). Although the weakness of the yen combined with hardening dollar prices for manufactured exports will boost exports, the higher trade surplus will mainly come from sharply lower imports estimated to total US$265.6 billion in 1998 (1997: US$307.4 billion).

In the **European Union (EU)** area, the current account surplus is projected to narrow to US$96.6 billion in 1998 from US$123.3 billion in 1997. The decline is mainly due to a marked change in the **UK's** current account balance which is estimated to record a deficit of 1.4% of GDP, reflecting the appreciation of the pound sterling and the strength of domestic demand. The UK's current account balance is estimated to record a deficit of US$18.7 billion in 1998 compared with a surplus of US$7.3 billion (or 0.6% of GDP) in 1997. In **Germany,** the trade surplus is expected to increase to US$44.2 billion in 1998 (1997: US$33.9 billion) on account of Germany's export cost-competitiveness. For 1998, the current account balance is expected to come back into surplus of US$6.4 billion (or 0.3% of GDP) compared with a deficit of about US$4 billion in 1997 (or -0.2% of GDP). In **France,** export growth is expected to slow to 7.4% in 1998 (1997: 12.2%) as demand from the developing economies of Asia falls significantly while imports are expected to rise more rapidly by 8.7% in 1998 (1997: 7.8%) to meet domestic demand particularly for household durable goods. France's current account surplus is expected to narrow to US$31.4 billion (or 2.2% of GDP) in 1998 compared with US$39.4 billion (or 2.8% of GDP) in 1997.

Other countries in continental Europe such as the **Netherlands, Finland, Switzerland, Denmark** and **Belgium-Luxembourg** are expected to experience very slight changes in current account balances as lower import prices and improvements in competitiveness in recent years are likely to offset the decline in exports to Asian countries. However, **Norway's** current account surplus is expected to decline sharply to about 1.3% of GDP in 1998 compared with 5.2% of GDP in 1997, largely due to lower oil export revenues. External current account deficit for **Australia** is expected to remain large in 1998 at 5.6% of GDP (1997: -3.3% of GDP). While in **New Zealand,** the current account deficit is expected to narrow marginally to about 6.5% of GDP in 1998 (1997: -7.7% of GDP) reflecting higher exports due to a sharp decline in the New Zealand dollar against the US dollar and European currencies.

Economic Situation in the Developing Countries

Developing countries in general are expected to register a lower growth rate of 2.3% in 1998 (1997: 5.8%) with the inflation rates expected to increase to 10.3% (1997: 9.1%). As a result of the adverse economic and social impact of the continuing financial crisis, the Asian countries are expected to register a sharp slowdown in economic growth in 1998 to 1.8% (1997: 6.6%). The Latin American countries which are also exposed to the contagion effects of the Asian and the Russian financial crisis are estimated to register a decline in growth to 2.8% in 1998 (1997: 5.1%).

ASEAN Economies

The economic and social impact of the financial crisis on the ASEAN economies has been more severe than anticipated. Substantial currency depreciations, sharp declines in equity prices, financial sector collapse, corporate bankruptcies, higher unemployment, increase in price levels, lower real household income and increased poverty levels have all lowered the growth prospects of ASEAN economies in 1998 leading to recession in some countries. External factors such as contraction in the Japanese economy and the threat of devaluation of the Renminbi have put additional pressures on the countries. In 1998, the growth rate of the four most affected ASEAN economies, namely Indonesia, Thailand, Malaysia and the Philippines (ASEAN–4) is expected to contract by 10.4% (1997: 3.7%).

Inflationary pressures are expected to be high with the currency depreciations resulting in higher import prices and supply shortages. In 1998, inflation rates in the ASEAN–4 economies are estimated to range from 5% in Malaysia (1997: 2.7%) to 60% in Indonesia (1997: 6.6%).

Table 3.2

ASEAN: Gross Domestic Product, Inflation and Current Account Balance

	1997	*1998*[e]	*1999*[f]
Gross Domestic Product Growth (%)			
Brunei	4.0	2.6	3.0
Indonesia	4.6	–15.0	0.0
Malaysia	7.7	–4.8	1.0
Philippines	5.1	–0.6	2.3
Singapore	7.8	0.0	1.5
Thailand	–0.4	–8.0	0.2
Vietnam	8.8	4.0	6.0
Inflation Rate (%)			
Brunei	1.7	2.0	3.0
Indonesia	6.6	60.0	12.7
Malaysia	2.7	5.0	3.5
Philippines	6.0	10.0	7.0
Singapore	2.0	1.8	2.0
Thailand	5.6	9.0	6.0
Vietnam	3.2	9.0	10.0
Current Account Balance (% of GDP)			
Brunei	–1.9	—	—
Indonesia	–1.8	2.5	2.7
Malaysia (% of GNP)	–5.4	7.7	4.2
Philippines	–5.2	–1.5	–0.7
Singapore	15.4	20.6	18.9
Thailand	–2.0	10.7	9.9
Vietnam	–6.4	–7.0	—

[e] Estimates
[f] Forecasts
Source: IMF World Economic Outlook, September 1998
ADB Outlook for 1998 and 1999

Output

Brunei has not been spared from the effects of the regional crisis. Brunei's currency which is pegged to the Singapore dollar, depreciated 17 % against the US dollar and its oil revenue decreased due to declining prices. Domestic construction and investment activity slowed down as a result of reduced financial allocation for government projects and programs. The growth estimates for 1998 have been revised downwards to between 2.5% and 2.7% from the 3.2% estimated earlier (1997: 4%). The **Indonesian** economy slided into recession with growth estimated to contract by 15% in 1998 (1997: 4.6%). The sharp depreciation of the rupiah against the US dollar was the main cause of the economic downturn, raising the costs of imports and the burden of settling offshore debts. Domestic demand contracted substantially both in terms of household consumption and investment activity. The government has pledged to implement closely the IMF stabilization and reform measures to restore the economy. The impact of the financial crisis on **Malaysia's** domestic economy has been significant and growth is expected to contract by 4.8% in 1998 (1997: 7.7%). Weakening domestic and external demand has resulted in an across the board contraction in all the major sectors especially agriculture, manufacturing and construction. The government has put in place a RM12 billion fiscal stimulus package, lowered interest rates, set up various funds and mechanisms to strengthen the banking and corporate sectors. These initiatives are envisaged to promote economic recovery.

The **Philippines** economy is envisaged to experience a contraction in 1998 with a negative real GDP growth of 0.6% (1997: 5.1%). Though the structural reforms over the past decade have reduced the country's vulnerability to external shocks, the Asian financial crisis has put the banking and corporate sector under stress. Added to this, the prolonged drought caused by the El Nino weather phenomenon has also affected agricultural output. The government is responding to the economic setbacks by undertaking an austerity programme and tax measures to boost revenue. **Singapore's** growth in 1998 is estimated to stagnate (1997: 7.8%). Asia's financial crisis and a glut in global electronics has affected Singapore's non-oil domestic exports. The banking, tourism, property and retail sectors also experienced significant slowdown affected by the deeper than expected contraction in the regional economies. To stimulate the economy, the government announced a S$2 billion stimulus package that comprised allocation for infrastructure projects and tax rebates for one year on commercial and industrial property in order to shore up the weak property market. Land sales for private development for the rest of 1998 and 1999 are frozen.

Thailand's economy is in recession and growth is projected to contract by 8% in 1998 (1997: -0.4%). Severe liquidity squeeze, weak exports, stagnating domestic demand and high interest rates caused the Thai economy to shrink more rapidly than expected. The government launched a 25 point economic recovery package to increase spending in the public and private sectors, open the domestic market to direct foreign investment, boost production to create more jobs, ease liquidity, increase exports and address problems confronting the financial institutions. The main thrust would be on reviving the agricultural sector to absorb some 2.2 million unemployed people. Though **Vietnam** has been relatively insulated from the financial crisis, reduced foreign investment from Asia, eroding export competitiveness, emerging stress in the banking sector and poor business environment have increased the vulnerability of the economy. Economic growth is expected to slow down to 4% in 1998 (1997: 8.8%). To stimulate growth, Vietnam has devalued the dong by 10% to the US dollar and narrowed the trading band from 10% to 7% on either side.

Inflation

Inflationary pressures in the ASEAN region were exacerbated by substantial exchange rate depreciations, high interest rates and supply shortages. In **Brunei,** the rate of inflation is expected to increase marginally to 2% in 1998 (1997: 1.7%) with tight monetary and fiscal policies and enforcement of regulations governing prices of essential goods and services. In **Indonesia,** inflation is expected to increase sharply to 60% in 1998 (1997: 6.6%) which is largely attributed to the more than 80% depreciation of the rupiah leading to higher import prices and supply shortages due to a protracted drought and poor distribution system. In 1998, **Malaysia** is expected to contain inflation at about 5% as against the earlier forecast of 7%-8% (1997: 2.7%), largely due to the immediate measures taken to increase local food production, source cheaper imports and buy domestically produced goods. In addition, the price levels are expected to stabilise with the exchange rate of the ringgit to the US dollar fixed as from 2 September 1998. In the **Philippines,** food shortages due to severe drought linked to the El Nino is expected to have an impact on the inflation rate in addition to the depreciation of the peso. The inflation rate is estimated to reach 10% in 1998 (1997: 6%). **Singapore's** inflation rate is expected to be maintained at a low level of 1.8% in 1998 (1997: 2%) due to weak consumer sentiments resulting in downward price pressures. Strong retail competition also assisted in containing price increases. In **Thailand**, the inflation rate is expected to increase to 9% in 1998 (1997: 5.6%) due to higher import prices and the consequent higher costs of production. The inflation rate in **Vietnam** is also expected to rise steeply to 9% in 1998 (1997: 3.2%), due principally to increases in the prices of food and non-food items as well as services.

Trade and Balance of Payments

The ASEAN countries are expected to register substantial improvements in their trade balances. Sharp declines in exchange rates have improved external competitiveness while contractions in domestic spending have reduced import demand. However weak economic activity in Japan and other Asian countries is expected to affect the export demand. In 1998, the current account surpluses of the ASEAN–4 economies is expected to total US$17.6 billion compared to the combined deficits of US$16.0 billion in 1997.

In **Brunei** the terms of trade is expected to be favourable with improved outlook in the hydrocarbon exports. The greater volume of transhipment activities of Muara Port is also expected to contribute to improve trade balance. In **Indonesia**, the depreciation of the rupiah, the contraction in domestic demand coupled with trade financing facilities extended by countries like Japan and the United States are expected to improve trade performance. In 1998, the current account balance is estimated to record a surplus of 2.5% of GDP (1997: -1.8%). **Malaysia** is expected to record a current account surplus of 7.7% of GNP in 1998 (1997: -5.4%). Export earnings are expected to increase due to higher export prices as a result of the depreciation of the ringgit. A major portion of Malaysia's exports are settled in dollars. Import earnings are expected to increase at a lower rate due to a drop in the quantity of imports as a result of contraction in domestic demand.

In the **Philippines**, the current account deficit is expected to narrow to 1.5% of GDP in 1998 (1997: -5.2%). Increased foreign exchange earnings from exports, higher foreign investments and remittances from overseas workers are expected to contribute towards a more manageable external position. The current account surplus of **Singapore** is expected to reach 20.6% of GDP in 1998 (1997: 15.4%), despite the moderation in its trade growth caused by the regional slowdown and decline in electronics demand. The growth in developed economies like the US and EU is however expected to provide the support for export growth. In 1998, **Thailand** is expected to record a current account surplus of 10.7% of GDP (1997: -2%), due principally to import compression, as a result of contraction in domestic demand and the weakened currency. Exports earnings have been weakened partly due to declining agricultural and manufactured good prices as well as lower external demand. In **Vietnam** export growth has contracted due to reduced demand from ASEAN and Japanese markets. The non-convertible Vietnamese currency has affected its export competitiveness and the rice exporters have particularly suffered. In 1998, the current account deficit is expected to reach 7% of GDP (1997: -6.4%)

ASEAN Sub-Regional Cooperation

The economic crisis that has engulfed most of Asia for over a year now has provided an opportunity to further enhance and deepen sub-regional cooperation at the ASEAN level. Economic activities at the **East ASEAN Growth Area (BIMP-EAGA)**, the **Indonesia-Malaysia-Thailand Growth Area (IMT-GT)** and the **Indonesia-Malaysia-Singapore-Growth Area (IMS-GT)** continued to be pursued to further promote economic development of the sub-regions. The sub-regions have now evolved into economic networks which generate opportunities for trade and investments.

In the **IMT-GT,** a total of 69 cooperative projects with a value of RM 18 billion have been initiated. About 28 of these projects are in the trade and investment sectors, 13 in infrastructure, 10 in agriculture, 6 in tourism, 5 in human resource development and 4 in the services sector. About 20% of the projects have been implemented and the rest are in various stages of implementation. The joint venture projects and areas of cooperation range from the development of the Common Border Wholesale Market at the Malaysia-Thailand Border Area; investments in oil-palm plantations in Indonesia; setting up of a Muslim Livestock and Food Processing Centre in the Pattani Industrial Zone; the establishment of a Special Telecommunications Zone; the Satun-Perlis highway project; the development of the Ro-Ro ferry services; the Landbridge Project; the introduction of border passes and staff exchange programmes; efforts to harmonize professional practices and standards and the establishment of interest free banking services in the sub-region. Emphasis is also placed on nurturing the small and medium scale enterprises (SMEs) to play a significant role in the economic development of the region. To support the SMEs, the Joint Business Council (JBC) has identified several measures which include encouraging the local commercial banks to open their windows to SMEs; to explore the possibility of establishing a regional merchant bank with ADB and the World Bank and implementing the private sector initiative with regard to interest free banking and over the counter market. The JBC is also planning to hold a SMEs convention in 1998 which would expose the SMEs to opportunities present in the region.

In the **BIMB-EAGA** there has been significant developments since its inception in 1994. Greater sea and air lingkages have been established and the tourism industry is particularly viewed as a potential cushion in the light of the economic crisis facing the region. Efforts are being taken to position the BIMP-EAGA region as a single holiday destination. Six shipping routes have been established and a BIMP-EAGA Shipping Association is expected to be set up soon. A new airline, the Borneo Airways has taken to the skies to tap the tourism potentials of Sabah, Sarawak, Kalimantan and Borneo. The Philippines has extended the travel-tax exemption for EAGA bound air and sea passengers embarking from the international ports in Mindanao until March 2000. Brunei Darussalam has harmonised air, land and sea entry requirements for nationals of Indonesia and the Philippines and introduced 72 hour transit visa for almost all travellers visiting the country. Malaysia and Brunei are also studying the possibility of having a special Smart Card for transboundary travel between the two countries.

Construction activities in the BIMP-EAGA region have intensified and an EAGA-wide consortium has been agreed to be formed as a vehicle for EAGA cooperation at the project level. The consortium is aimed at creating synergy and competitive products and services among contractor and consultant services providers within the EAGA sub-region. The first BIMP-EAGA Construction and Construction Materials Show was held in Davao City, Philippines in October 1997 which has generated US$5 million in terms of actual and negotiated sales. BIMP-EAGA's potential has also drawn interest from countries like Australia (Northern Territority) and Japan as well as the Islamic Development Bank. Trade Agreements between Australia and BIMP-EAGA include road building technology transfer, halal and chilled beef shipments to Brunei and Malaysia as well as remote power generation. The Japanese have been involved in the Davao Integrated Development Program and also have conducted a feasibility study on the establishment of a seaweed processing facility in Sulu or Tawi-tawi. The IDB is said to be interested in the establishment of an Islamic bank in Mindanao, Philippines.

In the **IMS-GT** region, emphasis has been placed on the improvement of the accessibility of the region as well as collaboration in the tourism sector. The lingkage between Singapore and Johore has been enhanced through the second link while Indonesia has proposed the development of a lingkage from Dumai to Port Dickson in Malaysia. The sea link is expected to facilitate trade, tourism, people mobility and industrial development. To generate greater awareness of the region, initiatives have been taken to develop an IMT-GT Travel Manual. There has also been a proposal to formulate a two-year tourism rolling plan which would seek to further enhance the region's collective attractiveness.

North East Asian Economies

The North East Asian economies, comprising China, South Korea, Taiwan and Hong Kong SAR are expected to register a sharp slowdown in 1998 as a result of the regional financial crisis. There has been a larger than expected decline in consumption and investment due to the loss of confidence, corporate debt burdens and large capital outflows. Evidence of greater economic weakness in Japan has also had an adverse impact on these economies. Consequently, the GDP growth for these countries is expected to range from negative 7% (South Korea) to 5.5% (China).

Output

Growth for **China** in 1998 is expected to slow down significantly to 5.5% (1997: 8.8%) due to weakening in both domestic and external demand and excess inventory accumulation that will need to be run down. The recent widespread floods has also contributed to lower growth. Proposed infrastructure spending on roads, airports and railways and cuts in interest rates will provide some support for increased activity in 1998. The slowdown in growth has also increased the importance of accelerating structural reforms in the financial and public enterprise sectors. In **South Korea**, growth is expected to contract to 7% in 1998 (1997: 5.5%). The financial crisis has brought about further declines in equity markets and assets values. There has been increased problems in financial and corporate sectors. Confidence and activity throughout the region has also eroded due to the slowdown in Japan. The decline in consumption (1998: -3.5, 1997: 3.5%) and domestic investment (1998: 25.1%, 1997: 35%) outweighed the strong positive stimulus to growth from net external demand. Spillovers from within the region have also affected **Taiwan** with growth slowing down but projected to remain positive at 4% in 1998 (1997: 6.9%). Taiwan has been less hard hit given the country's strong macroeconomic position and sound financial sector. **Hong Kong SAR's** economy is now projected to register a negative growth of 5% in 1998 (1997: 5.3%), reflecting the further slackening in consumer demand, a sharp fall in investment and a further drop in exports.

Table 3.3

North East Asia: Gross Domestic Product, Inflation and Current Account Balance

	1997	*1998[e]*	*1999[f]*
Gross Domestic Product Growth (%)			
China	8.8	5.5	8.1
Hong Kong, SAR	5.3	–5.0	0.0
South Korea	5.5	–7.0	–1.0
Taiwan	6.9	4.0	3.9
Inflation Rate (%)			
China	2.8	<1	3.5
Hong Kong, SAR	5.7	3.0	–3.8
South Korea	4.4	8.5	4.3
Taiwan	2.1	2.0	2.0
Current Account Balance (US$b)			
China	35.5	31.6	15.0
Hong Kong, SAR	–5.5	–0.0	–1.9
South Korea	–8.2	39.0	26.7
Taiwan	7.7	5.1	6.0

[e] Estimate
[f] Forecast
Sources: National sources, IMF World Economic Outlook, September 1998, EIU

Inflation

Inflation in North East Asian economies is expected to range between 1% to 8%. The inflationary pressures from the currency depreciation is becoming increasingly felt by most of the most affected countries. Inflation in **China** is however expected to be low as tight fiscal and monetary policies has kept money supply under control. Adequate grain reserves nationwide would also ease shortages in flood hit areas and no serious price rises are expected. Inflation in China is expected to be less than 1% in 1998. (1997: 2.8%). Consumer prices in **South Korea** recorded sharp increases of 9.5% and 9.% in February and March 1998 respectively. Since then inflation has come down due to the stabilised exchange rate, weakness in domestic demand and no wage pressures. Inflation is however expected to remain high at 8.5% in 1998 (1997: 4.4%). In **Taiwan,** while the weakening of the NT dollar against the US dollar has put upward pressure on domestic prices, the stable trend in international price levels, moderate domestic inflation in the services sector and stable food prices will help to hold down inflation. For 1998, inflation is forecast to remain at 2% (1997: 2.1%). In **Hong Kong SAR**, inflation is expected to decline to 3% in 1998. (1997: 5.7%). Externally induced inflation is expected to remain subdued and domestically generated inflationary pressures are likely to recede further with the envisaged slowdown in economic growth and the process of price and cost adjustment in the local economy.

Trade and Balance of Payments

The trade performance of the North East Asian economies will be lower in 1998 given the sharp fall in imports. The current account position is however expected to remain positive with the exception of Hong Kong SAR.

China's trade surplus surged by 22.8% to reach US$31.3 billion in the January to August period of 1998. (1997: US$40.3 billion). Exports rose on year-on-year basis by 5.5%, far below the export growth of 20.9% in 1997. Exports for the year are expected to slow down considerably to 4% in 1998 (1997: 20.9%). Imports for the January to August period grew by just 0.4% to US$87.3 billion. Imports from Hong Kong which have traditionally been heavily weighted in favour of inputs for processing before re-export have suffered a sharp slowdown. For 1998 as a whole, imports is expected to register a moderate growth of 5% (1997: 3.7%). The current account is expected to remain in surplus in 1998 at US$31.6 billion (1997: US$35.5 billion). In **South Korea,** the current account surplus reached a robust US$25.5 billion in the first seven months of 1998, compared with an US$11.1 billion shortfall in the same period of 1997. The current account position was mainly bolstered by a US$3.95 billion surplus in the merchandise trade account, as imports nose dived by 44.4% from a year ago, far out-pacing a 9.7% drop in exports. Imports declined because of the slowdown in domestic consumption and investment and the weakness of international petroleum prices. Meanwhile exports have been hit by external factors such as depressed Asian markets and the depreciation of competitor countries' currencies. Nevertheless, export volume is expected to register a 13.8% growth for the whole of 1998 while imports are projected to contract to 11.3%. The current account surplus for the whole of 1998 is projected at US$39 billion (1997: -US$ 8.2 billion).

In **Taiwan**, export growth fell by 7.2% in the second quarter of 1998 under the impact of Asian financial crisis resulting in a lower trade surplus of US$1.33 billion as compared to US1.69 billion in the same period last year. For the whole of 1998, exports are expected to slow down to 7% from 9% in 1997. Imports are also expected to fall to 9.4% (1997:14.2%). The current account balance for Taiwan will show a moderate surplus of US$5.1 billion in 1998 (1997: US$ 7.7 billion). In **Hong Kong SAR,** exports of goods and services are forecast to contract to 2.% and 4.% in 1998 respectively (1997: 6.1%; –0.6%) due to sluggish demand in the regional markets. Imports are also expected to follow suit given weakening consumption, rising unemployment and the contracting economy. Imports of goods are expected to contract to 3.5% in 1998 while services imports would slow down to 1% (1997: 7.2%; 4.3%). The current account is expected to remain in balance in 1998 (1997: -US$ 5.5 billion).

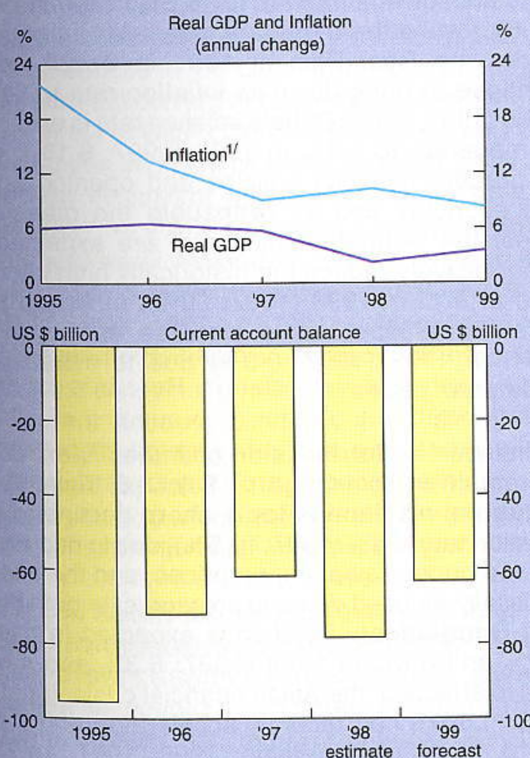
Other Developing Countries

Output

Overall growth in other developing countries of South Asia, Latin America, Africa and the Middle East is expected to moderate in 1998. The decline in growth rate is the largest in the case of **Middle East** from 4.7% in 1997 to 2.3% in 1998 due to the sharp decline in oil prices. This has not only affected the oil-producing countries in the region but also other countries due to the lower remittances and reduced regional demand. Reduction in the fiscal outlay of the **Islamic Republic of Iran, Saudi Arabia** and other oil producing countries, while containing the deterioration of budgetary and external balances, are likely to restrain growth. **Egypt, the Islamic Republic of Iran, Jordan,** and **Turkey** are expected to attain a slightly slower growth at between 1% to 5% in 1998. In **Africa**, output is expected to grow to 3.7% in 1998 (1997: 3.2%). Economic development in Africa remains uneven. A number of countries have benefited from improved agricultural production following last year's drought and from the strength of growth in Europe. Many countries in Africa have also benefited from the declines in oil and non-oil commodity prices. On the other hand, some countries have been adversely affected by the weakness in commodity prices and in some cases by civil and military unrest. In **Algeria,** strong recovery in agricultural output is expected to help growth rebound to 4% in 1998 (1997: 1.3%) despite the weak oil prices. In **Tunisia,** the expansion of manufacturing production is projected to be sustained at relatively high rates in 1998-1999 driven partly by the recovery in import demand in European markets. GDP as a whole is expected to strengthen to 5.9% in 1998 (1997: 5.6%). In **Nigeria,** growth is projected to weaken to 2% in 1998 (1997: 3.9%) driven partly by the fall in oil prices and political instability. In **South Africa,** the economy is expected to moderate to 0.8% in 1998 (1997: 1.7%). In **Kenya**, growth is projected to strengthen in 1998 to 2.7% (1997: 1.8%)

The Asian crisis as well as the economic situation in Russia which exerted pressure on the equity and currency markets in **Latin America** and the depressed oil and other commodity prices is expected to slow down economic growth in the region. In 1998, the regional economy is expected to grow at 2.8% (1997: 5.1%). In **Mexico**, growth is estimated at 4.5% in 1998 (1997: 7%) largely due to declining revenue from lower oil prices, public expenditure cuts and capacity constraints in certain non-export sectors. The slowdown in the growth of world trade caused by the crisis in Asia is expected to result in a deceleration of **Argentina's** growth in 1998 to 5% (1997: 8.6%). In **Brazil**, both the equity and exchange markets have come under pressure following the turmoil in the financial markets in Asia and Russia and growth is expected to slowdown to 1.5% in 1998 (1997: 3.2%). A steep fall in oil prices is expected to depress growth in **Venezuela** where nearly half of the government's revenue comes from oil sales. In 1998, the gross domestic product is expected to contract by 2.5% (1997: 5.1%). Venezuela is putting in place measures to promote economic diversification and opening up sectors such as banking, iron and steel and petrochemicals. Decline in copper prices and **Chile's** substantial exposure to Asian markets which account for half of its exports is expected to slowdown growth to 4.5% in 1998 (1997: 7.1%).

Chart 3.3
Developing Countries - Major Economic Indicators



1/ Median estimate
Source : IMF World Economic Outlook, October 1998, EIU.

In the **South Asian** region, overall growth is expected to moderate slightly in 1998 primarily due to contagion effects of the Asian crisis. Growth in **India** is expected to decrease slightly to 4.8% in 1998 (1997: 5.6%) while in **Pakistan** it is expected to register an increase to 5.4% in 1998 (1997: 1.3%) due to the adjustment measures implemented to boost the economy. Growth for **Bangladesh** is expected to moderate slightly to 4.2% in 1998 (1997: 5.7%) owing to a slowing down of exports primarily to the Asian countries. However Bangladesh's worst flood in a decade that started in July, has caused widespread damage to the economy and may pose a risk to this forecast. **Sri Lanka** is expected to register a lower growth rate of 5% in 1998 (1997: 6.4%), as a consequence of the slowdown in the export sector, which has been affected by cheaper exports from Southeast Asia.

Inflation

Inflation in the **Middle East** region for 1998 is expected to remain the same as in 1997, at 22.6% due to declines in oil and non–oil commodity prices that have affected activity and reduced

Table 3.4

Developing Countries: Output, Inflation and Current Account Balance

	1997			1998[e]			1999[f]		
	Real GDP (%)	*Inflation[1]*	*Current Account Balance[2]*	*Real GDP (%)*	*Inflation[1]*	*Current Account Balance[2]*	*Real GDP (%)*	*Inflation[1]*	*Current Account Balance[2]*
Developing countries	5.8	9.1	-61.8	2.3	10.3	-78.3	3.6	8.3	-63.2
By region									
Africa	3.2	11.0	-5.3	3.7	7.7	-14.7	4.7	7.1	-12.7
Asia	6.6	4.7	4.7	1.8	8.3	37.2	3.9	7.0	39.4
Latin America	5.1	13.9	-64.9	2.8	10.8	-80.5	2.7	9.4	-71.0
Middle East	4.7	22.6	3.7	2.3	22.6	-20.3	2.7	13.7	-18.9

[1] Consumer prices-weighted average
[2] US$ billion
[e] Estimate
[f] Forecast

Sources: IMF World Economic Outlook, September 1998, EIU

demand. In **Egypt**, inflation is expected to decline to 3.3% in 1998 from 6.2% in 1997 while in **Saudi Arabia,** the long term price stability measures undertaken continues to have a positive impact with inflation recording 0% (1997: -0.4%). In **Jordan**, inflation is projected to increase moderately to 4% in 1998 (1997: 3.0%).

In **Africa**, inflation has declined to 7.7% in 1998 from 11% in 1997. There has been a marked improvement in countries such as **Cameroon, Ghana, South Africa. Sudan** in particular has shown a significant improvement with inflation falling to 12.3% in 1998 from 46.7% in 1997, reflecting the success of the economic measures being implemented. In **Nigeria**, inflation is expected to increase slightly to 9% in 1998 from 8.5% in 1997.

The inflation rate in the **Latin American** economies is expected to decline further to 10.8% in 1998 (1997: 13.9%) due to the prudent fiscal and monetary policies being pursued, weakening aggregate demand due to the Asian financial crisis and lower commodity prices. **Mexico** with its relative stability of the peso is expected to record a sharp reduction of inflation rate to 15.3% in 1998 (1997: 20.6%) while the monetary measures introduced under the Real Plan in 1994 in **Brazil** would continue to bring down its inflation rate to 5% in 1998 (1997: 7.9%) **Chile's** inflation rate is expected to moderate to 5.4% in 1998 (1997: 6.1%), due to prudent financial policies and opening up of the economy and in **Venezuela** the measures under the "Agenda Venezuela" are expected to progressively reduce the historically high interest rate to 37% in 1998 (1997: 50%). In **Argentina**, inflation is expected to increase marginally to 1.3% in 1998 (1997: 0.8%) due to increase in consumer prices.

Inflation in **South Asian** countries is expected to remain in the range of 7 to 8.6 % in 1998. **Pakistan** will experience a sharp decline in the inflation rate to 8% (1997: 12.5%), due to decreases in food prices, lower import prices, and the easing of fiscally-induced demand pressures. In both **India** and **Bangladesh**, inflation is expected to rise to 7.2% and 8.6% in 1998 (1997: 6.3% and 4.8%) due to effects of the Asian financial crisis. Inflation in **Sri Lanka** had recently accelerated and stood at 10.2% as of Sepetmber 1998 (1997: 10.7%), following supply disruptions and a relaxation of liquidity conditions.

Trade and Balance of Payments

The trade performance of developing countries is expected to moderate in 1988 with the effects of the Asian crisis being felt in most regions. In the **Middle East**, exports are expected to slow down to US$190.7 billion in 1998 from US$209.2 billion in 1997, following a dip in oil and non oil commodity prices. Imports are expected to increase to US$196.7 billion from US$189.2 billion. The deficit in current account for the Middle East is also expected to deteriorate to US$ 20.3 billion in 1998 (1997: US$3.7 billion) with countries such as **Saudi Arabia** and **Egypt** showing large current accounts deficits of 8.3% and 2.4% of GDP respectively (1997: 0.2%; 0.2%).

Exports from **Africa** are expected to moderate to US$106.5 billion in 1998 (1997: US$113.6 billion) while imports will grow to US$105.3 billion (1997: US$103.1billion). For oil exporting countries in the region, the fall in oil prices has led to further weakening of the current account positions. The current account deficit for Africa is expected to worsen to US$14.7 billion in 1998 as compared to a deficit of US$5.3 billion in 1997.

Declines in private capital flows, weak export demand and declines in oil and other commodity prices are expected to contribute to widening current account deficits in the **Latin American** countries. In **Mexico** the current account deficit is estimated to reach 3.4 of GDP (1997: -1.9%) principally due to weakness in oil prices while in **Brazil** a modest reduction in current account deficit to 3.6% in 1998 (1997: -4.2%) is expected. The lower copper prices and weak Asian demand are estimated to widen **Chile's** current account deficit to 7% of GDP in 1998 (1997: - 5.3%). In **Argentina** the high domestic demand particularly for imports of capital and consumer goods is expected to increase the current account deficit to 4.4% of GDP in 1998 (1997: -3.5%). In **Venezuela**, lower oil revenue are expected to affect the country's current account position which is expected to be a deficit of 2% of GDP in 1998 (1997: 6.2%).

For the **South Asian** economies, exports are expected to increase moderately to US$52.8 billion in 1998 (1997: US$50.5 billion). Imports are also expected to increase to US$65.1 billion (1997: US$63.5 billion). The current account deficit is expected to remain about the same at US$10.3 billion in 1998 (1997: US$10.1 billion).

Economic Situation of Countries in Transition

Growth performance and prospects for the transition countries have been damaged by the intense financial market pressures in Russia. Although there are substantial differences in performance across countries, activity in the transition countries as a group is expected to stagnate with GDP growth now expected to contract to 0.2% in 1998 (1997: 2%). A major concern for these economies is the high inflation rate projected at 29.5% in 1998 (1997: 27.9%).

Output

Russia has been particularly exposed to the deterioration in market sentiments in the wake of the Asian financial crisis. There has been intense financial pressures following fiscal imbalances, significant short-term liabilities to foreign investors and delays in the implementation of structural reforms. On several occasions, Russia had to hike up interest rates to defend the rouble amid growing difficulties in rolling over short-term treasury bills held by non-residents, continuing capital flight and declining oil export revenues. Russia has also been unable to resolve its budget deficit and revenue collection problems. New policy commitments have been made and additional large scale financial support has been secured from the IMF. Despite this however, there has been no restoration of market confidence. The uncertainty surrounding the financial situation has adversely affected the growth performance and prospects for Russia. GDP growth for 1998 is projected to contract to 6% in 1998 (1997: 0.9%).

Inflation

The current economic difficulties faced by Russia has also affected its consumer prices. The devaluation of the rouble led to immediate inflationary pressures. Inflation rose to 15% in August 1998 against 2% in July and for the year as a whole, is expected to reach 48% (1997: 15%). The situation has been further aggravated by monopolistic pricing practices in trade, increase in customs duty and value added tax (VAT) and the introduction of sales tax in certain regions.

Balance of Payments

Foreign trade account for only a small proportion of the national economy. Russian exports represent

18% of GDP when measured in dollars while imports constitute 14%. For 1998, both exports and imports are expected to rise to US$98.7 billion and US$97.3 billion respectively (1997: US$94.9 billion; US$81.0 billion). The increase in imports is due to the crisis in the agriculture sector that has led to increased demand for imported foodstuff especially from Western Europe. Exports have been affected following the steep decline in oil and commodity prices. The current account balance of Russia is expected to run into a deficit of US$4.1 billion in 1998 (1997: -0.6% of GDP).

Economic and Financial Cooperation

Since the onset of the Asian financial crisis, various initiatives have been taken at both the multilateral and regional levels to strengthen financial systems and institute policies and measures to restore financial stability.

The **APEC** Finance Ministers process launched several collaborative initiatives to promote capital market development including the development of domestic bond markets; strengthening international financial systems; revitalising infrastructure financing in the APEC region and promoting freer and stable flow of capital in the region with the support of a voluntary action plan (VAP). A report on the current state of bond markets in the region and on the potential for development of domestic bond markets will be submitted for the consideration of the Finance Ministers in May 1999. With regard to the VAP, a work programme has been drawn up which would focus on how the VAP can operate as a vehicle for promoting and tracking confidence building measures that would assist efforts to return capital to the region. The Ministers at their meeting in Kananaskis, Canada, in May 1998 agreed to an initiative to examine ways of strengthening corporate governance and enhancing surveillance of the financial sector supervisory regimes in the region. A seminar on corporate governance is scheduled to be held in Australia in November 1998, to seek inputs from the private sector on this initiative and a report would be submitted to the APEC Finance Ministers in May 1999.

Responding to the Asian financial crisis, the **Asia–Europe Meeting (ASEM)** endorsed the establishment of the ASEM Trust Fund at the World Bank, to facilitate the recovery of countries affected by the financial crisis. The Fund which became operational since July 1998, would help finance technical assistance and advice both on restructuring of the financial sector and on finding effective ways of redressing poverty. An agreement has been reached on the legal basis for establishing the Trust Fund and UK pledged £5 million as its contribution. A European Financial Expertise Network (EFEX) would also be created to increase the quantity and quality of advice provided by experts on the financial sector in ASEM countries in Asia. On 29 July 1998, the European Commission decided to establish a small team (clearing house) to set up and manage the EFEX. ASEM has also agreed to address the issue of money laundering and cooperation in this area would include exchange of experts and a joint study on organised crime links with Asian and Western financial markets. Work is underway on a policy document detailing the scope and cost of this initiative.

Given the global impact of the Asian financial crisis, **the G–22 or the Willard Group**, set up three working groups to examine issues related to the stability of the international financial system and effective functioning of global capital markets. The three areas include increasing transparency and disclosure in order to enhance the decision making process by both the public and private sectors; strengthening financial systems and market structures in both industrial and emerging markets; and the management of international financial crisis through appropriate burden-sharing between the public and private sectors in times of crisis. The reports which have been considered by the Finance Ministers in October 1998 will be extended to the international financial institutions and member countries for further action.

At the **ASEAN** level, the member countries have strengthened regional cooperative initiatives aimed at restoring confidence and economic stability in the region. During the second Informal ASEAN summit held in Kuala Lumpur in December 1997, the ASEAN member countries endorsed the implementation of the Manila Framework as the basis for regional cooperation to restore financial stability. The Manila Framework for Enhanced Asian Regional Cooperation was initiated during a meeting of Asian Finance and Central Bank Deputies in November 1997. Consistent with this framework, ASEAN formalised the establishment of the ASEAN Surveillance Process in October 1998. The process is intended as a mechanism for providing an early warning system, alerting members to potential risks and a peer review process to enhance macroeconomic stability and the financial system in the region.

The ASEAN countries have also agreed to accelerate regional economic integration and increase intra-ASEAN trade through the liberalisation and facilitation of trade and investment. ASEAN is working actively to accelerate the realisation of the ASEAN Free Trade Area (AFTA) and the ASEAN Investment Area (AIA). The Framework Agreement on establishing the AIA for the establishment of a competitive investment area in ASEAN by the year 2020 was signed in Manila, Philippines in October 1998. In terms of industrial cooperation, the ASEAN Industrial Cooperation Scheme (AICO) is being reviewed to make it more attractive and draw new investments, as since its implementation in November 1996, only 14 AICO approvals have been given.

With regard to cooperation in the area of customs, efforts are being made to harmonise tariff nomenclature with all member countries adopting a harmonised text for customs classification by the year 2000. Member countries have also put in place a green lane system for expediting clearance of products under the CEPT scheme.

A bilateral payment arrangement (BPA) mechanism has been agreed upon to promote the use of ASEAN currencies in intra- ASEAN trade settlements. The Philippines and Malaysia have signed the BPA agreement in July 1998 while negotiations between Malaysia and Thailand are ongoing. The increase usage of ASEAN currencies is expected to reduce dependence on the US dollar and minimise the impact of extreme volatility in exchange rate movements.

The ASEAN countries have also formulated an ASEAN Vision 2020 which spell out the priority areas for ASEAN cooperation for the next 20 years or so. A Hanoi Plan of Action (HPA) to implement Vision 2020 over the next three to six years is expected to be adopted during the Sixth Summit to be held in December 1998 in Hanoi, Vietnam. The private sector is envisaged to play an important role in ensuring the implementation of the HPA.

Prospects For 1999

A spreading financial crisis can be expected to weaken further global economic growth in 1999 against a Japan in recession, falling demand and output in the Asian region and financial instability in Russia and Latin America. On a positive side, the policy programmes currently implemented in Thailand and South Korea appear to have begun to restore financial market confidence while growth in the United States and the future euro area is expected to remain strong. These positive factors may temper current weaknesses thereby underpinning aggregate world economic growth in 1999, estimated to rebound moderately to 2.5%. Across the industrial world, the underpinning of the current expansion in most countries are relatively sound. In North America and continental Europe, prospects for non-inflationary growth are still favourable given that fundamentals remain strong. For 1999, real GDP growth for industrial countries as a group is projected to moderate to 2%. In the **US** while the economy is projected to experience a cyclical moderation of growth in 1999, the degree of moderation still remains uncertain. The associated impact on corporate earnings of the financial crisis in Asia and in some emerging market countries in Latin America as well as an anticipated downward correction of inventory investment would contribute to some dampening of economic activity in the US. For 1999, real GDP growth is forecast to be at 2.0% as domestic demand softens and external demand remains weak. Inflation is projected to be contained at 2.3%, as monetary conditions can be expected to be tightened somewhat over the coming period.

In **Japan**, despite some positive effects expected from a series of government stimulus measures in 1998, the economic outlook is forecast to remain grim in 1999, as persistent weaknesses in domestic demand, consumption, capital spending and housing investment are expected to weigh heavily on the economy. In addition, growing worries in the labour market will ameliorate any increase in income brought about by income tax cuts. GDP growth is projected to be at 0.5% in 1999, mainly due to a boost by large public works spending packages by the government.

The financial crisis in emerging market economies is expected to lead to a slight dent in the economic situation in Europe, with some EU member countries having close trade and investment relationship with Asia and other emerging markets revising down their growth forecast for 1999. Growth in the **EU** countries as a whole is forecast to slow down to an average of 2.5% in 1999 with inflation at 1.8%. Unemployment prospects in the EU area remains unfavourable and is projected to decline only slightly to 10% in 1999 from 10.3% estimated for 1998. In **Germany,** real GDP is projected to moderate to 2.5%, as the financial turmoil in Asia and Russia will curb further export growth thereby affecting business investment. Despite the uncertain situation in the emerging market economies , unemployment prospects in Germany are rather favourable and is projected to fall to 10.6% of labour force in 1999 (1998: 10.9%). The economic outlook in **France** is projected to remain relatively strong in 1999 with real GDP growth of 2.8%. Unemployment is projected to decline further to 11.2% reflecting some success of the government's job policies. For 1999, economic expansion will be driven mainly by consumer spending and business investment. In the **UK,** the economy is forecast to slow down to 1.2% in 1999, reflecting shrinking exports and private consumption. Underlying inflation is projected to hover around the 1998 level estimated at 2.8%. Output in **Australia** is projected to decline to 2% in 1999 as uncertainty associated with international developments are likely to lower business investment and consumption growth. In **New Zealand,** real GDP growth is projected at 1.7% in 1999, led by buoyant non-commodity manufactured exports and a strengthened tourism sector, mainly reflecting the positive effects of a depreciation of the New Zealand dollar against other world major currencies. Gradual tightening in monetary conditions should also help ensure inflation will be contained at 1.6% in 1999.

Growth for the developing countries is forecast to improve to 3.6% in 1999. Though the Asian economics as a whole are projected to recover strongly to 3.9% in 1999, the prospects for the ASEAN economies remain uncertain. Policy measures to be instituted and implemented especially in terms of financial and corporate sector restructuring and to restore investor confidence would have a significant bearing on the recovery of the ASEAN economies. The ASEAN-4 countries are projected to register a negative growth of 0.1% in 1999. In **Brunei,** with the prudent approach towards development and fiscal consolidation measures, growth is projected to be maintained at about 3% in 1999. Inflation will remain below 3% in 1999. **Indonesia's** economy is projected to stagnate in 1999 with inflation rates declining to 12.7% as a result of the tight monetary policies being pursued. **Malaysia** is projected to register a real GDP growth of 1% in 1999 especially with the fiscal stimulus measures being implemented and the easing of monetary policies. With the stabilization of the ringgit and supply-side measures being instituted, inflation is expected to decline to 3.5% in 1999. In the **Philippines**, growth is projected to pick-up at 2.3% in 1999 with the continuation of structural reforms including liberalisation of trade, deregulation and privatization. A decline in inflation to 7% in 1999 is expected.

Thailand is making considerable progress in implementing the IMF economic and financial reform measures and is projected to see a recovery in growth of 0.2% in 1999. The gradual relaxation of monetary policy and the relative stability of the baht are expected to reduce the inflation rates to about 6% in 1999. **Singapore's** growth prospects in 1999 hinge on the pace of recovery of the regional economies and growth in developed economies like the US and the EU. Growth is projected at about 1.5% in 1999 with inflation being maintained at 2%. In **Vietnam**, a GDP growth of 6% is forecast for 1999 with inflation level controlled at below 10%.

The **North East Asian** economies are projected to show a marked improvement in 1999 as the economies consolidate and the economic measures introduced in 1998 to restore growth begin to take effect. **China's** economy is forecast to grow at 8.1% in 1999 attributed to the planned investments in large infrastructure projects and the rapid development of the manufacturing sector. In **South Korea**, economic growth is forecast to contract by 1% in 1999, a marked improvement from the high negative growth of 7% in 1998. This is due to the structural reform efforts particularly in the corporate and financial sectors which are intended to restore confidence and stimulate growth. In **Taiwan**, GDP growth is expected to remain the same at 3.9% in 1999 due to strong domestic demand, the on-going economic reforms and improving conditions in the world economy. **Hong Kong SAR's** economy is expected to improve from negative growth to zero in 1999 as economic recovery begins to take effect in other Asian countries. External trade in both goods and services and domestic demand should gradually pick up. Property prices are also expected to stabilise with intensified building activity particularly in the public sector.

The prospects for other developing countries in 1999 remains optimistic with expectations of continued improvements in the Asian economies following the aftermath of the crisis and the general recovery in world growth. Economic growth for the **Middle East** is expected to improve to 2.7% in 1999. However the decline in oil prices will continue to have a dampening effect in a number of oil producing countries. Efforts to counter this decline is expected to be taken through revenue raising and expenditure reducing measures to ensure medium term external and fiscal sustainability. In **Africa** growth is expected to improve to 4.7% in 1999 due to improved agricultural production, the improvements of growth in Europe and the economic measures being put in place by a number of African countries. In **Algeria** the recovery in agricultural output in 1998 is expected to expand well into 1999. This also applies to **Morocco.** In **Tunisia** the expansion of manufacturing production driven by the recovery in import demand in European markets are expected to improve the growth rate for the country for 1999.

The performance of the Asian countries and Russia is expected to have an impact on the growth prospects of the **Latin American** countries in 1999. **Mexico** is forecast to grow at 5% in 1999 with inflation rates declining further to 10% while in **Argentina**, growth is projected to slowdown to 4.5% with inflation rates increasing to 2.1. **Brazil** may withness an increase in growth to 3% in 1999 and a rise in inflation rates to 6%. In **Venezuela**, the structural reforms pursued vigorously are expected to accelerate growth to 3.8% in 1999 while reducing inflationary rates to 18%. **Chile** is projected to experience further slowdown in growth to 4% in 1998 and inflation is projected to be maintained at 4%.

In **South Asia**, growth is projected to improve to 6% in 1999 with **India**, **Pakistan** and **Bangladesh** expected to show improvements in the growth given anticipated signs of recovery in Asia.

Issues in the Global Economy

The projection for 2.5% growth for 1999 is cautiously optimistic and to a large extent, based on the assumption that financial market confidence in the Asian crisis economies will gradually resume during the last few months of 1998 and in 1999, against a background of continued external adjustment and financial and corporate sector restructuring. However, a significantly less favourable outcome not only for Asia but for the world economy is clearly possible in the light of several recent developments.

Despite several announcements of stronger measures to restructure the banking system and stimulate domestic demand in Japan , the danger remains that weakness of activity and the fragility of the financial system will further erode confidence and worsen existing deflationary tendencies. A **deepening of recession in Japan** would have its consequential impact on its banking system which may in turn result in repatriation of dollar assets held by Japanese financial institutions, putting pressure on United States interest rates and equity prices and ultimately leading to turbulence in the global exchange rates and asset markets. Furthermore, given the role that Japan has played as a source of direct investment and as a market for exports from the rest of Asia, recession in that country would preclude early recovery in the region.

Renewed instability in Asian financial markets would set back the efforts of South Korea, Thailand, and Indonesia to stabilise their economies. While these countries have been steadfast in implementing restructuring programmes in order to improve their prospects for recovery, they are also dependent on a favourable external market environment.

Adverse developments in Japan and setbacks in Asian financial markets would put further **pressure on China's exchange rate policy**, given that growth in that country has already slowed to a significant extent due to slower exports growth and the dampening effects of the summer floods. Devaluation of the Chinese currency could set off another round of devaluation in South East Asia.

The situation in Russia raises concerns about the authorities' ability to deliver credible economic and financial policies, thereby holding out the possibility of further rattling the financial markets. Russia's economic problems have already had a dampening effect on the world's equity markets, but further instability would become a serious problem for Europe especially for the export sector, and given that several countries have high exposures to Russia. The Latin American economies are already facing the effects of the Russia's financial crisis.

In the industrial countries of western Europe and North America, **high equity prices** - boosted in part by the redirection of portfolio investment flows toward mature economies - are vulnerable to changing investor perceptions of future corporate profits and the outlook for inflation and interest rates. Should significant stock market corrections occur, other countries, including the already depressed stock markets in Asia would be severely affected. This could further undermine prospects for recovery.

There is also a broader risk that countries adversely affected by spillovers from Asia may engage in **defensive exchange rate or trade actions** with negative international repercussion.

To a considerable extent, **economic policies of important industrial countries** over the coming period will have an important bearing on the rest of the world, especially the prospects for financial stabilisation and economic recovery in Asia. While policies in the crisis economies are being implemented to promote recovery, they need to be supported with a concerted international effort. In the United States, some of the special factors - appreciation of the US dollar, declines in energy and commodity prices - that have helped to dampen inflationary pressures and fuel its robust growth can be expected to reverse. While the Federal Reserve has thus far maintained an unchanged level of short-term interest rates, it has had to weigh the implications of its monetary policy as a rise in US interest rates at this time would not be helpful for the Asian crisis countries. A further tightening of US monetary policy could certainly lead to a sizeable correction in global bond and stock markets, as well as contribute to a pronounced slowdown in U.S. growth. A weaker US economy would not be able to import much and this could be detrimental to Asia if it occurred at a time when the region has not fully started on a recovery path.

In Europe, **the introduction of the Euro plus the adoption of a common monetary policy** by eleven member countries of the European Union – eventually perhaps the entire EU – will have far-reaching implications not only for Europe, but for the world economy as well. While monetary union carries many benefits, it also poses new challenges and merits reflection on the role of economic policies in safeguarding macroeconomic stability and securing high levels of employment.

It has been estimated that the cost of the East Asian crisis is about 1% of global output (some US$ 260 billion) for 1998 alone. Financial instability has become a familiar feature of the global economy in the 1990s. Each crisis has caused serious damage to the real economy , particularly in the developing world. Global surveilance and regulation have lagged behind the integration of the financial markets with increasingly costly consequences. The international financial community must act in consert to reduce the volatile movements of international capital. As suggested by UNCTAD, a more effective policy framework for the prevention of financial crisis through adopting a more even-handed approach to policy surveillance is required. Such surveillance should recognise that changes in interest rates and exchange rates in the larger industrial economies would have a destabilising effect on other countries. Regional consultation and collaboration should be encouraged where none exist and intensified where such mechanisms are already in place. Failure of the international community to act with speed would create severe consequences for the world economy. Finally, developing countries should be allowed the flexibility to introduce capital controls, a proven technique for dealing with volatile capital flows.